

Chapter 13: Fiscal and Monetary Policies

Comic strip idea: Fiscal policy decides where public money goes; monetary policy influences the cost and availability of money. Both affect the economy, but they cannot solve every problem alone.

A family hears several economic announcements in the same week. Congress approves a larger budget for classrooms and public hospitals. The government raises an excise tax on a harmful product. The Bangko Sentral ng Pilipinas (BSP) increases its policy interest rate because inflation is rising. Later, a bank raises the interest rate on housing and business loans.

These decisions come from two different areas of economic policy. Fiscal policy concerns government revenue, spending, and borrowing. Monetary policy concerns interest rates, credit, liquidity, and the overall conditions under which money moves through the economy. Both policies influence employment, prices, investment, public services, and household living standards, but they work through different institutions and channels.

This chapter explains how fiscal and monetary policies work, why governments use expansionary and contractionary measures, how the two policies can support or weaken each other, and why good policy depends on timing, design, and implementation.

A. Fiscal Policy

Fiscal policy is the use of government revenue, spending, and borrowing to influence economic activity and to finance public responsibilities. It is often discussed in relation to recessions and inflation, but its role is much broader. Through the national budget, the government decides which services will be provided, how much will be spent on them, who will pay through taxes, which groups will receive assistance, and how the costs of present decisions will be shared between current and future generations.

One important function of fiscal policy is the **allocation of resources**. Markets do not always provide enough of the goods and services that society needs, especially when the benefits are widely shared or when access should not depend only on a person's ability to pay. Government spending therefore finances public schools, hospitals, roads, flood-control systems, disaster preparedness, public safety, environmental protection, and other services that support both daily life and long-term development. These choices also affect economic priorities. A larger budget for health and education can strengthen human capabilities, while investments in transport, energy, and digital infrastructure can improve productivity and connect communities to jobs and markets.

Fiscal policy also performs a **redistributive function**. Income and opportunities are not distributed equally, and some households face greater risks because of poverty, illness, unemployment, disability, old age, or disasters. Government can respond through progressive taxation, cash transfers, subsidies, pensions, health insurance, and other forms of social protection. These measures do not simply transfer money from one group to another. They can also reduce barriers that prevent people from studying, obtaining healthcare, finding work, or recovering from shocks.

The effectiveness of redistribution depends on whether programs are well targeted, adequately funded, accessible, and protected from political favoritism.

A third function is **economic stabilization**. During a recession or crisis, households may reduce spending, firms may delay investment, and unemployment may rise. Government can support demand by increasing public spending, accelerating infrastructure projects, providing income support, or reducing selected taxes. These measures can help prevent a temporary slowdown from becoming deeper and more prolonged. When inflation becomes broad and persistent because demand is growing faster than the economy's capacity to produce, government may instead reduce nonessential spending, improve revenue collection, or phase out poorly targeted subsidies. Fiscal policy can therefore help stabilize output, employment, and prices, although its effects depend on timing, implementation capacity, and coordination with monetary policy.

These three functions are closely connected. A school-building program allocates resources to education, supports employment and local demand, and can reduce inequality by improving access for poorer communities. A health insurance subsidy redistributes resources, protects families from catastrophic expenses, and can also stabilize household consumption during illness. For this reason, fiscal policy should not be judged only by the size of the budget or deficit. It should also be assessed by the quality of public services, the fairness of the tax system, the groups that benefit, and whether spending strengthens the economy's long-term capacity.

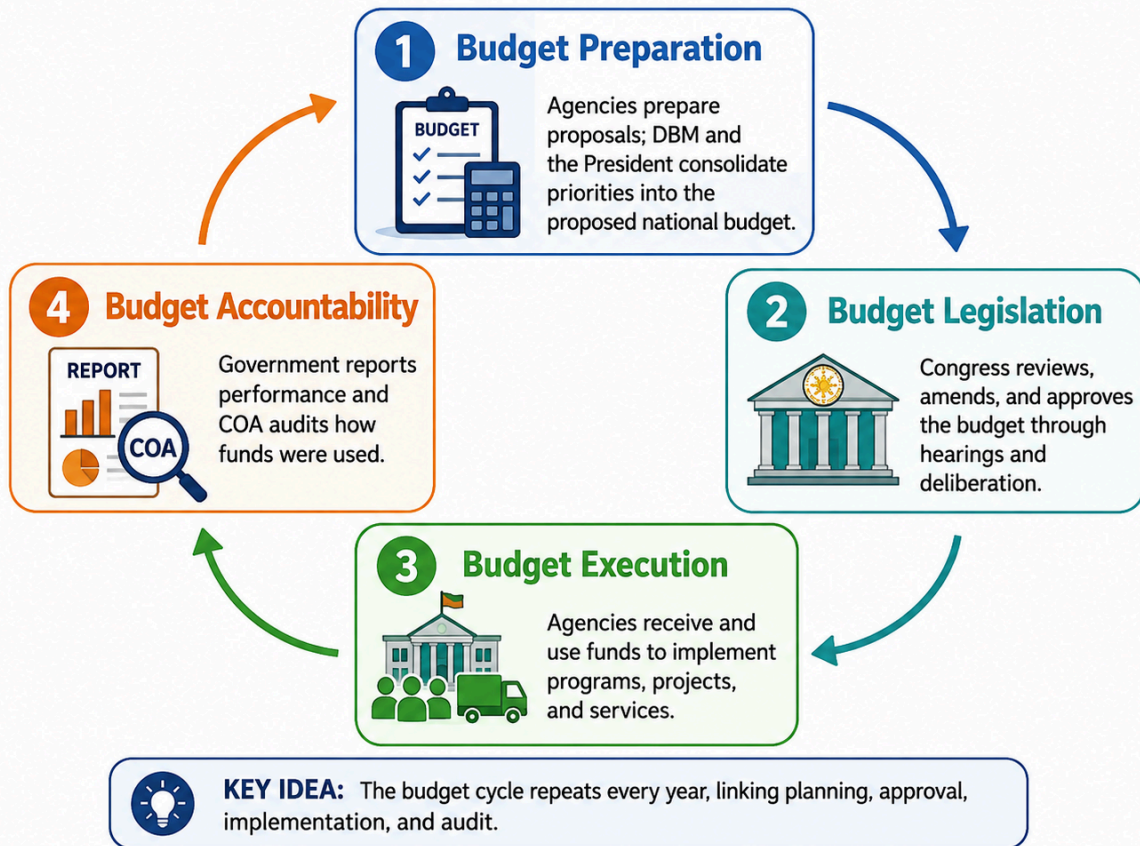
1. The national budget

The national budget is one of the most important fiscal tools of the government. It is the government's annual plan for collecting and using public money. It reflects policy priorities. However, appropriation doesn't automatically turn to outcomes. A school budget improves education only when classrooms are actually built in the right places, teachers are hired, learning materials arrive, and funds are used efficiently.

For fiscal year 2026, the Philippine General Appropriations Act authorized a national budget of ₱6.793 trillion. The size of the budget is important, but do we analyze this? We can ask the following: What problems are being addressed? Who benefits? Are the programs properly designed? Are funds released and spent on time? Do they produce measurable improvements?

