The effectiveness of economic policy under a globalized economic order

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The rapid expansion of world trade in recent years has dramatically altered the economic landscape in nearly every nation. Its impact is felt on literally the whole range of economic activities - our options as consumers, income earners, borrowers and lenders, savers and investors. Agricultural products, consumer goods, and manufacturing equipment flow across nations as never before. So do oil and minerals, knowledge, weapons, migrant labor, illicit drugs, pollution, insect pests and so much else. Multinational corporations increasingly blur the economic meaning of political boundaries. The "gains from trade" that incite all of these transactions across geographical boundaries are no less powerful in the capital markets. Stocks and bonds and other assets increasingly attract foreign buyers. Financial intermediaries alter global portfolios at the speed of electronic communication.

Although the increased volume of international transactions is of major significance, it is also important to see that expanding the playing field doesn’t change the underlying rules of the game. In capital markets, funds still flow to the highest expected return and borrowers still search for the lowest rates of interest. The uncertainty of many foreign ventures means fast and reliable information is more important than ever, adding increased cost and risk to these transactions. But the lure, as always, is the mutual gains from trade across individuals, businesses, or governments with differing economic circumstances and goals, as well as different rates of time preference and attitudes toward risk.

Capital markets

Before we look further at the macroeconomic role of capital markets, it is important to have a clear view of their basic ingredients. Capital markets connect savers and users of funds. Savers make resources available to users in exchange for either a share of ownership (the "equity market") or a promise of future repayment (the "credit market"). The distinctive characteristic of a capital market transaction is that it makes a current commitment to a future outcome.

The presence of uncertainty creates further possibilities for mutual gain between those willing to accept risks associated with an unknown future and those willing to pay for a reduction in that risk. Financial intermediaries - such as commercial banks, savings and loans, insurance companies, investment companies, pension funds, and mutual funds - act as the go-between in such arrangements. For a fee, they reduce the uncertainty facing individual households or businesses wishing to set aside funds now to have more later. Part of their ability to reduce risk is because their size allows them to diversify their assets holdings.

A well-developed capital market provides a wide variety of financial options to suit the particular characteristics and goals of a broad spectrum of savers and borrowers. Put another way, capital markets bring together suppliers and demanders with differing economic circumstances, time preferences, and attitudes toward risk, all hoping to make a favorable trade. The extent of mutual gain is an index of capital market efficiency, a measure of how successful financial intermediaries are at reducing and sharing the risks of an uncertain future. The growth of capital markets and the spread of financial intermediation creates "gains from trade" in precisely the same way as increased international trade or increased monetization of the economy. It is an increase in institutional efficiency that expands productive capacity.

Events and policies that impede capital markets show up as a reduction in institutional efficiency and inflict a negative sup-

See GLOBAL, next page
GLOBAL...
from previous page

ply shock on the macroeconomy. Nations without well-organized capital markets are at a great disadvantage in making the “save now or consume later?” choice that lies at the heart of the growth process. Lacking well-developed and stable capital markets, they find it difficult and costly to channel resources from saving to investment and very expensive to attract resources from outside the economy. It could be one of the desperately poor nations of the world or the more advanced economies of the former Soviet bloc countries struggling to set up market structures. Without effective capital markets, the economic growth so fervently sought will remain beyond their reach.

Capital markets and monetary policy

The links between capital markets and macroeconomic policy run in both directions. The most obvious is capital reactions to policy changes that alter expectations of future economic performance. Bond markets are especially sensitive to changes in expected inflation and therefore to actions of the Central Bank. But it is also true that policy makers use feedback from the markets as a way to assess the results of their policy actions.

Suppose the Central Bank decides to alter the rate of growth of the money supply. The Central Bank typically does this through open market purchases (or sales) of existing national government bonds. When it purchases bonds, for example, new reserves are injected into the banking system which are then loaned out in a process that expands the nation’s total stock of money. Investment portfolios must be altered to absorb this increased supply of money and to reflect the reduced amount of government bonds holding available outside the banking system. If the Central Bank moves in the opposite direction and sells bonds on the open market, then portfolios will absorb the influx of bonds from the CB’s vault and adapt to the reduced monetary growth.

