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The Neoclassical Counterrevolution and Developing Economies: A Case Study of Political and Economic Changes in the Philippines

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I. Introduction

Throughout much of the 20th century and especially following the fall of communism, the number of democracies in existence increased dramatically. In fact, although there was not a single democracy in existence in 1900 with universal suffrage, by 2000, 120 of the world's 192 nations were considered democracies[1]. This change is no doubt an indication of a shift in political ideology and conception of human rights, but it must be considered that democracy may have also become popular due to its effect on national economies.

As the developed world continued to make great economic progress through much of the 20th century, the developing world was left behind. Governments of impoverished nations struggled to find ways to "catch up" as they fell further and further behind. Various schools of thought emerged claiming to hold the key to putting countries on the fast track to moving through the stages of economic development. Some claimed the path to prosperity was through communism or authoritarian rule, allowing the government to control the means of production. Others claimed that open markets, democracy, and capitalism would be the surest way for countries to develop quickly.

Eventually, communism in its most extreme forms was largely suppressed, though questions still remained as to whether outright democratic capitalism with little government control was, necessarily, the solution for all nations. Even today, some governments with relatively high degrees of government intervention and lower political freedom are successful (such as China).

The purpose of this paper is to attempt to correlate changes in the political systems, as well as other government policies, with changes in economic health. It will do so through a case study of the Philippines, a country which has gone through major political and economic changes in the past 25 years. It will be shown that a move toward democracy and free market practices was the key to growth in the Philippines. The findings will support the objectives of organizations such as the World Bank and International Monetary Fund, which encourage developing nations to liberalize their trade practices and move toward a stable democracy as a path to economic growth.

First, the history of the Philippines will be recounted, and it will be shown why this particular country is important to study. Next, a theoretical background will be given showing the basis behind the neoclassical growth school of development thought as it pertains to political systems and government economic policy.

In the data and analysis section, the economy of the Philippines will be analyzed using a number of economic statistics. The results will be compared to changes which occurred in the political system and in government policies to observe correlations.

Finally, a conclusion will be drawn as to the reasons behind economic change in the Philippines and the implications for other developing nations. Through this type of nation-specific analysis, it will be possible to match empirical evidence to theoretical claims that democratic capitalism is the best policy for developing nations.

A. Economic History of the Philippines

During the 19th century, a landowning elite emerged in the Philippines, which grew based on the export of hemp, sugar, and other agricultural products. When Americans gained control in 1898, they granted political power to the landowning elite, who then used their power to enhance their own financial and economic standing. Generally, the government did not interfere with the economy during this period, which lasted throughout the early part of the 20th century.

When independence came in 1946, the Philippines agreed to economic concessions in controlling its exchange rate and agreed not to restrict U.S. imports in exchange for American economic aid. However, due to a negative balance of trade, the economy went into crisis in 1949, and caused the government to place controls on imports and exchange rates.

The import restrictions helped the economy, especially the manufacturing sector. In fact, the GNP began to grow at an average rate of 7.7 percent. At this point, the economy was considered to be in an import-substitution phase. Import substitution is when an economy first imports goods, and then slowly begins to manufacture goods for themselves. However, demand for imports was still larger than what was being exported, creating a need for policy change.

[1] *Freedom in the World.* Freedom House: 2006.

In 1962, the government devalued the peso, and removed import controls and exchange licensing. Although exports rose initially, manufacturing eventually stalled. Exchange controls were reinstituted in 1968. Overall GNP growth continued to be unimpressive, averaging fewer than five percent. Although there were calls to reduce tariffs and liberalize the economy, efforts were largely unsuccessful.

The Philippines was once again in economic crisis by 1970, largely due to spending of government funds by President Marcos during his re-election campaign. The government held huge international debts on which it became unable to make payments, and submitted to an agreement with the International Monetary Fund to renegotiate their debt.