Answering these questions requires an understanding of the budget process. The Philippine budget cycle has four main stages: budget preparation, budget legislation, budget execution, and budget accountability. These stages overlap because government may be implementing the current budget while preparing the budget for the following year. The budgeting process also happens both at the national and local (provincial, municipality, city, barangay) levels.

The 4 Main Stages of the Budget Process



During **budget preparation**, executive agencies estimate the funding they need for the following year. The Department of Budget and Management issues guidelines, while agencies prepare proposals based on government priorities, existing programs, expected revenues, and fiscal limits. The executive branch combines these proposals into the National Expenditure Program, which the President submits to Congress.

This stage is important because many major decisions are already made before the proposed budget reaches Congress. Agencies decide which programs to continue, expand, reduce, or terminate. They also determine the proposed location, cost, and design of projects. Poor planning at this stage may later result in projects that cannot be implemented, duplicate existing programs, or fail to address local needs.

During **budget legislation**, the House of Representatives and the Senate review the proposed budget. Legislators conduct hearings, question agencies, propose amendments, and approve an appropriations bill. The two chambers reconcile their versions through a bicameral conference committee before sending the final measure to the President. The President may sign the bill and veto particular items or provisions.

Legislative review is necessary because Congress represents citizens and has the constitutional power to authorize public spending. However, amendments should remain transparent and connected to clear policy objectives. When projects are inserted late in the process without adequate technical review, it becomes harder to assess their necessity, cost, location, and readiness for implementation.

During **budget execution**, agencies receive authority to obligate and spend the funds approved by Congress. They conduct procurement, enter into contracts, hire personnel, transfer funds, and deliver programs and services.

A large appropriation does not guarantee that the money will be used effectively. Projects may be delayed because of incomplete plans, procurement failures, land disputes, shortages of qualified personnel, weak coordination, or limited implementation capacity. Some agencies may report high spending but still produce poor outcomes. Others may have low spending because the projects included in the budget were not ready to begin.

During **budget accountability**, agencies report how public funds were used and what programs produced. The Department of Budget and Management monitors financial and physical performance, while the Commission on Audit examines whether government transactions followed laws and regulations and whether public resources were properly accounted for. COA's audit process includes planning, fieldwork, reporting findings, and monitoring agency responses.

Accountability should not begin only after the money has been spent. It should influence the next budget. Programs that consistently fail to reach beneficiaries or achieve their objectives should be corrected, redesigned, or discontinued. Programs that demonstrate strong results may be expanded.

Case Study: Opening the Budget Process—How Civil Society Participation Can Reduce Waste and Corruption

The national budget determines which public needs receive funding and which must wait. It pays for schools, hospitals, social protection, transport systems, agriculture, disaster preparedness, and other public services. Because it distributes trillions of pesos, the budget process also creates opportunities for political bargaining, weakly planned projects, and corruption.

These risks are especially serious when major changes are made late in the process and are difficult for the public to examine.

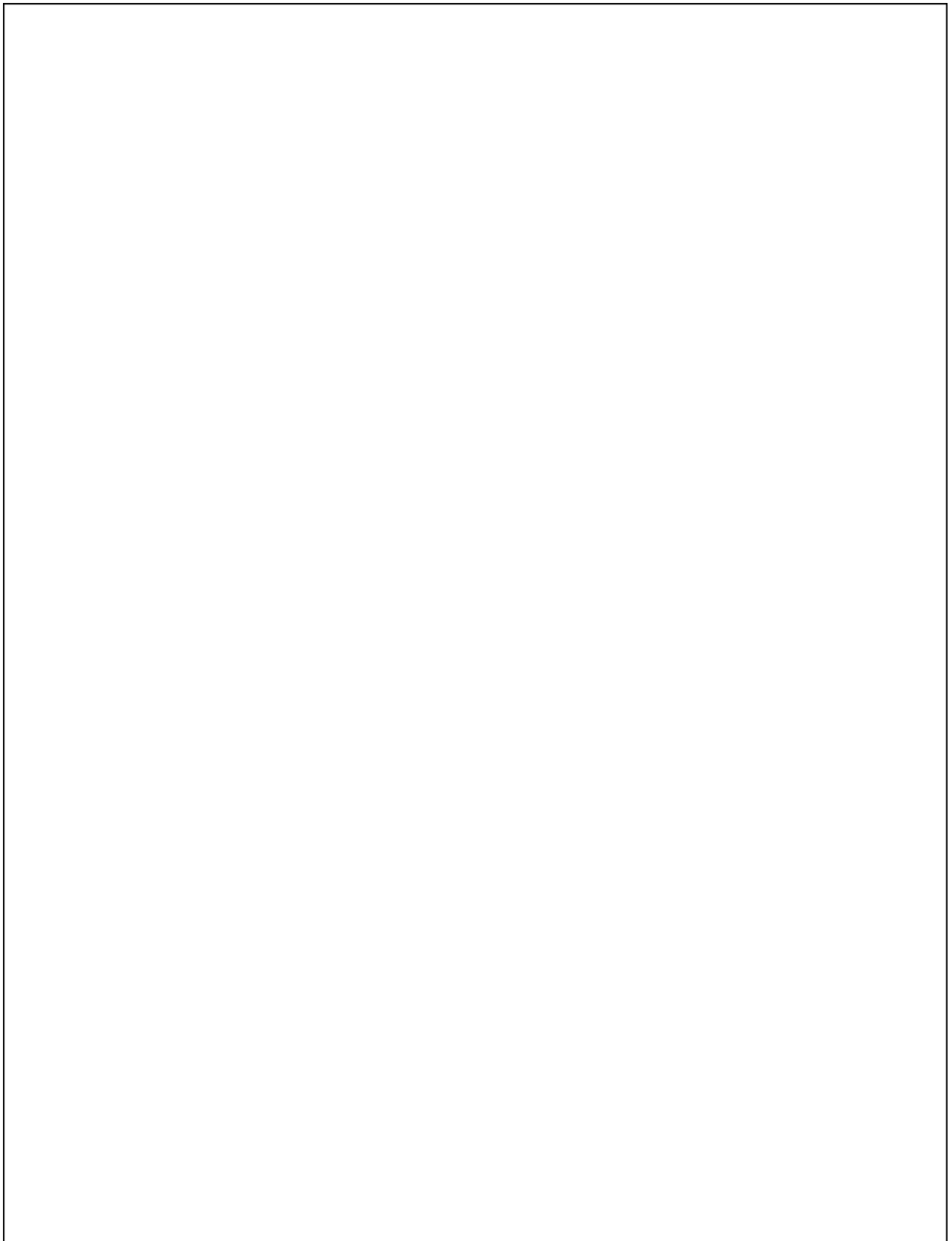
The problem of the closed bicameral process

