Lessons from Sectoral Financial Balances for Philippine Crises

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Introduction to Sectoral Financial Balances

The Philippines has suffered one major economic crisis, defined as negative GDP growth, and two smaller ones, since the 1980s. The first one was in 1984-85 under the administration of President Marcos Sr. In 1984, GDP growth shrank by 7% and by 6.8% in 1985. In 1991, under the administration of President Corazon Aquino, growth contracted by 0.5%. This was caused by natural disasters (notably the Mount Pinatubo eruption), and an energy crisis that led to power shortages. The third one was the Asian Financial Crisis of 1998 (AFC), together with El Niño effect, under the administrations of Presidents Fidel Ramos (outgoing) and Joseph Estrada (entering). That year, GDP contracted also by 0.5%. The worst crisis took place in 2020, provoked by the COVID-19 pandemic (-9.5%) but this was of completely different nature, not an economic-induced crisis. Growth during the 2022-2023 supply shock, provoked by the Russia-Ukraine war, was positive, as well as during the current shock as a result of the US-Israel war on Iran (low but not negative).

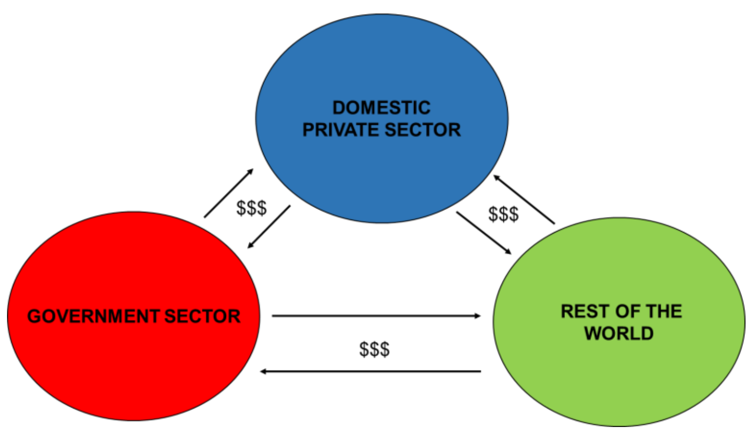
At the macroeconomic level, the mid-1980s crisis and the AFC were different events with different causes. The first one was a combination of: (i) an economy that did not shift from industrial protection to an export-oriented economy during the 1960s and 1970s, and which failed to produce a sustainable growth path; (ii) incurring foreign debt; and (iii) a corrupt regime that wanted to hold on to power in a rent-seeking context. The second crisis was milder than in Indonesia, Malaysia, Korea, and Thailand because the Philippines did not have the same amount of short-term foreign borrowing or portfolio capital inflows as the other countries, a property bubble, or a banking system that collapsed. Nevertheless, and partly as a result of contagion, growth declined.

Economists typically search, at the macroeconomic level, for signs of a crisis by analyzing if the current account and the fiscal position are in *deficit* (referred to as imbalances). Prior to both crises the Philippines was running current account deficits and fiscal deficits. Yet, these were not large enough to truly justify what came in 1984-85 and in 1998. What happened then?

Our view is that economists missed to look into the financial balance of the sector that links the fiscal and external positions of an economy: the domestic private sector balance. This overlook persists today and we often see references to the current account and the fiscal position in isolation, without considering the relationship with the private sector balance.

In any economy, the financial balances of the domestic private sector, the government sector, and the external sector, add up to zero by definition. These balances comprise the total economy. The domestic private sector balance is the difference between domestic private saving (S) and domestic private investment (I); the government financial balance is the difference between taxes (T) and government spending (G); and the external balance (foreign private sector) is the current account (CA), measured as credits minus debits. Algebraically: $(S - I) + (T - G) - CA = 0$. See Figure 1. This is not a theory but an accounting identity that holds in all economies. Unfortunately, many economists and market watchers fail to understand it.

Figure 1. Sectoral Financial Balances



Domestic Private Balance + Government Balance + Rest of the World Balance = 0
Rest of the World Balance = - Current Account Balance

This identity has several important implications:

-Analyzing any of the three financial balances in isolation and focusing on a single "imbalance" (e.g., fiscal deficit if $T < G$), as it is often done, is not very meaningful. It is in fact dangerous to draw conclusions about any of them.