When Marcos declared martial law in 1972, he began using decrees to create monopolies to which he gave control to his friends and associates. This practice became known as "crony capitalism." However, Marcos also did many things to give the appearance of complying with the international economic community. Foreign investment was encouraged, an export-processing zone was opened, and an image of an attractive economic center that offered low wages was adopted in the Philippines. In response, capital coming from foreign countries increased dramatically.

Due to these factors and a rise in material prices, the Philippine economy began to grow. GNP was growing at an average of seven percent per year. Although this was an improvement, manufacturing was only growing at six percent, less than the overall economy. In 1980, the public sector continued to grow, and the government borrowed massively from international sources to finance spending. Economic problems began to creep up, especially related to paying for government debt. There were other internal problems related to the mismanagement of crony enterprises, and in 1981, businessmen fled the country with P700 million, requiring massive emergency loans to be taken out.

In 1980, massive policy changes were undertaken. The government agreed to reduce tariffs and eliminate quantitative restrictions on trade in exchange for a large loan from the World Bank. Exports did not increase, while imports were increasing dramatically. More political turmoil followed with the assassination of Senator Benigno Aquino, a critic of President Marco. Debt repayment eventually ceased by the time Marco fled the country in 1986.

When Corazon Aquino rose to power in 1986, she focused her efforts on privatization. Her goals were to reduce unemployment, encourage small businesses, and develop neglected rural areas. However, over time Aquino's cabinet became increasingly influenced by businesspeople and international creditors, who gained significant influence on economic decision-making. The economic recovery that had taken place was largely of benefit to the wealthy, whereas the poor had reaped few of the benefits.

Foreign debt of US$28 billion remained a problem. Economists in the government said that a sustainable economic recovery was not compatible with the large outflow of payments to service the debt. In the end, the President rejected repudiation and agreed to honor all debts. The economists also called for more purchasing power to be put in the hands of the masses, something that could be achieved through a land reform program. Though Aquino had previously supported such reforms, she only left Congress with a broad framework, leading to the enactment of weak legislation, influenced by landowning interests.

A turnaround was achieved in 1986, which accelerated in the following years. Consumption led to growth, followed by increases in investment. International aid also came into the Philippines. The Philippine Assistance Plan, for example, pledged a total of US$6.7 billion. Although the trade deficit rose, growth continued through the late 1980s. In 1990, growth slowed to about three percent due to several factors. There was a prolonged drought, a major earthquake, and a typhoon. Also, the country was attempting to recover from a December 1989 coup attempt. There were also major infrastructure problems. Brownouts were a common occurrence, there was limited public transportation and crowded roadways, inadequate garbage removal, and government construction was on a decline.

Aquino had significant trouble implementing an economic plan. Debt was soaring, but Congress was reluctant to pass greater taxes onto an economy in trouble. Aquino was replaced as President in 1992 by Fidel Ramos, who won the election with only 24 percent of the vote. Under the Ramos administration, growth went from .5 percent in 1991 to seven percent in 1996.

The first major move by Ramos was to dismantle the protectionism that had been present for so long. He removed foreign exchange controls and freed the Philippine peso. He reduced import duties and abolished other trade restrictions. Industries were deregulated and privatized, and foreign banks were allowed to enter the country. Foreign investment increased and allowed the Philippines to deal with some infrastructure problems, such as shortage of energy.

The Ramos government enacted the *Special Economic Zone Act* in 1995, which created the Philippine Economic Zone Authority. The authority was successful in attracting foreign investment, and from 1994-2001, employment in Special Economic Zones (SEZ) went from 229,650 to 716,990, and manufactures for export went from $2.7 billion to $19.4 billion. The sector even experienced growth during the Asian financial crisis of 1997.

The Ramos government established a more stable peace and order in the Philippines and improved infrastructure. Generally, state intervention in the economy was reduced, and the Philippines were moved closer to industrialization. A democratic political system was developed, largely due to the 1991 Local Government Code, which included 229 structural laws-79 of which was economically-related.