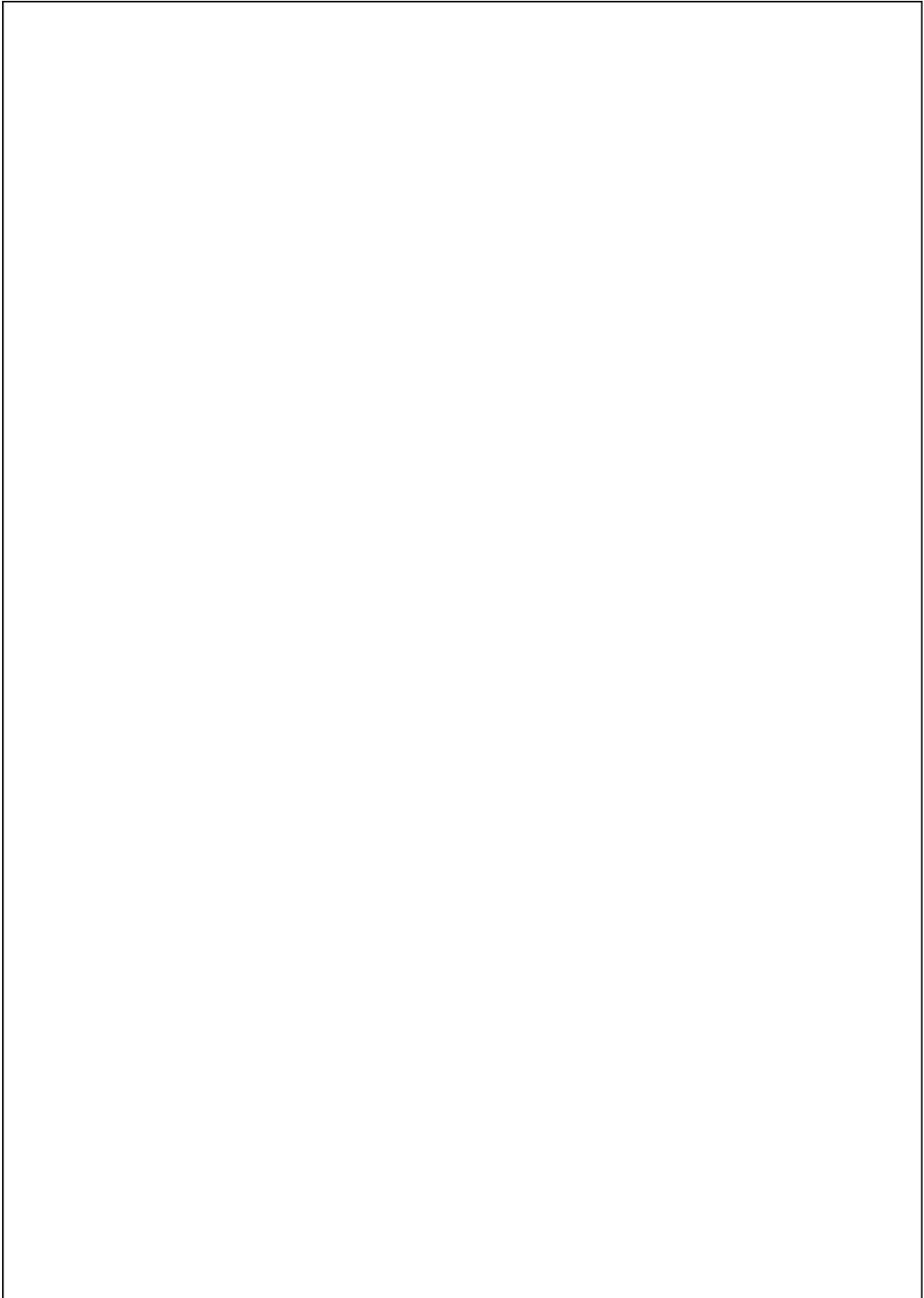
The House of Representatives and the Senate approve separate versions of the national budget. A bicameral conference committee, commonly called the **bicam**, is then formed to reconcile their differences.

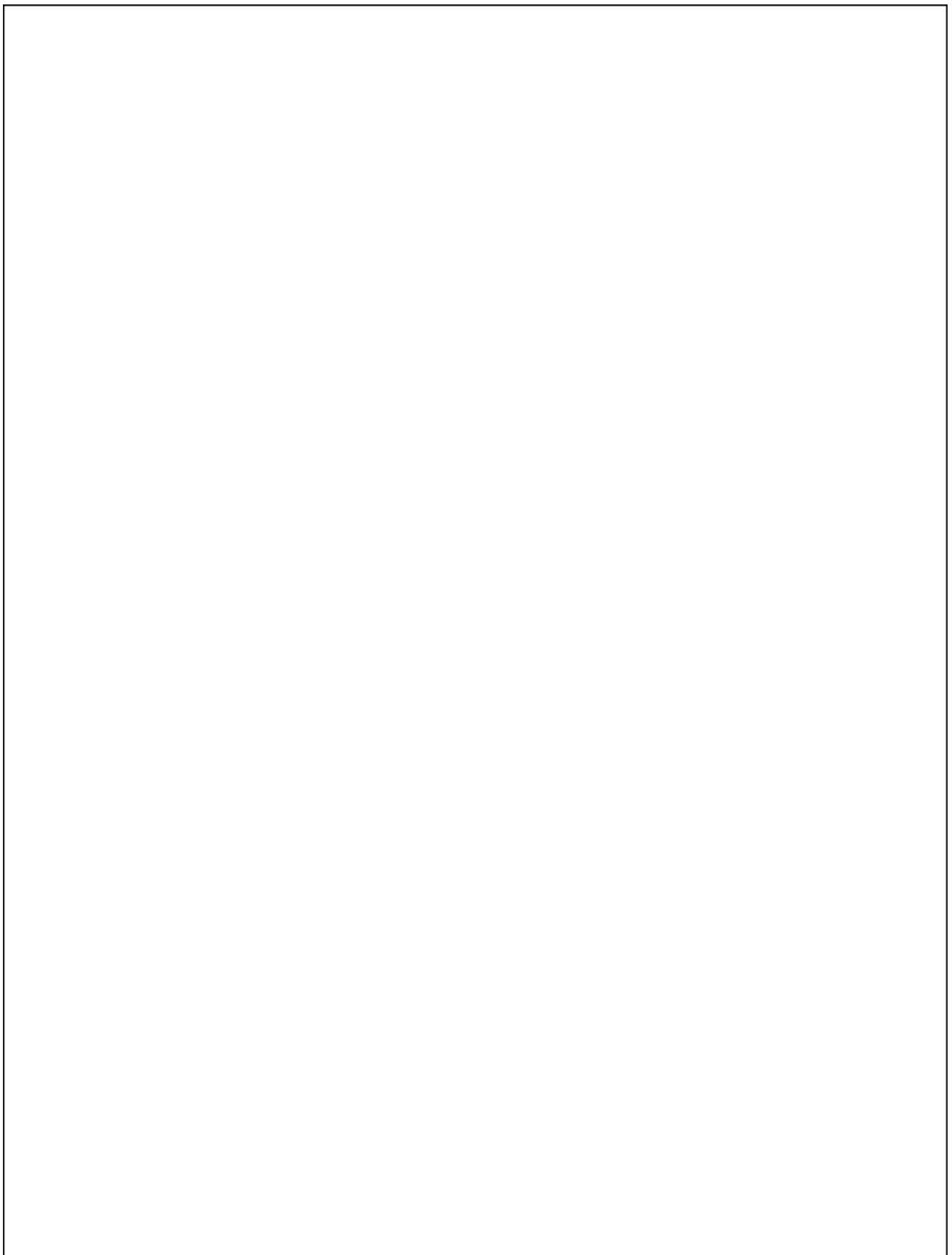
The bicam performs a necessary function. The two chambers cannot send conflicting budget bills to the President. However, the bicam has traditionally been one of the least transparent stages of the process. Deliberations were often conducted behind closed doors, with the public seeing the final conference committee report only after many decisions had already been made.

