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Is the Philippines a nation of gluttons?

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Central Bank Governor Eli Remolona argued during a Senate hearing last August 27, that when investment exceeds what the country saves, the difference has to be *financed* from overseas. Governor Remolona connected this to our poor export performance and dependence on BPOs and OFWs for dollars. All this is the result of having a “consumption culture”, he argued: we (private citizens) consume (a lot?), hence we do not save, hence we do not have enough to invest. The story is simple and appealing, but is the economics behind it correct?

Before turning to what I think is the wrong economics, I will quickly dismiss the consumption claim: Filipinos’ saving rate is low because their incomes are low, not because they are gluttons.

What many economists, including the Governor, have in mind when they argue in such terms is the association between private saving and investment. It leads to the cliché that the Philippines has a consumption-oriented culture and the difference between saving and investment has to be borrowed from abroad. It is important to be precise: this argument, when applied at the country level (national accounts data), is a straightforward extension of the family analogy. The story is appealing to many commentators because it is simple. This, however, does not make it correct: the national accounts do not work like those of a family.

To understand this, one must understand the national accounts. Ignoring some technical complications, total (economywide) expenditure or Gross Domestic Product (GDP) is the sum of private consumption (C), gross capital formation (I), the sum of private (I^P) plus

public (I^{Pu}) investment, that is, $I = I^P + I^{Pu}$, government spending (G), and the current account (CA) – as credits (exports) minus debits (imports). Likewise, economywide disposable income is allocated as private consumption (C), gross private saving (S), and taxes (T). Private saving (households plus firms) is $S = GDP - C - T$, a *residual* of income. S is a flow of saving during the current accounting period, not the stock of savings accumulated in the past.

Equating expenditures and disposable income gives: $C + S + T = C + I + G + CA$, and therefore one can write $I^P = S + (T - G^*) - CA$, where recall that I^P denotes private investment (part of I), $(T - G^*)$ is the fiscal surplus (if the difference is positive) or deficit (if the difference is negative), and G^* includes public investment (that is, $G^* = G + I^{Pu}$). The second expression is, presumably, the reading that the Governor made of the accounting identity.

Objecting to “saving finances investment”

The problem is not the equation *per se*, as it is necessarily true. The problems are conceptual and causal. Saving asks: “How much of current income was not consumed during the accounting period?” Finance, on the other hand, asks: “Where did the purchaser obtain the money needed to make the payment?” These are fundamentally different concepts.

The second problem is the causal reading: households and government save; those savings become funds; firms borrow those funds; and firms invest. This is the old and loanable-funds neoclassical interpretation (that there is a pool with money to be used as a fund for investment) of saving and investment. It is unfortunate that this interpretation is still circulating. Moreover, the accounting identity does not establish it.

Suppose a firm decides to invest PHP100,000. What does it do? It will approach a bank and obtain a loan. This will immediately create a PHP100,000 loan to finance the purchase of a machine (on the debit side of the bank; on the credit side of the firm’s account at the bank). The bank does not, in fact, first have to find PHP100,000 of somebody else’s saving. The loan creates a deposit; the investment expenditure creates income for somebody else; and part of that additional income will subsequently be saved.

Thus, from this perspective, the causal sequence runs: investment generates income; and income generates saving; rather than: saving is funds available and these become investment.

An economically meaningful reinterpretation of the accounting identity

The national income identity $C+S+T = C+I+G+CA$ is better understood as: $(S-I^P)+(T-G^*)-CA = 0$. This shows the three sectoral financial balances of the private, government, and foreign sectors, respectively. The identity shows that one sector's financial surplus must correspond to another sector's financial deficit (the sum is always zero). These relationships follow from national accounting and hold "as a matter of accounting."

$(S-I^P)$ is not a pool of saving available to finance investment. It is the net financial balance of the domestic private sector: its income minus its total expenditure. It is the private domestic financial balance, different from household saving. The two concepts can therefore easily be confused: S is gross private saving – income not consumed. The other one is $(S-I^P)$, net private financial saving – the private sector's financial surplus after its investment expenditure.

The mistake is treating $I^P = S+(T-G^*)-CA$ as though the right-hand side were a fund that finances I^P . Algebraically, it is perfectly correct. Economically, that causal interpretation does not follow from the identity.

I prefer the sectoral-balance form precisely because it makes the accounting meaning much clearer: $(S-I^P)+(T-G^*)-CA = 0$ tells us who is spending more than their income and who is spending less than their income, rather than suggesting that one particular flow called "saving" is the prior source of finance for investment.

Examples

Suppose $S = 100$ and $I = 120$. The identity does not mean that the economy first generated 100 of saving and then used that 100 to "fund" 100 of the 120 investment. It tells us what happened to income and expenditure over the accounting period.