If this monetary policy change comes as a surprise, it will create temporary misperceptions followed by a revision of expectations in future economic performance. The basic Aggregate Supply framework shows us how an unexpected shift in aggregate demand can have short-run impact on real output, real interest rate and real exchange rate. It can also have long-run impact on the price level, the actual and expected rates of inflation and therefore on nominal interest and exchange rates.

The current prices of stocks and long-term bonds will respond to this constellation of changes as investors realign their portfolios in light of the new information. Expectations of risk inflation are built into nominal interest rates. These rising nominal interest rates mean falling prices of existing bonds since their future interest payments, fixed in nominal peso terms, will have lower purchasing power as inflation rises. Even rumors of monetary changes can trigger portfolio adjustments as investor’s scurry to avoid losses and accumulate gains.

So monetary policy affects capital markets directly by changing the relative availabilities of two key assets-money and government bonds, and indirectly through its economy-wide influence on output, price, and interest rates. But the causality can also run in the other direction, with policy makers reacting to changing signals in the capital markets. This is because the capital market provides a continual assessment of how current events or policies are expected to affect coming economic performance.

It is not an infallible crystal ball, of course, but it is a relatively sensitive instrument that reflects an overall market verdict, based on the latest information, as to what lies ahead for the economy. It reveals an outline of the future based on how the so-called smart money is placing its current bets.

For example, if expected events and policies are viewed as contractionary and likely to lead to recession, we would expect to see falling prices of stocks (reflecting reduced future earnings of corporations), but stable or event rising bond prices (reflecting steady or declining expected inflation that usually accompanies recession). Policy makers may use these signals (in combination with their own careful economic analysis of the economy) to move toward a more expansionary policy. As they implement the expansion they will surely keep an eye on market responses to see if capital market participants are convinced that sufficient stimulus has been applied. This two-way linkage between policy and capital markets has become increasingly evident in recent years and there is general belief that it can operate as an important constraint on policy excesses.

Capital markets and fiscal policy

Fiscal policy’s primary task is the day-to-day job of keeping the government operating. When public spending out runs current revenues, as it does in most countries most of the time, the government must either print money (another way to tax) or borrow (postponing the tax). Experiences of many countries have vividly shown that tax postponement is sustainable under certain conditions, but can also end up in the unsustainable, consumption-draining category if the borrowing is not matched by expected future returns.

The connection between deficit/debt and capital markets is that government bonds are a large part of our investment portfolios and hence in our choice between “now or later?” Treasury bills not only offer a competitive rate of return but are widely regarded as virtually default-free investments, giving them an important role in asset diversification. Households, businesses and financial intermediaries have made them a basic ingredient in their investment strategies. In addition, we have seen that the CB buys and sells government securities via “open market operations” as its primary means of controlling bank reserves and, thereby, of changing the rate of growth of the money supply.

This adds up to a national debt/asset of sizable proportions and which serves
a variety of functions in the capital market. To taxpayers, it represents tax postponement; to the investor, a relatively low-risk option for portfolio diversification; and to the Central Bank, a conveniently neutral asset for conducting open market operations to control money growth. But to those seeking funds for capital expenditures, public borrowing can mean head-to-head competition for the saver’s peso. The process through which increased deficits bid up interest rates to attract funds that would otherwise go to private investment (through purchases of corporate bonds or stocks rather than government bonds) is called crowding out.

Most economists see “crowding out” as the primary reason for concern with continued large public deficits. Continued large deficits are seen as diverting private savings from private investment and thereby slowing the economy’s rate of growth.

In carrying out its basic job of transferring resources from private to public use, fiscal policy also has the potential to influence both the short-run stability of the macroeconomy and, through capital markets, its long-run rate of growth. These three dimensions of fiscal policy will often be in conflict with each other setting the stage for some very difficult policy choices.

