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El Niño or El Peso? Crisis, Poverty and Income Distribution in the Philippines

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Summary. — Using household survey data for 1998, this paper assesses the distributional impact of the recent economic crisis in the Philippines. The results suggest that the impact of the crisis was modest, leading to a 5% reduction in average living standards and a 9% increase in the incidence of poverty, with higher increases indicated for the depth and severity of poverty. The largest share of the overall impact on poverty appears attributable to the El Niño shock as opposed to shocks mediated through the labor market. Both household and community characteristics mattered to the differential impact of the crisis. There is some evidence of consumption smoothing by the crisis-affected households, though the poor amongst them were more constrained in their ability to protect their consumption.
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1. INTRODUCTION

When devaluation of the Thai Baht in July 1997 marked the beginning of the Asian financial crisis, the Philippine economy was in relatively good shape. In the three years prior to the crisis, the Philippines was not only enjoying favorable economic growth, inflation had returned to manageable levels after the double-digit rates of 1988–91, the Peso was stable against the US dollar, net international reserves had grown to comfortable levels, and the fiscal budget was in surplus. Poverty rates had been declining; for instance, the incidence of poverty declined from 32% in 1994 to 25% in 1997 (Balisacan, 1999, 2000). [1]

Nonetheless, the Thai financial crisis was rapidly transmitted to the Philippine economy and large capital outflows instantly created downward pressure on the Peso. The *Bangko Sentral ng Pilipinas* initially tried to defend the Peso but as foreign reserves were insufficient to counter the massive capital outflows, the Peso depreciated from P26.40/$ in June 1997 to P37.20/$ in December 1997 to a peak level of P42.66/$ in January 1998. To ease the pressure on the exchange rate the government raised interest rates. In tandem with the depreciating exchange rate, interest rate on 91-day treasury bills rose from 10.5% in the first half of 1997 to

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a high of 19.1% in January 1998. Net domestic credit stopped growing and there was a sharp decline in investment (by 17% during 1998).

With the setting in of the financial crisis by the last quarter of 1997, the Philippine economy stalled in 1998. Real GNP shrank by 0.5% in 1998. Per capita real GNP declined by 2.7%. The financial crisis was compounded by the worst drought in 30 years caused by the El Niño beginning September 1997. This was reflected in the 1998 sectoral growth rates. Agriculture contracted the most, by 6.6%, while industrial production fell by 1.7%.

With the slowdown in output growth came the slowdown in employment. Unemployment rates increased to double-digit levels during 1998 (averaging 10.1% in 1998 against 8.7% in 1997). Inflation also accelerated to double-digit levels. With the plummeting of agricultural output, food prices increased even faster than the general level of prices. The crisis also reduced government revenues, which constrained public spending despite an overall countercyclical fiscal policy adopted by the government. In 1998 real per capita spending on social services declined.

These macroeconomic developments raise a number of questions related to the potential impact of the crisis on living standards of the Filipino population. In this paper, we address the following four.

(a) How large was the impact in terms of the effect on average living standards and measures of absolute poverty?

(b) How was the impact distributed across the population? What factors contributed to rendering some households more vulnerable to the adverse shock than others?

(c) How did the impact on household consumption compare with that on household incomes? Is there any evidence of consumption smoothing by households?

(d) Was the Philippines crisis more of an adverse weather phenomenon than a financial crisis? What was the relative contribution of the El Niño shock to the total impact?

In addressing these questions, this paper limits its focus to the consumption or income dimension of the welfare impact. The crisis of course potentially affected other dimensions of welfare, however, their analysis remains beyond the scope of this paper. [2] The paper is organized as follows. The following section reviews what is known about the impact of the crisis in the Philippines. In the course of this review, we also make some methodological comments on related literature for other countries in the region. Sections 3 and 4 respectively describe the data and our methodology. Our results are presented in Section 5. Section 6 sums up with some concluding observations.

2. WHAT DO WE KNOW ABOUT THE DISTRIBUTIONAL IMPACT OF THE CRISIS?

While it is generally believed that the Philippines escaped the worst of the regional financial crisis, [3] relatively little is known about the distributional impact of the crisis (which for the Philippines turned out to be a combination of financial and weather-related shocks). One strand of work for other countries in the region has involved comparisons of distributional parameters, including measures of absolute poverty, based on household survey data before and after (or during) the crisis. [4] For the Philippines, the latest available household survey is the 1998 Annual Poverty Indicators Survey (APIS) conducted by the National Statistics Office (NSO). [5] Using these data in conjunction with data from the 1997 Family Income and Expenditure Survey (FIES), Reyes, De Guzman, Manasan, and Orbeta (1999) reported that per capita income declined by 3.6% in nominal terms and 12.1% in real terms. [6] But, as Reyes *et al.* acknowledge, even these before–after comparisons are problematic for the Philippines due to noncomparability of the income and consumption modules across the two surveys (see below for details). The before–after comparisons also run into the problem of a misspecified counterfactual. Even for a systemic shock, "before" estimates may not be a good approximation of the estimates "in the absence of a shock."

A different approach has been used for Thailand and Korea (Kakwani & Pothong, 1998; Kakwani & Prescott, 1999) where the counterfactual level of an indicator of interest is constructed by obtaining a predicted value from past trends of the indicator up to the crisis. Thus, if y_t is the value of, say, the poverty indicator in the crisis period t, and y_t^* is its predicted value based on past trends, then a crisis index for the poverty indicator is defined as $((y_t/y_t^*)-1)$ and it measures the percentage change in poverty due to the crisis. This approach, though nonimplementable for the Philippines for lack of comparable distributional data for the crisis period, is also meth-

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