The *Foreign Investment Act* of 1991 liberalized investment by allowing 100 percent foreign equity in domestic and foreign enterprise. Procedures were simplified for registering incoming foreign investment. The Philippines also became a member of the Association of Southeast Nations (ASEAN) and hosted the Asia Pacific Economic Cooperation (APEC) summit in order to show that they were part of the international community and that they were seeking foreign investment.

During the Asian Financial Crisis of 1997, the Philippines were not affected as other countries. It has been suggested that part of the reason might be their reduction of external debt since the mid-80s and improved standing with credit agencies. Others say that earlier crisis in the 1980s gave the Philippines the experience to deal with such problems, and that these earlier episodes led the Philippines to develop a strong banking sector and open financial markets, and caused the creation of the *New Central Bank Act*, which helped to stabilize the country financially.

This dramatic move towards democracy and transparency shows the effect such changes can have on economic growth in developing nations.

B. Theoretical Background

During the 1980s, many governments of the developed world adopted a free-market theory of economics. This viewpoint has been referred to as the Neoclassical Counterrevolution. The theory supported freer markets, private ownership, statist planning, and government regulation of economic activities. Economists that supported this theory argued that poor resource allocation and too much state intervention was preventing markets from functioning properly and hampered growth.

This viewpoint supports increasing exports and free trade, eliminating government controls on prices, and attracting foreign investment. In contrast to dependence theorists who argued that the developed world was taking advantage of the developing world and keeping them from growing beyond that, the neoclassical counterrevolution placed the blame on the governments of developing nations who were often corrupt and did not offer economic incentives.

This theory stems from the basic argument that markets are most efficient when they regulate themselves. In other words, the forces of supply and demand will determine production and consumption, and that the collective will of all producers and consumers will allocate resources better than a central body is capable of doing. Under this theory, any government intervention that interferes with this automatic self-regulation of the market will distort prices and hinder growth.

The world's most powerful financial agencies, the International Monetary Fund and World Bank, advocate this point of view. Their efforts to provide incentives for developing nations to adopt a free-market approach have been successful in causing change in many countries. They also encourage governments to set up strong financial systems with a high degree of transparency, and for the government to invest in key infrastructure and education.

The other side of this argument is that through this process of liberalization, greater foreign investment will be attracted. Foreign capital is attracted to markets, which are free and stable. They are also attracted by the stability of democracies, secure, and transparent financial systems. An infusion of foreign capital is equivalent to raising the savings rate, which can be shown to increase GDP using the Harrod-Domar growth model.

The Solow neoclassical growth model also factors in labor and technology. It shows diminishing returns to scale for labor and capital separately and constant returns jointly. Technology explains long-term growth, though this factor is exogenous, which means it is set outside the model. Therefore, growth in the traditional neoclassical model can result from increases in labor quantity and quality, increases in capital, and improvements in technology. The free-market system is especially important in influencing capital and technology because openness to outside markets allows capital and technology to flow in from the developed world.

Generally, democracy and free-markets go together, as demonstrated by Thomas Friedman in his book, *The Lexus and the*

Olive Tree: Understanding Globalization. The freedom to choose political leadership as well as allocate resources as one sees fit is a natural match. Democratic government provides stability because it provides a method for dealing with corruption and a model for change that is oriented towards the best interests of the people and the economy as a whole, rather than a particular political leader or party.

Free markets and democracy continue to be "sold" to the developing world as routes to economic growth. This paper will examine a real-world example of how political and economic systems effect economic growth, and will test the theories of the neoclassical counterrevolution.

C. Research Methodology

The economy of the Philippines will be analyzed over the period 1980-2006 using data available from the International Monetary fund. The statistics that will be analyzed are:

- GDP, Current Prices
- Population
- GDP Per Capita, Current Prices
- GDP Based on PPP Valuation
- GDP Per Capita Based on PPP
- Annual Inflation Rates
- Exports

The data will be presented graphically and in tables. It will be analyzed by comparing changes in economic trends to changes in the economic and political systems of the Philippines. An attempt to correlate changes in the economy with changes in policy will be made.