Globalization of capital markets

One dimension of expanded world trade (in goods and services and capital markets) is very important for macroeconomic policy making. In the analysis of the macroeconomy, the expansion of foreign trade shows up in two ways. On the supply side, the more efficient use of resources means a positive supply shock that shifts aggregate supply and production possibility frontier to the right. On the demand side, more world trade means a large role for exports and imports. Any event that increases our real rate of interest will also increase the international demand for pesos. This in turn means a rise in the real exchange rate(s), discouraging exports and encouraging imports.

The final step is to see how this international transactions involved. In other words, the larger the foreign sector the smaller the impact of fiscal changes on aggregate demand.

For monetary policy, the effect is the opposite. Since monetary expansion causes a short run drop in the real interest (shifting LM to the right), this will lead to a decline in the international demand for the peso and exchange rate depreciation. The lower value of the peso will stimulate our exports and reduce im-
ports, increasing net exports. Hence, in an open economy, monetary policy affects aggregate demand through two channels—the lower rate interest rate expands both investment spending and net export spending. The larger the foreign sector, then, the stronger the impact of monetary changes on aggregate demand.

Conclusion

The globalization of capital markets is a companion to the expansion of world trade in goods and services. As countries have lowered barriers to trade and technological change has accelerated the flow of information, capital markets have become increasingly global. One sequence for countries operating under flexible exchange rates has been to weaken the impact of fiscal policy on aggregate demand. The rising real rate of interest from expansionary fiscal policy not only crowds out investment demand but also reduces net export demand via exchange rate appreciation. Monetary policy, on the other hand, is enhanced by international linkages, since inverse short run impact on real interest rates increases its demand-side impact.

References


Personal investing and wealth accumulation can be both compared and differentiated from the investments that a fund manager does for an institutional account. As in investing for a pension fund or a foundation, for instance, the individual who seeks the best for his investments tries to develop an investment philosophy that would yield optimum returns, given his or her appetite for risk, and then proceeds to make the investments. The similarity ends there, however. For, while such a long and tedious process may bring better returns, the yields for the individual investor, such wealth, accumulated over one’s lifetime in various forms of assets, if not carefully planned and managed, may not always be available when needed, or worse, dissipated or otherwise reduced for reasons, among others, as a large transfer tax bite, forfeiture by creditors, or mismanagement by the eventual heirs.

The Need for a Properly Planned Estate

Consider a number of typical day-to-day cases of individuals who bring their problems to their bankers, their lawyers or even their accountants:

Client A, a successful physician, from the exercise of his profession, is used to taking home to his family a tidy sum of say, P200,000 monthly. He has been used to seeing that regular cash flow, which either finances the wife and children’s extravagant lifestyles, and probably leaves a few thousands for some occasional investments. Unfortunately, A (the sole breadwinner of the family) meets an accident and dies, and the family wakes up to discover that not only have they lost a provider, but worse, cash and liquid assets are hardly enough to support them for the next six months.

No life insurance was left behind, and investments were mostly in non-earning real estate properties and in a few stocks, the prices of which deteriorated with the market.

Or take Client B. A man in his middle forties, B boldly decides to leave his present job to put up a business of his own. His business needed a sizeable amount of capital so he decides to capitalize it at P2 Million, and the wise businessman that he confidently thought he was, he decided to leverage and borrow a bigger amount from his bank for additional working capital. His banker, of course, covers B’s obligation and asks him to pledge his personal assets through a suretyship agreement. Unfortunately, his business did not do too well, and after a few years, he finds himself losing not only the business but personal assets that he had intended to leave to his children.

Or take Spouses C and D. The couple, over the years, have been accumulating income generating properties, mostly in the form of apartments and condominiums that they have been renting out. The couple’s philosophy was, while the properties were earning rent today, the same properties can be transferred at the proper time to each of their children. Mr. C, however, derives other forms of income. A practicing architect with his own firm during the day, he finds time to teach in the evenings. The situation, however, makes him the most worrisome individual every time he asks his accountant to prepare his tax returns. The combined income brings him to a very high income tax bracket. He, therefore, has to pay a sizeable amount of tax on top of some final taxes that he had paid for some of his and his wife’s combined income.