Then $(S-I^P) = -20$, and so the private sector is in deficit. To make it more realistic and complete, we add the current account, $CA = -15$, that is, the nation runs a current account deficit. Substituting all into the full accounting identity $(S-I^P)+(T-G^*)-CA = 0$ implies that $(T-G^*) = 5$ (don't forget to change the sign of CA). That is, the government has a fiscal surplus of 5. The interpretation is that the domestic private sector is investing 20 more than it is saving. Its deficit of 20 has as counterparts: a government surplus of 5, and a current-account deficit of 15, which means the foreign sector has a surplus of 15 vis-à-vis the domestic economy. This is a particularly good example of why the interpretation of $I^P = S+(T-G^*)-CA$ as saying that "saving finances investment" is incorrect: investment is 120 even though saving is only 100. The identity is describing *ex post* sectoral financial positions, not a financing mechanism.

Suppose instead that $CA = -40$, that is, we run a larger current account deficit. Then, the algebra of the identity, with $(S-I^P) = -20$, implies that $(T-G) = -20$, that is, the government runs a fiscal deficit. The interpretation is particularly clear: both domestic sectors are in deficit. The private domestic sector spends 20 more than its income, and the government spends 20 more than its revenue. Together they have a deficit of 40. The counterpart is the foreign sector's surplus of 40, reflected domestically as a current-account deficit, $CA = -40$. The point is that the foreign sector accumulates 40 of net financial claims on the domestic economy. In that sense, the foreign sector is providing (financing) 40 to the domestic economy.

Yet, the accounting identity does not tell us the causal financing mechanism. Suppose Philippine firms invest more, financed initially by loans created by Philippine banks. This raises domestic expenditure and income and may also increase imports. If imports exceed exports, the Philippines runs a current-account deficit. Foreigners, consequently, acquire net claims on the Philippines. So, the sequence could be: domestic bank credit provides domestic spending/investment, which induces imports, and then $CA < 0$ (negative current account), the counterpart of which is foreign accumulation of claims.

It is potentially misleading to look at $CA = -40$, and infer the causal story: foreigners first provided 40, then domestic sectors could spend 40. The identity itself cannot establish that direction of causation. This is parallel to the objection to saying that S finances I^P . The identity tells us the ex post financial balances: domestic deficit of 40 equals a foreign surplus of 40, but it does not by itself tell us who initiated the transaction, where the initial credit came from, or whether foreign borrowing was required before domestic expenditure could occur.

In sum: the correct accounting statement is "The foreign sector's surplus of 40 is the financial counterpart of the domestic economy's deficit of 40." A possible economic statement is "The domestic economy's spending was financed by foreign lending." This second statement may be true in a particular case, but we need information about the financial transactions and causal sequence to establish it. It does not follow merely from $CA = -40$.

This distinction is especially important for the Philippines: a current-account deficit does not necessarily mean that it had to obtain foreign currency loans in order to finance domestic peso expenditure.

Consider another subtlety. Imagine I receive PHP10,000,000 of income this year and use PHP5,000,000 of it as a down payment on a newly constructed house. At the household level, it is perfectly reasonable to say: "I saved PHP5,000,000 of my income and used it to

finance the down payment.” But at the macroeconomic level, we cannot infer from this that aggregate saving S constitutes a pre-existing fund that is necessary for aggregate investment I . Why? Because someone's expenditure is someone else's income. The construction company's receipts from my purchase generate wages, profits, supplier income, etc. Those incomes themselves affect aggregate saving.

Final points

I stress that referring to the Philippines as a nation of gluttons is misleading. The reality is that this is a country where most workers earn very low incomes. Save what?

Second, it is important to add that, in general, $(S-I^p)$ cannot be negative for an extended period of time. This would imply that the private sector (households, corporate, financial) is, altogether, in deficit. By experience, we know that the private sector desires to net save; that is, $(S-I^p)$ tends to be positive. The reason is that if $(S-I^p)$ is negative for an extended period, a financial crisis will ensue. This point requires a deeper analysis as the overall private sector financial balance is the sum of the balances of households, corporations, and the financial sector. Also, constructing the identity $(S-I^p)+(T-G^*)-CA = 0$ with actual data is not straightforward because the series come from different sources (central bank, department of Finance, PSA). As a first approximation, taking CA from the central bank (often in deficit) and $(T-G^*)$ from Finance (often in deficit), $(S-I^p)$ is positive most years. This makes sense. In simple terms: since we run a current account deficit, the algebra of the identity tells us that the government must be running a deficit for the domestic private sector to be in surplus. This is why we do not have a financial crisis, i.e., thanks to the fiscal deficit, which accommodates the saving preferences of the private sector.

Third and final, if private saving does not finance investment, what does actually finance it? Investment can be financed by bank credit, retained earnings/internal funds, issuance of securities, or the spending of previously accumulated financial assets. But aggregate current saving S , as defined in the national accounts, should not be interpreted as a pre-existing pool of funds that finances aggregate investment I .