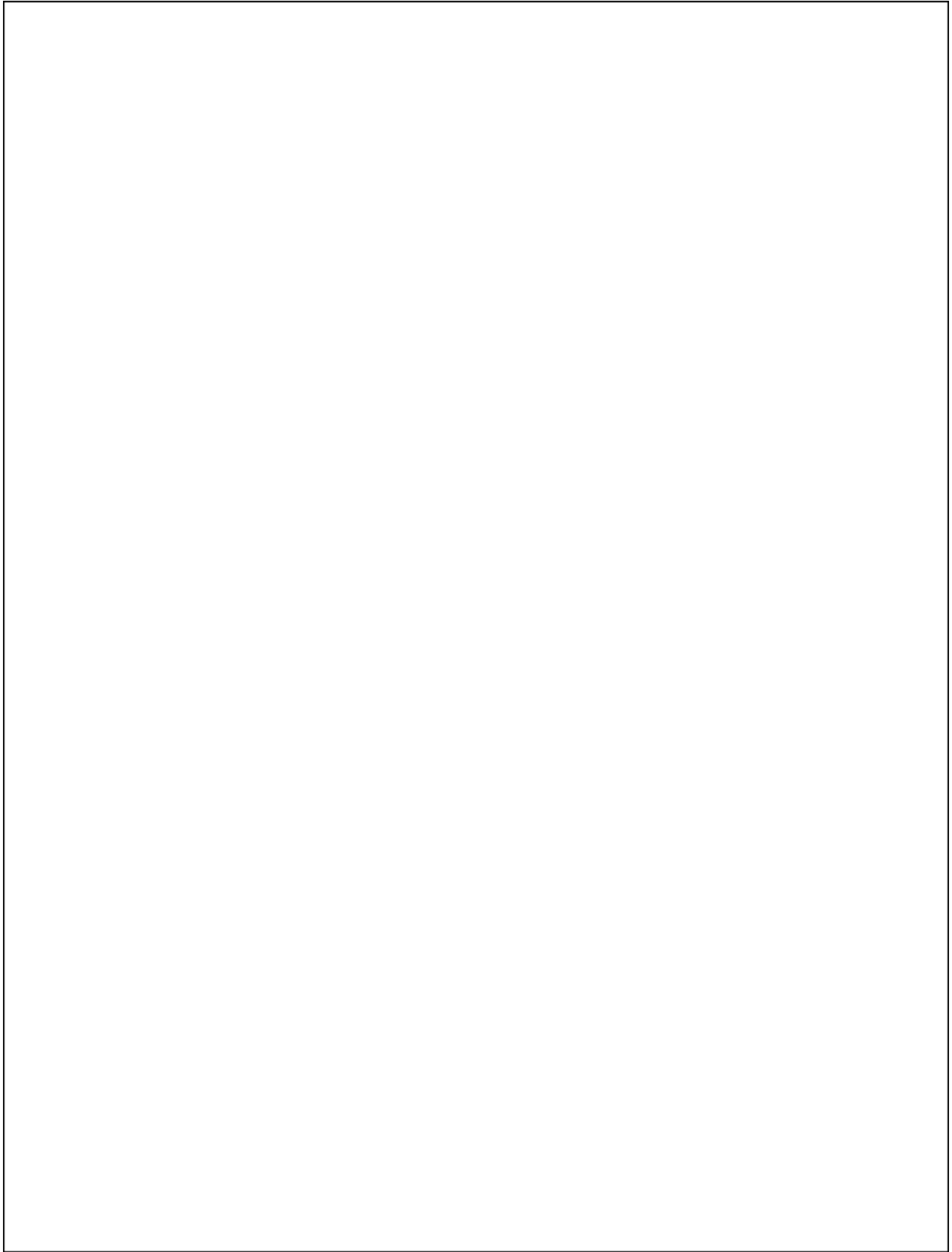
This created an accountability problem. Large appropriations could be added, removed, or transferred without a clear public record of:

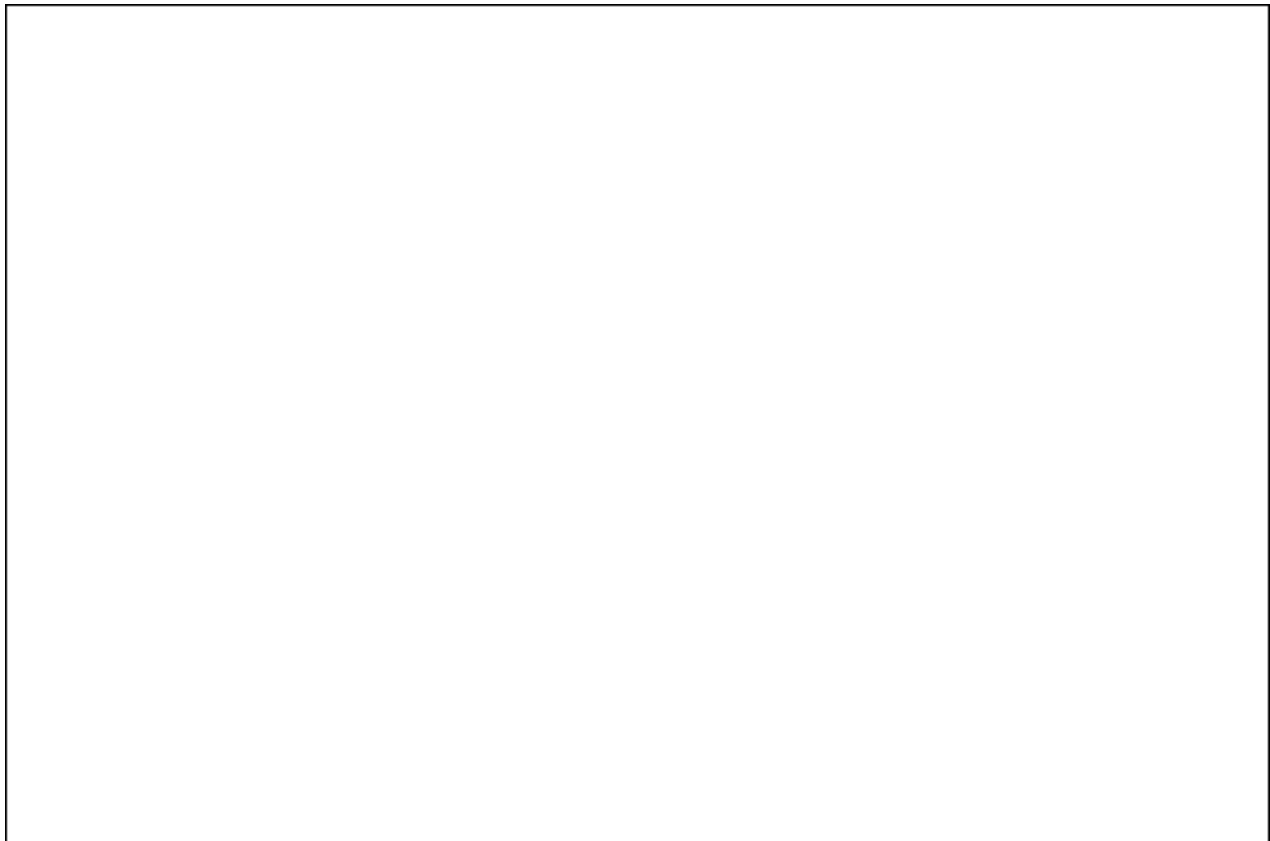
- who proposed the change;
- what problem the expenditure was intended to solve;
- how the project cost was estimated;
- whether the responsible agency had requested it;











2. Government spending

Government spending covers several kinds of public expenditure, including the purchase of goods and services, compensation of public employees, infrastructure investment, transfers to households, subsidies, and interest payments on public debt. These forms of spending do not affect the economy in the same way. Their impact depends on what is financed, how quickly the money is spent, who benefits, and whether the program or project is implemented well.