Fortunately for all of these individuals, and probably for some of us here today who may be faced with similar situations, a number of alternatives can be done to make possible the accumulation and transfer of properties in the most efficient manner.

Estate Planning

The activity of estate planning involves the design of a plan through which various properties accumulated by an individual over his/her lifetime are incorporated into an arrangement in order to safeguard his/her maximum welfare and assure a proper administration of the estate in the future for that individual’s family members.

Two things ought to be pointed out at this stage.
One, while it may invariably involve some activity of investing in order to accumulate wealth over a period of time, it goes beyond simply investing and into the realm of ensuring that an orderly transfer of accumulated wealth is done to benefit the individual’s family.

And Two, while the trust officer of a bank ordinarily takes the most active role in crafting the estate plan and in managing the individual’s properties, estate planning is a collective job of the trustee, the individual himself and his accountant, his lawyer, and in some cases, even his insurance underwriter.

The principal objectives of estate planning can be summarized in the following manner:
- to save on taxes
- to ensure liquidity of the estate
- to reduce expenses incurred in property transfer to heirs
- to provide competence in property transfers

While estate planning describes the collective services done to prepare the client for what he eventually needs to do - transfer properties to his intended beneficiaries, what should be interesting to discuss are the tools of estate planning: the instruments and devices that will serve the objective we pointed out earlier. How versatile trust is can be seen from the many different kinds of trusts now in use.

Living Trusts

When the trustor wants the transfer of some or all of his properties to take effect during his lifetime, the trust is called a “living” or “inter vivos” trust. The advantage of doing a real living trust can actually be best appreciated from a taxation viewpoint. When one transfers a property during his lifetime, as when he donates a property in trust to a child, the property no longer becomes part of his estate at that point. Which means at least two things: (1) if the property is income-generating, it is now taxed to the trust (or beneficiary, if it is a simple donation) as a new taxpayer, and therefore, allows a valid income-splitting that results in much lower income taxes; and (2) when the owner dies, the property is no longer part of his estate and will no longer be subject to estate taxes.

It might be well to remind ourselves that under our gift tax laws, gift taxes are generally cheaper than estate taxes, as these taxes are so structured as to encourage early distribution of the nation’s wealth through lifetime gifts or donations. And since gift taxes are computed on the basis of donations made during a taxable year and independently of donations made in earlier years, splitting of donations gives further transfer tax savings. Moreover, when the property being given as a gift appreciates in value over time, a living trust or a gift becomes more advantageous over a transfer after death.

Tables 1, 2, and 3 will explain what I mean. The first two tables show the most current version of the transfer tax tables, while the third table shows comparative transfer taxes due, assuming various amounts of transfers made by way of a gift and a transfer after death.
However, doing a living trust does not necessarily carry with it the intent to just save on taxes. Other valid reasons may include:

- making sure that the property eventually goes to the intended beneficiary, or
- the fact that the owner lacks the time to manage a property properly as he may have other equally important concerns; or
- he may want to insulate his properties against his creditors and wants the assurance that certain properties will eventually go to intended beneficiaries.

For this reason, living trusts may have several variations.

It may be revocable - a situation where the owner reserves the right to get back his property. People use revocable trusts when they are not certain that they will not, in the future, need the entrusted property for themselves or will not want to later on change their beneficiary. A practical use of this device is when a trustee creates a trust that requires its automatic return to him after a lapse of a certain period of time or upon the happening of a condition or an event. This is an example of a reversionary trust. For instance, a good well-to-do child might wish to set up a trust out of some of his properties for his aged mother as long as she lives, with instructions that the same property goes back to him upon his mother's death. This does not involve a donor's tax, but, obviously, the property remains part of his gross estate should he die during the term of the trust.