-We know that the domestic private sector (households, corporations, financial sector) prefers to run a surplus, that is, $S > I$. The reason is obvious: if the sector is in deficit ($S < I$), it means that it is spending more than its total income, and that it is running down its stock of net financial assets. These include money, bank deposits, shares, capital equipment, land and property. Liabilities represent financial obligations that need to be settled over time, by some form of payment. Eventually, the sector would accumulate debt, a situation that is not sustainable for the private sector in the long run. More on this later.

-If the total private sector desires to run a surplus (i.e., $(S - I) - CA > 0$), the government has the power to accommodate it by running a fiscal deficit ($(T - G) < 0$)), of identical size, such that $(S - I) + (T - G) - CA = 0$. A government deficit is about net financial assets of the non-government sector, NOT about financing.[1]

-Moreover, if the economy runs a current account deficit ($CA < 0$), as the Philippines does, and the domestic private sector desires to run a surplus ($S > I$), the government will have to run a fiscal deficit ($T < G$) for the identity to be satisfied. A government deficit is, peso for peso, an increase in net financial assets of the non-government sector.

We add the following observations:

-Sovereign governments (those that make payments in their own currency, like the Philippines), can run fiscal deficits because they make payments in their own currency. We do not know of any sovereign nation that, in normal circumstances (that is, outside wars or large supply shocks), collapsed as a result of a fiscal deficit (in its own currency), however long it lasted.

-Like any modern government, that of the Philippines makes payments (government spending) through the central bank (Bangko Sentral ng Pilipinas —BSP), where it has its account. When Treasury instructs BSP to make a payment, BSP creates new "reserve balances" (electronic money

[1] To stress this point: rearranging the sectoral balances identity with private investment on the left-hand side and the rest of the variables on the right-hand side as $I = S + (T - G) - CA$ and interpreting it in terms of "saving drives investment" is incorrect. The correct interpretation is that government deficits create private saving.

used to settle banking transactions) *ex nihilo* (out of nothing) and these are transferred electronically to a commercial bank (on the liability side of its balance sheet), which becomes the deposit (on the asset side) for the beneficiary of the payment (e.g., a construction company) — there is no physical money involved up to here.

-Additionally, it may come as a surprise to many that taxes are not used to make government payments. To repeat: every time the government spends, BSP creates new money. This appears in BSP's balance sheet. Taxes are payments made by all of us that return to the Treasury's account at BSP. This means that taxes eliminate reserves created previously, and implies that the central bank's reserves in the banking system are reduced, and Treasury's BSP balance goes up. Taxes are not used for anything else and do not supply spending power.[2]

-It is important not to confuse the law, that is, a series of voluntary constraints (e.g., that before BSP can execute a payment, the Treasury's account must have a positive balance; or that to address a global shock like the current one, the government may need to request a special budget from Congress), with the reality of how the government spends, as explained above.[3]

-It is puzzling, that the Philippine government operates as if it faced a true financial constraint (like a family or a business), and that it fears more a fiscal deficit than a domestic private sector deficit (is it even aware?), the one that truly matters. It also refers often to "pesos" (the national currency) as a "resource", something that is scarce (e.g., natural resources). Pesos are never scarce in the Philippines, much less to the government.

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[2] RA 7653 (this is the core law that governs the BSP's role as government depository and fiscal agent) and Treasury/BSP operating rules support the idea behind the statement that when taxes are collected and remitted to the Treasury, central bank reserves in the banking system are reduced. The law establishes the central bank as the official depository of government funds and the mechanism through which tax remittances and government payments are processed. The economic effect on reserves comes from how the banking system and central bank settlement operations work, as mandated by law. RA 7653 defines where government funds must be kept and how government accounts are handled. The operational consequence of this is the accounting effect on bank reserves. See in particular Sections 113 and 114.