Current spending finances the government's regular operations and services. It includes teachers' and health workers' salaries, medicines, school supplies, utilities, maintenance, and social assistance. This spending keeps public institutions functioning from day to day. Cutting it too sharply may weaken service delivery even when buildings and equipment are available.

Capital spending creates or improves assets that can be used for many years. Examples include roads, irrigation systems, classrooms, laboratories, public transport facilities, hospitals, and flood-control infrastructure. Good capital projects can raise productivity, improve access to services, and support long-term development. However, these benefits depend on proper planning, suitable location, adequate maintenance, and coordination with other services. A new hospital building, for example, will have limited value if it lacks doctors, nurses, equipment, medicines, and operating funds.

Transfers provide income or financial protection without requiring the recipient to supply a current good or service. These include pensions, conditional cash transfers, unemployment support, disability benefits, and emergency assistance. Transfers can reduce poverty and help households maintain food consumption, schooling, and healthcare during difficult periods. Their effectiveness depends on clear objectives, fair targeting, adequate benefits, timely delivery, and protection from political favoritism.

Subsidies are government payments intended to reduce the cost of a good, service, or activity. They may support public transport, agriculture, energy, education, healthcare, or selected industries. Subsidies can correct market failures or protect vulnerable groups, but poorly targeted subsidies may mainly benefit higher-income households or firms that do not need assistance. They can also become expensive when continued without regular review.

Interest payments are the cost of past borrowing. Unlike spending on schools, health services, or infrastructure, they do not directly create a new public service in the current year. However, they are legal obligations that must be paid. When interest costs rise, a larger share of the budget may be unavailable for other priorities.

Government spending should therefore be evaluated not only by its amount, but also by its purpose, design, implementation, and results. A well-designed vaccination program may prevent illness at relatively low cost and reduce future hospital expenses. A properly planned irrigation system may increase farm productivity for many years. By contrast, a poorly selected infrastructure project may absorb billions of pesos while producing limited public benefit.

The central question is not simply whether government should spend more or less. It is whether public money is being used for programs and projects that address real needs, reach the intended beneficiaries, and produce benefits greater than their costs.

Concrete examples of fiscal spending

- A municipality hires additional nurses and buys vaccines. This directly expands a public service and may prevent larger medical costs later.
- The national government repairs bridges after a typhoon. This restores transport, employment, and the movement of goods.
- Government expands the 4Ps education grant while improving school and health services. The transfer supports household consumption and long-term human-capital investment.
- Government accelerates maintenance projects during a slowdown. Because repairs can begin faster than large new projects, they may support employment while preserving public assets.

3. Taxation

Taxes are compulsory payments collected by government to finance public purposes. They pay for schools, hospitals, roads, public safety, social protection, environmental programs, and other services that benefit society. Taxes can also influence behavior, reduce inequality, and help government respond to economic and social problems.

Governments use several kinds of taxes because relying on only one tax would place too much pressure on a single group or activity and would make public revenue less stable. For example, financing the entire government through income tax would require very high rates on workers and businesses, while depending only on VAT would place a heavier relative burden on households that spend most of their income. Different taxes also serve different purposes: income and property taxes can reflect ability to pay, VAT provides a broad and steady revenue base, excise taxes can discourage harmful activities, and local taxes help finance services within communities. A diversified tax system also protects government revenue when economic conditions change. During a downturn, income and corporate tax collections may fall sharply, while consumption and property taxes may be more stable. Using a combination of taxes therefore allows government to balance revenue adequacy, fairness, economic efficiency, and administrative practicality rather than expecting one tax to accomplish every objective.

A good tax system should raise enough revenue to finance public responsibilities, distribute the burden fairly, avoid unnecessary disruption to work and investment, and remain understandable and enforceable. These goals do not always point in the same direction. A tax that is easy to collect may not be the fairest, while a highly progressive tax may be difficult to administer when income is hidden or poorly recorded. Governments therefore rely on a combination of taxes rather than a single source of revenue.

Personal income tax is generally progressive because people with higher taxable incomes face higher marginal tax rates. This means that the tax rate applied to additional income rises as income increases. A progressive income tax can help distribute the tax burden according to ability to pay. However, its effectiveness depends on accurate reporting, withholding systems, reasonable exemptions, and strong enforcement. When tax avoidance is widespread, compliant employees and businesses may carry a larger share of the burden.

Corporate income tax applies to the profits of businesses. It raises revenue from firms that benefit from public infrastructure, educated workers, legal protection, and access to markets. Its design can also affect investment decisions, business organization, and the treatment of firms of different sizes. Very high rates may discourage investment or encourage tax avoidance, while excessive exemptions and special incentives may reduce revenue and favor selected companies without producing enough additional jobs or investment.

Value-added tax, or VAT, is imposed on the consumption of covered goods and services. In the Philippines, the standard VAT rate is 12 percent. Businesses collect VAT from consumers and remit it to government after accounting for taxes paid on their own inputs. VAT is an important source of revenue because it applies to a broad range of transactions and can be collected throughout the production and distribution chain.

However, VAT can place a heavier relative burden on lower-income households because they spend a larger share of their income on consumption. For this reason, VAT should not be evaluated in isolation. Its fairness depends on which goods and services are exempt, how effectively government provides public services, and whether poor households receive adequate transfers or social

protection. A broad VAT may raise substantial revenue, but the overall fiscal system should ensure that this revenue is used in ways that reduce hardship and improve access to basic services.

Excise taxes apply to selected products such as tobacco, alcohol, sweetened beverages, fuel, and other goods that may create health, environmental, or social costs. These taxes serve two purposes. They raise revenue, and they can discourage consumption or production that imposes costs on society. Higher tobacco taxes, for example, can reduce smoking while helping finance health programs. Fuel taxes may encourage more efficient energy use, but they can also affect transport and food prices. Their design therefore requires attention to both behavioral effects and the burden on households.

Property taxes and local business taxes are important sources of revenue for local governments. Property taxes are commonly assigned to local governments because land and buildings are visible, fixed in location, and difficult to move or conceal. Revenue from these taxes can finance local roads, waste collection, public markets, health centers, schools, and disaster response.

The effectiveness of property taxation depends on accurate and regularly updated property values, complete records, efficient billing and collection, and transparent use of revenue. When assessed values remain outdated, owners of high-value property may pay much less than they should. Weak collection can also make local governments overly dependent on transfers from the national government. A well-administered property tax gives local governments a more stable source of revenue and strengthens the connection between local taxation and local services.