D. Data and Analysis

An important graph in this analysis is the graph of GDP in current prices. It shows the period from 1980 to 2006, and shows how the economy as a whole has grown over time. Please see Graph 1-1 below. The corresponding values are shown in Table 1-1.

Graph 1-1

Table 1-1. Gross Domestic Product, Current Prices

U.S. dollars	*Billions*	*U.S. dollars*	*Billions*
1980	32.45	1993	54.368
1981	35.647	1994	64.084
1982	37.14	1995	75.525
1983	33.212	1996	84.371
1984	31.408	1997	83.736
1985	30.734	1998	66.596
1986	29.868	1999	76.157
1987	33.196	2000	75.912
1988	37.885	2001	71.216
1989	42.647	2002	76.814
1990	44.164	2003	79.634
1991	45.321	2004	86.703
1992	52.982	2005	98.371
		2006	116.931

As shown in Graph 1-1, the economy experienced a recession from 1983-1986 after disappointing growth in the early part of the decade. This was, of course, during the period of the dictatorship of Marcos, who established state-owned enterprises run by his associates. Problems of national debt and corruption also limited growth of the economy. GDP finally bottomed out at P29.868 billion in 1986.

The effects of the ouster of President Marco in 1986 and the installation of Corazon Aquino under the democratic system can be seen almost immediately in GDP growth. Aquino promised privatization and a reduction in unemployment, and began to develop economic policy in line with free-market practices. Growth was steady and positive through 1989, though growth stalls in 1990. Environmental factors as well as a coup attempt contributed to this result. Clearly, political instability can have effects on economic growth. There were also infrastructure problems to blame. Note that neoclassical theorists as well as the World Bank and IMF support investment in infrastructure. Unfortunately, the Philippines had grown past the point where its infrastructure was adequate.

The next jump in growth can be seen with the election of Fidel Ramos in 1992. This began a period of significant sustained growth. GDP increased from P45.321 billion in 1991 to 84.371 in 1996. This can be attributed to numerous free-market policy changes enacted by the Ramos administration. A stable peace and improved infrastructure also assisted growth.

The Asian financial crisis of 1997 caused a reduction in GDP in the Philippines from a peak of P84.371 billion in 1996 to P66.596 billion in 1998. Although the crisis caused a stalling of the economy, the effects were not felt as strongly as in other countries. Political turmoil involving corruption charges against President Estrada may have led to uncertainty and a slight contraction of GDP from 2000-2001. However, overall the Philippine economy showed resiliency and there was a full recovery in the 2000s, with growth returning to level of around seven percent per year.

Table 1-2. Philippines Gross Domestic Product Per Cap

U.S. dollars	*Units*	*U.S. dollars*	*Units*	*U.S. dollars*	*Units*
1980	671.573	1989	709.604	1998	910.436
1981	719.553	1990	718.114	1999	1,018.88
1982	731.393	1991	719.384	2000	994.291
1983	637.959	1992	822.695	2001	913.9
1984	588.725	1993	825.012	2002	966.176
1985	562.178	1994	949.209	2003	982.148
1986	533.364	1995	1,104.99	2004	1,037.62
1987	578.327	1996	1,206.14	2005	1,153.78
1988	645.409	1997	1,170.32		