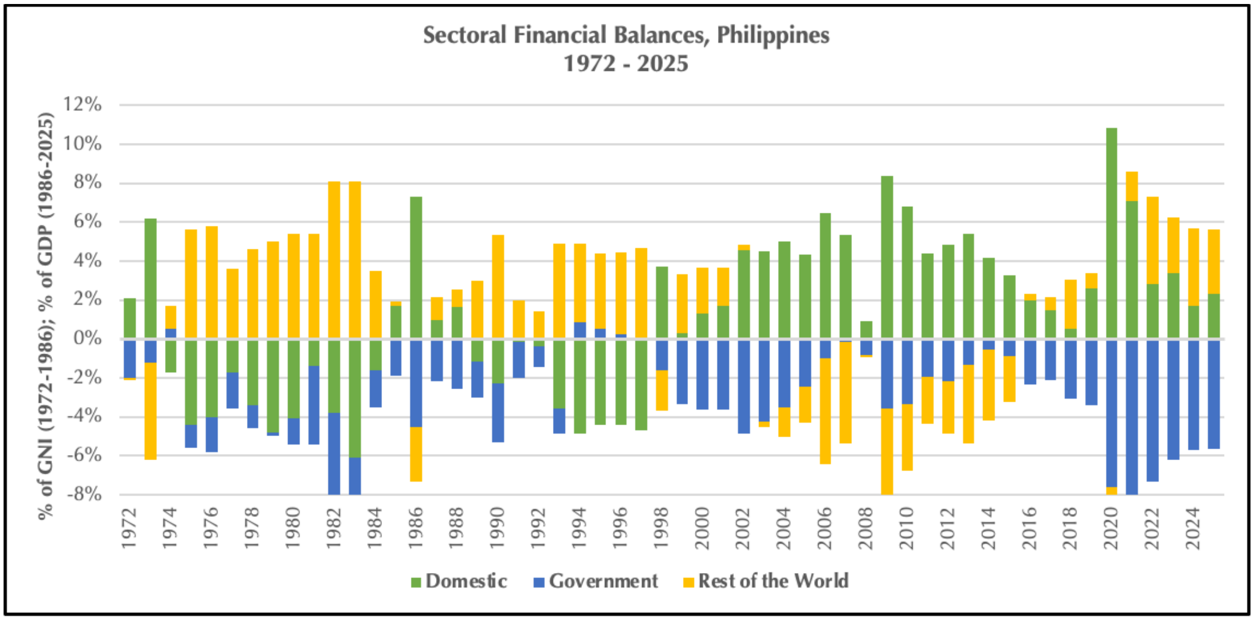
3 The statement that the central bank creates money out of nothing and the fact that the Treasury must have positive balances in its account prior to spending, are both true—the government can and does require itself through its own self-imposed constraint to obtain credits to its own account at BSP that were created via previous deficits or BSP lending before it spends again. Not a contradiction.

What do Philippine sectoral balances tell us about crises?

Figure 1 plots the three sectoral financial balances as percentage of GNI or GDP for the Philippines, for 1972-2025. At each point in time, the three bars (sectoral balances) add up to zero. Since the current account position (CA) has a negative sign in the sectoral balances identity, we need to 'invert' it (change sign) to ensure that the three bars add up to zero. When this is done, the current account becomes the financial account, or rest of the world, in the balance of payments. This is what we show. Remember that, when interpreted it in terms of the current account, it will have the opposite sign.

As an example, let's take the year 1986. This year, the domestic private sector (green bar) ran a sizeable surplus of about 7.5% of GDP; the government (blue bar) ran a fiscal deficit of slightly about 4.3% of GDP; and the current account (yellow bar) was in surplus, equivalent to about 3.2% of GDP.

Figure 1. Sectoral Financial Balances, Philippines, 1972-2025, % GDP



Sources: Authors based on data from the Bangko Sentral ng Pilipinas, Bureau of Treasury, and Dohner & Intal 1989. "Government expenditures and revenues." In J. D. Sachs & S. M. Collins (Eds.), Developing country debt and economic performance, volume 3: Country studies—Indonesia, Korea, Philippines, Turkey (pp. 401–433). The University of Chicago Press.

What does Figure 1 tell us about the Philippine economy, in particular about the 1984-85 and 1998 crises?

-Prior to 1984-85, the Philippines ran current account deficits (rest of the world in surplus), between 1974 and 1985. The important point to notice is that the private sector was running deficits (increasingly larger), i.e., the sector accumulated debt. While the government ran fiscal deficits, these were not large enough to compensate the current account deficits and ensure that the domestic private sector would run a surplus. This persisted until 1984. The situation reversed in 1985 and even more so in 1986, when the government ran a significant deficit, which allowed the private sector to run a surplus, i.e., started recovering. This situation persisted until 1988. The 1984-85 was not caused by the fiscal deficits but by the deficits of the domestic private sector.