No tax should be judged only by how much money it raises. Government must also consider who ultimately pays, whether the tax changes behavior in useful or harmful ways, how difficult it is to administer, and how the revenue is spent. The fairness of a tax system therefore depends not only on tax rates, but on the combined effect of taxes, public services, and social protection.

Case Study 1: Taxing digital services

Digital consumption has expanded rapidly. A Filipino household may pay for video streaming, online advertising, cloud services, software subscriptions, or digital marketplaces supplied by a company with no physical office in the country. When local providers were required to charge VAT but some foreign providers were not effectively covered, similar services received different tax treatment.

Republic Act No. 12023, signed in 2024, clarified the application of the 12 percent VAT to digital services consumed in the Philippines, including services supplied by nonresident digital providers. The policy aims to improve neutrality between local and foreign suppliers and to protect the revenue base as consumption shifts online (DOF, 2024).

The case illustrates an important principle: tax systems must adjust when technology changes how goods and services are produced and sold. It also shows that expanding the tax base is not the same as raising the tax rate. Government may collect more by applying existing rules more consistently.

4. Budget deficits and government borrowing

A budget deficit occurs when government expenditure exceeds revenue during a given period. The government finances the gap mainly by borrowing through Treasury bills, bonds, and loans from domestic or foreign sources. A budget surplus occurs when revenue exceeds expenditure. A balanced budget occurs when the two are approximately equal.

A deficit is not automatically a sign of irresponsible fiscal management. Borrowing can be justified when it finances productive infrastructure, supports the economy during a severe recession, responds to disasters or public-health emergencies, or spreads the cost of a long-lived asset across the generations that will use it. A railway, irrigation system, or major hospital may provide services for decades. Financing part of its construction through borrowing can therefore be reasonable, provided that the project is well selected and the government can meet the resulting payments.

Borrowing nevertheless creates future obligations. Government must pay interest during the life of the loan and eventually repay the principal. These payments use revenue that could otherwise finance public services. Debt becomes more difficult to manage when borrowed funds are wasted, projects produce little economic or social benefit, interest rates rise, revenue collection remains weak, or government repeatedly borrows to finance ordinary expenses without improving productive capacity.

The purpose of borrowing also matters. A deficit used to prevent mass unemployment during a crisis may protect the economy from deeper damage. A deficit caused by poorly targeted subsidies, unnecessary projects, weak tax collection, or corruption is harder to justify. Similarly, a surplus is not always evidence of good policy. Government may achieve a surplus by postponing needed

infrastructure, failing to deliver services, or collecting revenue without spending it on urgent public needs.

Government borrowing can come from domestic sources or foreign sources. Domestic borrowing means the government raises funds within the country, usually by issuing Treasury bills and bonds that are purchased by banks, financial institutions, and other investors. Foreign borrowing means the government obtains loans from external creditors, such as foreign governments, multilateral institutions, or international capital markets.

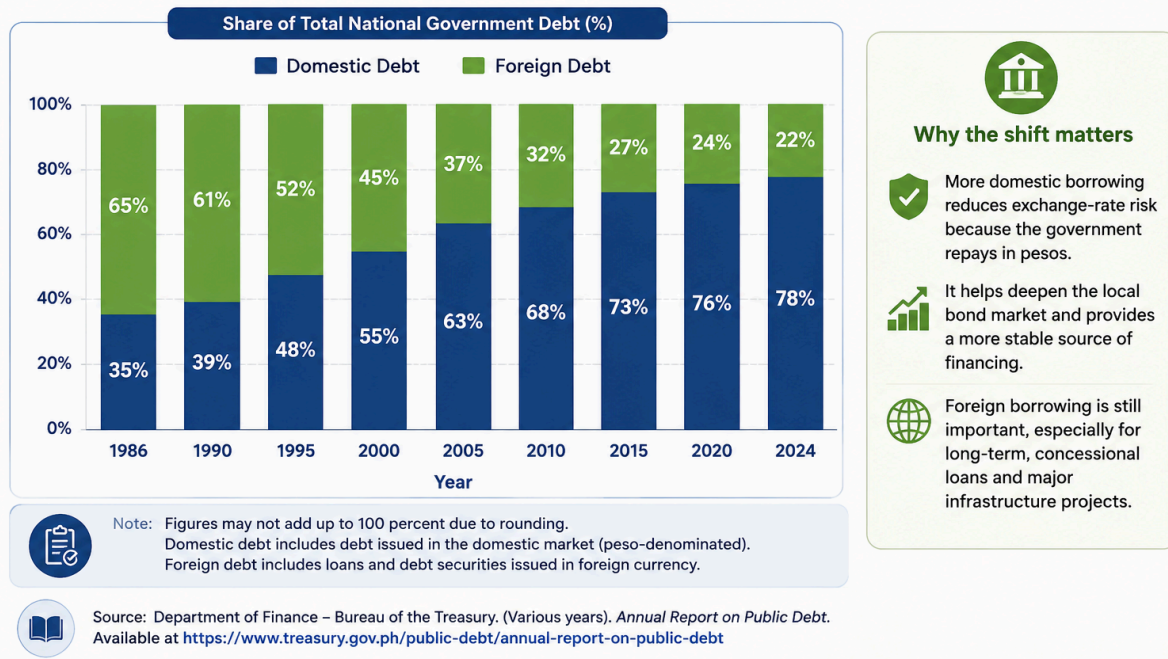
The mix of domestic and foreign borrowing has changed over time in the Philippines. In the years after EDSA, public debt was more heavily dependent on foreign borrowing, partly because of the debt structure inherited from the past and the more limited development of the domestic capital market. Over time, however, the government shifted toward greater reliance on domestic borrowing, so that domestic debt now makes up the larger share of total national government debt.

This shift has several advantages. Borrowing domestically reduces exchange-rate risk, because the government repays in pesos rather than in foreign currency. It also helps deepen the local bond market and gives government a more stable source of financing. Foreign borrowing still has an important role, especially when it comes with longer maturities, concessional terms, or financing for major infrastructure. However, it also exposes the government to currency depreciation and changes in global financial conditions.

The important point is that debt management is not only about how much government borrows. It is also about where the borrowing comes from, what risks it creates, and how well the debt supports development goals.

Figure 13.1 Shift in the Composition of National Debt

Over time, the Philippine government has relied less on foreign borrowing and more on domestic sources.



The Philippine experience after EDSA

The Philippines has operated with a national-government deficit during most years since the restoration of democracy in 1986. In the late 1980s and early 1990s, the government faced substantial fiscal pressures arising from weak revenue, debt inherited from the previous regime, high interest payments, and the need to restore public institutions and services.

National-government deficits were particularly large relative to the economy in 1986 and 1990 (DBM, 2024).

The fiscal position gradually improved in the early 1990s. The national government recorded relatively small surpluses from **1994 to 1997**. These were unusual in the post-EDSA period and reflected stronger economic growth, improved revenue performance, privatization receipts, and efforts to control expenditure. The surpluses were modest—less than 1 percent of GDP—but they showed that revenues could temporarily exceed national-government spending (DBM, 2024).