On the other hand, where one is already decided on setting aside portions of his lifetime investments, say before retirement, to specific beneficiaries and wants to gain tax-related advantages, aside of course from being able to enjoy the bliss of his or her retirement years, then the irrevocable trust is the proper instrument to consider.

Other variants of the living trust are also worth mentioning. When an agreement is executed before any property is actually transferred to the trustee, the trust is called a dry trust. A variant of a dry trust is the so-called step-up trust. Under this arrangement, the trustee holds no property until the happening of a certain event. For example, an active individual may wish to set up a trust for his children that will take effect only when he retires or otherwise becomes incapacitated or unable to support them. In the meantime, he continues to manage the property. The trust remains dormant or "dry" until the trustee is informed that is sufficient to pay for the expenses of the priest-to-be. A directive to the Bank to pay out all the income to the beneficiary in the year it is earned suits his purpose.

In another type of arrangement called a discretionary trust, the trustee is given authority to decide whether to accumulate or distribute in accordance with the needs of the beneficiaries. Where there are many beneficiaries and the trustee is authorized to decide how much to give each one, not necessarily equal but according to need, the trust is called a sprinkling trust. This achieves considerable income tax savings because income is spread out among many taxpayers.

Among parents whose children tend to squander their money, an alternative is a spendthrift trust. This trust prohibits the beneficiary from transferring his interest in the trust property prior to the actual distribution of the income or principal to him as well as prohibits him from putting his interest as collateral for loans. Thus, it prevents a rather ingenious or gullible beneficiary from prematurely spending away his interest by excessive borrowings or assignment of future interests.

A person considering how to go about his estate should not overlook his testamentary trust, or even his will. In the absence of any lifetime transfer, his will is his entire property transfer program especially for heirs that are still minors. He is assured that specific items of the estate goes to his intended beneficiaries.

Testamentary Trusts

Other than transferring accumulated assets during one's lifetime, let us not discount the presence of individuals who might also decide that transfers of properties should only be done through an act that is effective only after his death. In which case, as distinguished from living trusts, the individual goes through the formalities of a will, and for this reason the trust he creates is a testamentary trust.

A person considering how to go about his estate should not overlook his testamentary trust, or even his will. In the absence of any lifetime transfer, his will is his entire property transfer program especially for heirs that are still minors. He is assured that specific items of the estate goes to his intended beneficiaries.
Life Insurance and Life Insurance Trust

Not to be overlooked when planning one's retirement years is the role of life insurance and life insurance trust. Life insurance is, after all, now only known as a person's instant estate builder, but, in a carefully planned estate, it holds the key to the liquidity of the estate owner's family, should the unexpected happen.

Obviously, there are two elements to that last statement that needs to be further explained.

Life insurance is a person's source of instant estate because for the amount of premium that one pays for during his lifetime or for a defined payment period, his family is assured of proceeds many times over that premium cost. Thus, depending on the person's age and health condition at the time he insures himself, he can, say, buy a P10 million coverage for a very reasonable premium cost.

My second statement was that life insurance holds the key to the liquidity of your family, should the unexpected happen. Which means that, most other properties you accumulate during your lifetime, say, real estate properties, stock investments, country club memberships, may not be immediately convertible to cash for one reason or another, to pay for last illness expenses, debts, taxes and other liabilities that may have to be settled before any transfer or sale can even be made, unlike the proceeds of life insurance. Thus, without having to resort to sale of assets at sacrifice of fire-sale prices, proceeds of life insurance can be used to provide the much-needed liquidity to a person's estate after death.

However, despite the presence of life insurance in a person's estate plan, these proceeds, if improperly handled, can defeat the purpose for which the person covers himself.

To prevent this from happening, banks' trust departments offer an alternative: the life insurance trust. Through this device, instead of the ordinary life insurance arrangement where the insurer simply releases the proceeds of insurance to the named beneficiaries upon the insured's death, the insured under a life insurance trust can describe in detail how he wants to allocate, manage and distribute the proceeds of his coverages, through his trustee-bank.