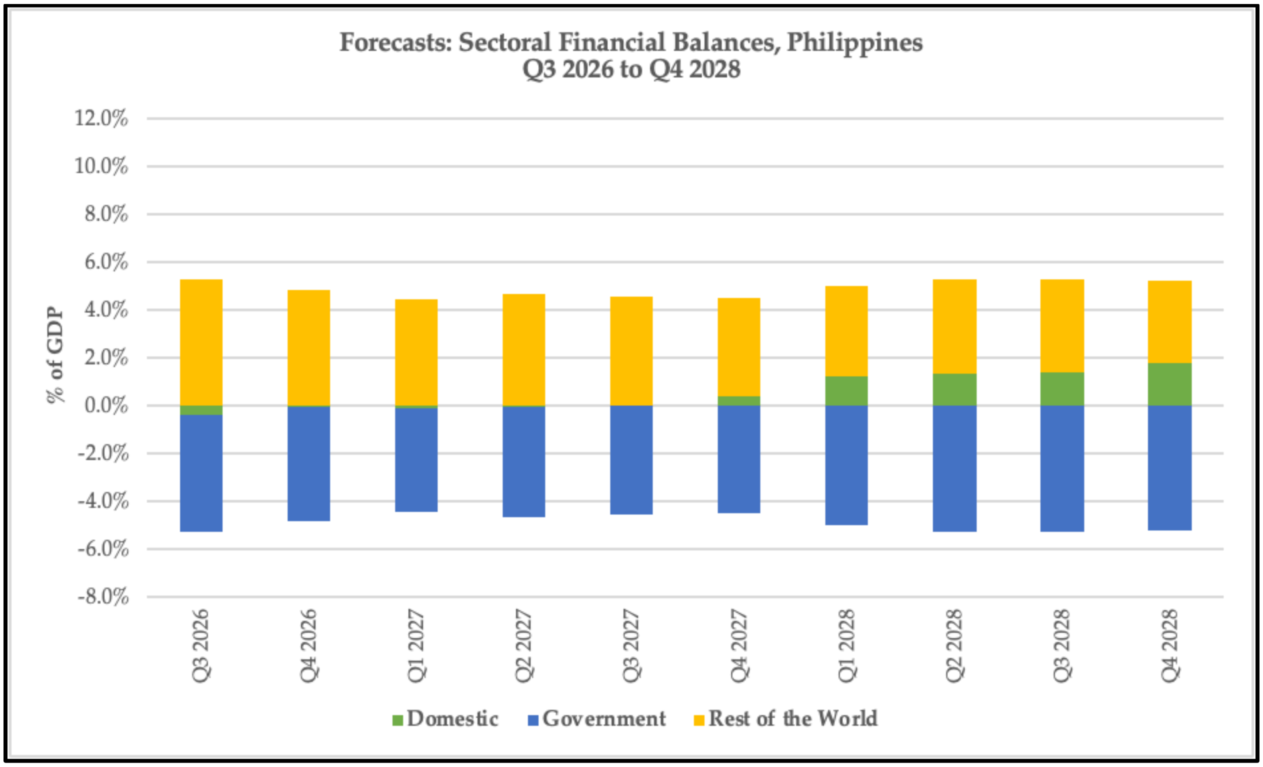
-In 1989, the domestic private sector started running deficits again, and these remained through 1992-97. This was combined with years of fiscal surpluses and current account deficits. This was a deadly combination that exploded in 1998, when the government had to run a fiscal deficit to escape the crisis (and allow the private sector to run a surplus). It was, again, the domestic private sector deficit, not that of the government, that was behind the AFC, the same as in Indonesia, Korea, and Thailand (private sector deficits prior to 1998).

-Since the early 2000s, the Philippine domestic private sector has been able to run surpluses, largely because the government has run a fiscal deficit, the mirror image. It is worth noting the year 2009, which combined a fiscal deficit and a current account surplus, leading to a large domestic private sector surplus. This coincided with the Global Financial Crisis of 2008-09. Particularly large are the fiscal deficits since 2020 (see 2020 and 2021, the COVID-19 years), reflected in large domestic private sector surpluses. It is this situation that has provided macroeconomic stability to the Philippine economy. Let's not miss the point.