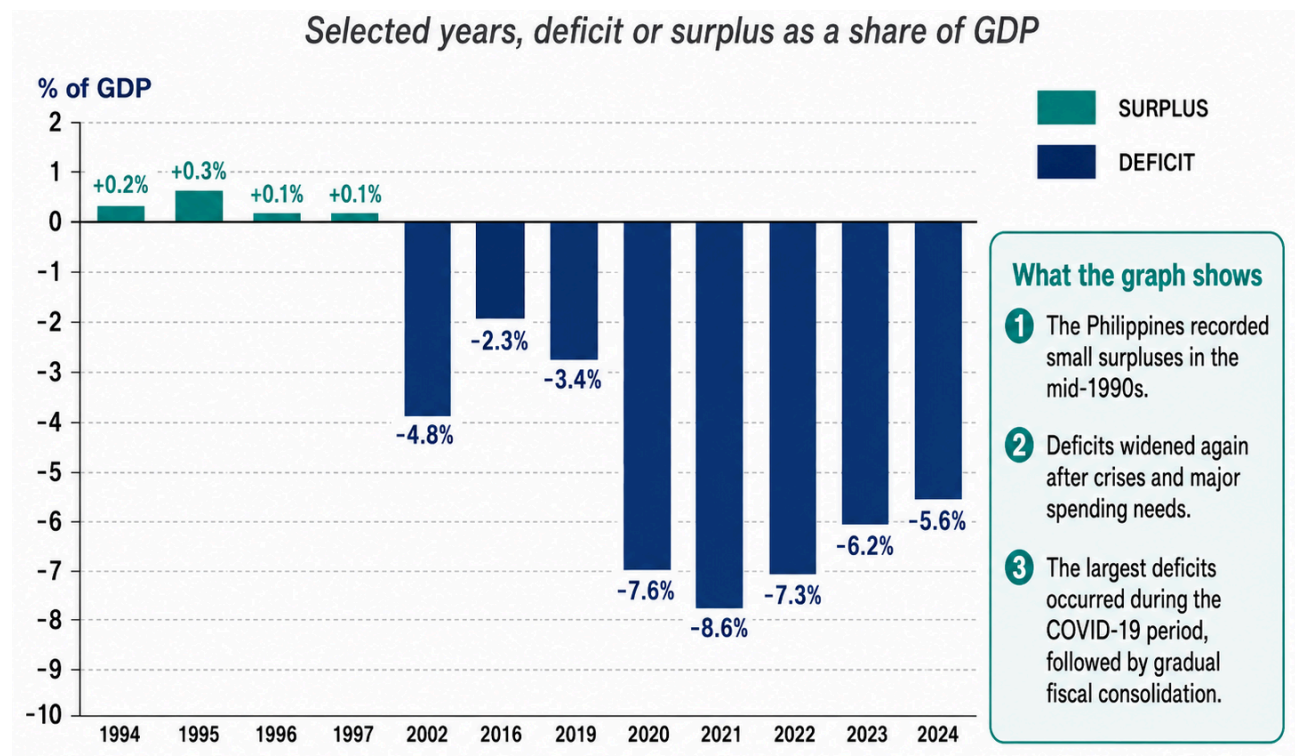
This improvement did not last. The Asian financial crisis weakened economic activity and government revenue beginning in 1997–1998. The national government returned to deficit, and the gap widened in the early 2000s as revenue collection weakened and debt-service costs remained high. By 2002, the national-government deficit was about 4.8 percent of GDP. Fiscal reforms, including changes in value-added taxation and improved revenue administration, later helped narrow the deficit during the second half of the 2000s (DBM, 2024).

Deficits widened again during the global financial crisis as government used public spending to support the economy. In the years before the COVID-19 pandemic, the national-government deficit generally remained moderate but increased as infrastructure spending expanded. It was approximately 2.3 percent of GDP in 2016 and reached about 3.4 percent in 2019 (DBM, 2024).

The pandemic produced the largest deficits in the post-EDSA period. Revenue fell as economic activity contracted, while government increased spending for health services, emergency assistance, vaccines, and economic support. The national-government deficit rose to about **7.6 percent of GDP in 2020** and **8.6 percent in 2021**. These deficits were partly the result of a deliberate response to an extraordinary crisis rather than ordinary fiscal policy (DBM, 2024).

As the economy reopened, the government began fiscal consolidation, meaning a gradual effort to reduce the deficit and slow the accumulation of debt. The national-government deficit declined to around 7.3 percent of GDP in 2022, 6.2 percent in 2023, and 5.6 percent in 2024. The improvement reflected the recovery of revenue and the withdrawal of some emergency measures, although the deficit remained larger than before the pandemic (DBM, 2024).

Figure 13.2. Philippine National Government Budget Balance



Note: Positive values indicate surplus; negative values indicate deficit.

Source: Department of Budget and Management (DBM), *Fiscal Statistics Handbook*; *National Government Fiscal Operations, 1983–2026*; and *Budget of Expenditures and Sources of Financing, FY 2026*.

This history shows that fiscal balances change for several reasons. They respond to recessions, crises, tax reforms, political priorities, infrastructure programs, interest costs, and the quality of

revenue administration. The same deficit figure can therefore have very different meanings in different years.

Several important questions can be asked in evaluating the financial position of the government: Why did the deficit arise? How large is it compared with the economy and government revenue? Is it temporary or persistent? How is it financed? What programs or assets are being created? Can future revenue support the resulting debt payments? Most importantly, does the borrowing produce public value that is greater than its financial and social cost?

The public should not simply look at whether government has a deficit or surplus. It is important to examine whether fiscal decisions are sustainable, transparent, and used to strengthen public services, productive capacity, and the country's ability to withstand future crises.

5. Expansionary and contractionary fiscal policy

Expansionary fiscal policy is used to increase aggregate demand when economic activity is weak. Government may raise spending, reduce selected taxes, increase transfers, or accelerate projects that put income into the hands of households and businesses. These measures can support consumption, investment, and employment, especially when unemployment is high, private spending is weak, and factories, workers, and other resources are not being fully used.

For example, during a recession, government may speed up the construction of classrooms, hospitals, and transport facilities. This creates direct demand for labor, materials, and services. It may also provide temporary cash assistance or unemployment support so that households can continue buying basic goods. Tax relief for low- and middle-income households can have a similar effect because it leaves them with more disposable income. The strength of the expansion depends on how quickly the measures are implemented, who receives the additional income, and whether domestic producers can respond to the increase in demand.

Expansionary fiscal policy is usually more effective when the economy has unused capacity. If many workers are unemployed and businesses have idle equipment, additional demand can raise production and employment without causing large price increases. However, when supply is constrained, more government spending may instead add to inflation, increase imports, or raise project costs. Expansionary policy must therefore consider both the level of demand and the economy's ability to produce more goods and services.

Contractionary fiscal policy moves in the opposite direction. It reduces the growth of aggregate demand by slowing expenditure, postponing lower-priority projects, withdrawing broad subsidies, increasing selected taxes, or improving revenue collection. Government may consider this approach when demand is expanding too quickly, inflationary pressure is becoming widespread, borrowing costs are rising, or public debt needs to be stabilized.

Contractionary policy does not always require across-the-board spending cuts. Government can protect essential services while reducing inefficient or poorly targeted expenditures. For instance, it may phase out a fuel subsidy that benefits many high-income households while preserving transport support for low-income commuters. It may also defer projects that are not ready for implementation

while continuing health, education, and disaster-preparedness programs. The quality and composition of adjustment matter as much as the total reduction in spending.