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Graph 1-2

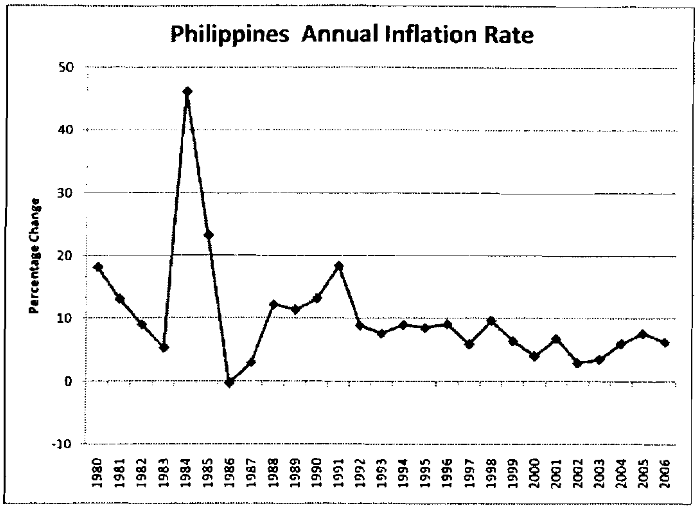
In Graph 1-2, it is clear that the GDP per capita follows the same basic trend as total GDP, but growth is less exaggerated, and losses are more significant. This is important because even in places where there seems to be economic stagnation of total GDP, this means that GDP per capita is decreasing since the same amount of income is being split amongst more persons. By observing GDP per capita, we can see how GDP has changed when controlling for changes in the population. One important finding of these results is that the economy has not fully recovered on a per capita basis to levels achieved prior to the Asian financial crisis of 1997. GDP per capita peaked at P1206.14 in 1996, and had only reached 1153.78 in 2005.

Another important measure is GDP Purchasing Power Parity. Even though one might compare GDP from one country to another to determine total income, it is not possible just by looking at GDP what the amounts are "worth," given the variation in prices of goods and services from one country to another, and within a country over time. This is a meaningful statistic to the consumer because it determines what they can afford.

Table 1-3. Philippines Inflation, Annual Percent Change

1980	18.2	1994	9
1981	13.1	1995	8.5
1982	9	1996	9.1
1983	5.3	1997	5.9
1984	46.2	1998	9.7
1985	23.2	1999	6.4
1986	-0.3	2000	4
1987	3	2001	6.8
1988	12.2	2002	2.9
1989	11.4	2003	3.5
1990	13.2	2004	6
1991	18.4	2005	7.6
1992	8.9	2006	6.2
1993	7.6		

Graph 1-3



As shown in Graph 1-3, there was extreme variability from 1984-1986. This was around the time of political turmoil and transition for the dictator. This shows how when countries do not have a system for the peaceful transition of power (i.e. democracy), uncertainty may lead to price changes and inflation. Since the formation of the democratic government, inflation has been lower and steadier. There was a mean of 8.015% from 1987-2006 with a standard deviation of 3.8. Although not perfect, Philippines monetary policy since the formation of democracy has been reasonably successful at keeping interest rates under control.

Lastly, exports are an important statistic because it indicates the degree of involvement in the international economy. Neoclassical growth theorists support export-led growth.

E. Conclusion

Given the political and economic history of the Philippines, it is easy to see how changes in the political system and economic policy can affect the economy of a country. This confirms the commonly held assumption of the developed world that growth can be encouraged in developing countries by creating free democracies with stable and transparent financial systems. The state should generally be laissez-faire when it comes to regulating industry, but should encourage growth by developing infrastructure and creating a secure financial system.

It is important to note that these free-market democratic policies may be necessary but not sufficient for growth. Undoubtedly, there are countries which have adopted the policies put forth by the IMF and World Bank and have not experienced growth for one reason or another. There are many factors, which must be in place in order for growth to occur, as growth is a complex process.

However, due to the success of countries like the Philippines, once considered a "laggard" among Asian economies, neoclassical growth theories should be an important part of economic policy for developing nations. The evidence shows that democratic, free-market systems are more likely to attract foreign investment and show sustained growth over time than countries with greater government controls in place.

Further research must be done to determine the right balance of government control and private freedom. All but those on the fringes accept that government serves some function in advancing an economy, so the question is how much and what type of intervention creates the best balance. Due to the economic growth possible with these types of policies, there will no doubt be more countries moving to this type of system. Hopefully, this will reduce poverty, and allow developing nations to move further along through the stages of growth.

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