Looking into the Future

-Figure 2 provides our quarterly forecasts of the three sectoral balances until 2028. The figure indicates that the Philippines will continue running fiscal and current account deficits. In Q3 2026, the fiscal deficits (injection into the economy) will not be enough to compensate current account deficit (leakages), hence the domestic private sector will run a small deficit. The domestic private sector balance will move to surplus in Q4 2027 and in 2028. Given the expected current account deficits between now and the end of the current administration, it is important to understand the role of the fiscal deficit as a supplier of net financial wealth (assets) to the domestic private sector, to avoid a financial crisis.

Figure 2. Forecasts Sectoral Financial Balances, Philippines, Q3 2026-Q4 2028, % GDP



Source: Authors' forecasts

-Eliminating today's fiscal deficit implies returning to a state like that of the 1970s and early 1980s, or to that of the early 1990s. The current government's objective to lower the fiscal deficit (referred to as fiscal consolidation) to 3% of GDP is a meaningless target because the size of the fiscal position will ultimately be determined by the saving desire of the private sector. If the government does not accommodate it, a crisis will follow sooner or later, like in the two past instances mentioned. This point is very important in the current context of uncertainty and a growth rate below potential.

-The counterpart of a fiscal deficit ($T - G < 0$) is new bond issuance (the sum of which is called national debt, amounting to about PhP 18 trillion as of now) plus the change in the money supply (with some adjustments). The split between these two is a decision of the private sector. Bond issuance is a key aspect of a modern financial system. Bonds are issued by Treasury and BSP <u>not</u> to finance the government (we said above that BSP makes the payments by crediting reserve balances to the commercial banking system —neither the government nor BSP need *our money*) but to drain excess liquidity (that is, unwanted reserve balances) from the banking system. We recommend to witness a bond issuance auction to understand what transpires. Those in the private sector who own bonds and Treasury bills refer to them as "wealth." Bonds are also necessary for BSP to maintain the policy rate within the corridor system: if the excess liquidity is not drained, the central bank's policy rate would be pushed down, eventually to zero, rendering monetary policy irrelevant.

-We live complicated times and the deficit hawks (doomsayers) are back complaining about the fiscal deficit and national debt. Their predictions about the end of the world have not materialized, and there is no reason why they should —they just do not get it. The government's job is to spend to compensate low private investment and consumption in order to maintain the economy afloat. Government spending in no way crowds out the private sector (quite the opposite!). If the government (Treasury and BSP) stopped issuing debt, the result would be chaos in the financial system. Banks would not know what to do with their excess reserve balances because nobody wants to borrow them (that's why they are excess reserves), and BSP's monetary policy would come to an end. It is how the financial system works, in the Philippines and in the rest of the world. If the private sector does not want more bonds (debt), the solution is not to offer T-bills any more, and to ask banks (primary dealers) to deposit their excess reserves in BSP at the deposit rate of the interest rate corridor. End of the problem.

Final remarks

-The claim that central banks create money "out of nothing" often provokes strong reactions among audiences. We believe this is because accepting it requires acknowledging that the textbook account is wrong—or, perhaps more importantly, that its implications are far more significant than many are willing to concede. More than a decade ago, the Bank of England made it clear that banks do not lend out deposits and do not multiply reserves: "Money creation in practice differs from some popular misconceptions —banks do not act simply as intermediaries, lending out deposits that savers place with them, and nor do they 'multiply up' central bank money to create new loans and deposits." In doing so, it effectively rejected both the Loanable Funds and Money Multiplier theories. Similar statements have been made by the Norges Bank, the Bundesbank, and even the BBC. Yet resistance remains. Why? Because once the actual mechanics of banking are understood, attention inevitably turns to the next issue: government finance.

-We are told that governments face a budget constraint and can spend only what they first collect through taxation or borrowing. But *what if* such narrative is as inaccurate as the idea that banks lend out deposits? Suppose government spending itself creates money, taxes destroy money, and bond issuance serves primarily to provide investors with safe assets. If commercial banks can create money out of thin air, why could a sovereign government with full monetary sovereignty not do the same? And if that is the case, what becomes of our debates about deficits, public debt, and fiscal rules? Perhaps these are the deeper reasons why these discussions generate such strong reactions.

-The issue is not really the mechanics of banking. Rather, it is the challenge posed to the comfortable myths that underpin flawed approaches to economic policymaking and many popular doomsday narratives that plague the Philippine economics narrative.