To give you an example, if Mrs. Cruz buys a coverage for P20 million, ordinarily she names the husband and children as beneficiaries, and the latter get their shares upon her death. However, in an alternative arrangement, she can name the trust department of a bank as the beneficiary of the insurance through a life insurance trust, and in the life insurance trust, describe exactly how the proceeds are to be managed. She can specify for instance: "I want 50% of the proceeds to go to my husband, and 50% distributed equally to each of my surviving children, provided each of them are of major age at the time of my death," and continue to declare that "in case any of my children are still minors, the trustee shall hold and invest their shares of the proceeds until they finish college or reach the age of 25, whichever comes first, and provide them with monthly allowances and reimburse their educational expenses in the meantime that their full share has not been released to them."

In addition, the Bank may be called upon to manage the policy even while the policyholder is still alive by giving authority to the Trustee to manage the cash surrender values of the policy or otherwise manage a fund that the trustor may want to leave with the trustee bank to manage or pay premiums when due.

Finally, before I leave life insurance altogether, one use of this estate planning tool is to provide a temporary fund after death, which when invested, may be used to temporarily substitute for the monthly income that a person is used to take home to his family when he was alive, until such time that family members find other ways to generate the same kind of income that will shorten their adjustment from the loss of a breadwinner.

Final Considerations in the use of Estate Planning Tools

To wind down our discussions in property transfers, allow me to point to some considerations that used to be made before deciding which device to properly use, or whether to do one at all:

- the financial circumstances of the donor
- the personal circumstances of the donee
- the health condition of the recipient
- the probability that the property being transferred will appreciate in value over time
- the possibility of a gift falling under transfers in contemplation of death
- the possibility that indiscriminate gifts or donations will violate the legitime of other compulsory heirs.

Corporate Retirement Trust Services

Since we have decided to tackle preparations for our retirement years, I
would like to talk about the services that banks do to manage companies’ retirement plans.

Among the most important of trust services provided by banks is the management of employee benefit plans, which refers to pension, gratuity and provident plans that companies set up to prepare their officers and employees for the day when they need to leave the company either due to resignation or retirement.

The rationale for the setting up of trusteed retirement plans in companies stems from existing legislation that provides tax incentives for the setting up of such plans. Under Republic Act No. 4917, companies’ employee benefit plans properly set up and registered with the BIR enjoy the following tax benefits:

- employer contributions are considered deductible business expenses for purposes of computing the companies’ corporate income tax payable;
- employee benefits are considered tax exempt income in the year they are received, provided the employee meets certain conditions of age and tenure in the company and are available for tax exemption for the first time; and
- the income of the fund is tax exempt,

thus effectively bringing down the actuarial cost of funding the plan.

While the trustee’s main function is to manage the portfolio of investments consisting of the companies’ and/or its employees’ contributions to the fund, the trustee’s role may actually start from setting up the plan, assistance in preparing and filing of documents needed to secure tax exemption of the plan contributions, income and benefits, assistance in securing actuarial services to determine actuarial soundness of each plan, and in the disbursement of retirement benefits.

Employee benefit plans may be one or a combination of non-contributory or contributory plans. Non-contributory plans, where only the employer contributes, may either be the pension type, where benefits are paid periodically from the time of an employee’s retirement, or the gratuity type, where a lump-sum benefit is paid upon the retirement of the employee. On the other hand, contributory plans, or otherwise known as the provident type, consists of contributions from both the employer and the employee, and is one where depending on the vesting rules of the plan may or may not entitle the employee to the employer’s contribution made in his name.

Conclusion

I have attempted to describe the variety of financial devices and instruments available to the individual to help him or her plan out his retirement years without having to worry about the orderly transfer of his or her properties to their intended beneficiaries. An appropriate instrument or instruments can be crafted for nearly any objective that the person needs to be addressed. A Trust department of a bank, an important personality in every estate planning team, is just a phone call away.

References


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