The effects of contractionary policy also depend on economic conditions. Cutting spending during a strong expansion may help moderate inflation with limited harm to employment. The same action during a recession may deepen the slowdown, reduce household income, and delay recovery. Timing is therefore critical.

The terms expansionary and contractionary describe the expected effect of fiscal policy on overall demand. They do not indicate whether a policy is morally good, socially fair, or economically well designed. An expansionary program may waste money if it finances poorly planned projects. A contractionary measure may improve public welfare if it removes an ineffective subsidy and redirects resources toward essential services.

Government can also change the composition of the budget without greatly changing total demand. It may reduce a broad subsidy, cut a low-priority project, and use the savings to strengthen health insurance, nutrition programs, or targeted support for poor households. The net fiscal effect may be approximately neutral because total spending remains similar. Yet the distributional and developmental effects may improve because resources are transferred from a less effective use to one that better addresses poverty and vulnerability.

For this reason, fiscal policy should be assessed using more than the size of the deficit or the direction of aggregate demand. Important questions include who benefits, who bears the cost, whether the measure addresses the source of the problem, how quickly it can be implemented, and whether it improves the economy's productive capacity over time.

6. Automatic stabilizers and discretionary policy

Some fiscal responses happen automatically because they are already built into the tax and social protection systems. These are called **automatic stabilizers**. They operate without the government having to pass a new law every time the economy weakens or strengthens.

When the economy slows, many households and businesses earn less income. As a result, personal income-tax and corporate income-tax collections usually decline. At the same time, more people may qualify for unemployment support, cash transfers, food assistance, or other social protection programs. These changes help cushion the fall in household income and spending. Because taxes fall and transfers rise automatically, the decline in aggregate demand is smaller than it would otherwise be.

The process also works in the opposite direction. When the economy grows strongly, incomes and profits rise, so tax collections increase. Fewer households may qualify for income support. This automatically withdraws some purchasing power from the economy and helps prevent demand from expanding too quickly.

Automatic stabilizers are useful because they respond quickly and predictably. They do not depend on the timing of new legislation, political negotiations, or emergency budget approval. However, their strength depends on the design of the tax and social protection systems. In a country where many workers are informal, few people pay income tax, and unemployment insurance is limited,

automatic stabilizers may be weaker. Poor targeting or outdated beneficiary lists can also prevent assistance from reaching households whose income has suddenly fallen.

Discretionary fiscal policy, by contrast, requires a deliberate government decision. Examples include creating an emergency cash-transfer program, increasing health spending during a pandemic, accelerating infrastructure construction, temporarily reducing a tax, or introducing a subsidy for an affected sector. Because government chooses the size, timing, and beneficiaries, discretionary measures can be directed toward a particular crisis or group.

This flexibility is an advantage, but it also creates delays and risks. A policy may require legislation, budget realignment, procurement, beneficiary identification, and coordination among agencies. By the time the program begins, the economic problem may have changed. Poorly designed emergency programs may also suffer from exclusion errors, duplication, leakage, or political favoritism.

Automatic and discretionary measures are therefore best understood as complementary. Automatic stabilizers provide an immediate first line of support, while discretionary policy can address needs that existing systems do not cover. A strong fiscal system combines both: reliable tax and social

Case Study 2: Fiscal policy during the COVID-19 shock

The pandemic caused an unusual combination of problems. Health restrictions reduced production and mobility, while households and firms lost income. Government needed to finance public health, protect vulnerable households, support displaced workers, and prevent viable firms from collapsing.

The fiscal response included emergency health spending, cash assistance, wage and credit support, and additional borrowing. The objective was not to create normal economic growth while movement was restricted. It was to prevent a temporary health shock from causing permanent damage through hunger, school withdrawal, business closure, and loss of productive capacity.

The experience also revealed design problems. Outdated beneficiary lists, incomplete digital payment systems, fragmented records, and uneven local implementation delayed assistance. The lesson is that fiscal capacity must be built before a crisis. A government cannot quickly deliver well-targeted support if identification, payment, procurement, and accountability systems are weak.

protection mechanisms that respond automatically, together with the capacity to design and implement targeted measures when an unusual crisis requires additional action.

7. Limits of fiscal policy

Fiscal policy can support growth, employment, public services, and social protection, but it does not work instantly or perfectly. Its effects depend on how quickly government can act, how programs are designed, and whether the economy has the capacity to respond.

Implementation lags are one major limitation. A program may be approved quickly, but actual delivery can take much longer. Agencies may still need to prepare plans, identify beneficiaries, complete procurement, sign contracts, hire personnel, and coordinate with local governments. A classroom budget, for example, does not immediately become a usable classroom. The site must be identified, designs completed, contractors selected, construction finished, and teachers assigned. When these steps take too long, fiscal policy may arrive after the worst part of a downturn has already passed.

Political incentives can also weaken spending decisions. Public officials may prefer projects that are highly visible, easy to claim credit for, or concentrated in politically important areas. This may lead to too much spending on ribbon-cutting projects and too little on less visible but essential needs such as maintenance, preventive healthcare, teacher training, data systems, or drainage rehabilitation. A project may therefore be politically attractive even when its social return is low.

Leakage and corruption reduce the value of public spending. Funds may be diverted, overpricing may occur, low-quality materials may be used, or ghost beneficiaries and projects may be reported. Even when money is not directly stolen, weak monitoring and poor contract management can result in incomplete or defective outputs. The fiscal cost is not only the amount lost. Citizens may also receive worse services, and future budgets may need to pay again to repair or replace the failed project.

Poor targeting is another problem. Broad subsidies are often easier to administer, but they may give larger benefits to households that consume more. A general fuel subsidy, for example, can provide greater assistance to higher-income households with several vehicles than to poorer households that rely on public transport. Targeted support may be fairer and less costly, but it requires accurate data, updated registries, and accessible application and appeal systems. Poor targeting can therefore create both exclusion errors and inclusion errors.

Debt and interest costs place limits on how long expansionary fiscal policy can continue. Persistent deficits require borrowing, and borrowing creates future interest payments. As debt service rises, less budget space remains for health, education, infrastructure, and social protection. This does not mean that all deficits are harmful. The issue is whether borrowing finances productive programs and whether future revenues are sufficient to meet the obligations. Debt becomes more difficult to manage when borrowing repeatedly supports low-value spending or when interest rates rise.

Supply constraints can reduce the effectiveness of additional spending. Fiscal policy works best when businesses can increase production and workers can be employed. If the economy already faces shortages of skilled labor, construction materials, electricity, transport capacity, or food supply, higher spending may raise prices rather than output. For example, rapidly expanding infrastructure budgets without enough engineers, contractors, or cement supply may increase project costs. Similarly, cash transfers can protect household consumption, but they cannot by themselves solve a shortage of rice or medicine.

These limitations do not mean that fiscal policy should be avoided. They show why timing, program design, transparency, implementation capacity, and coordination matter. The relevant question is not only how much government spends, but whether the spending can be delivered on time, reach the intended groups, avoid waste, and increase the economy's ability to produce and provide services.

B. Monetary Policy

Monetary policy refers to the actions of the central bank that influence interest rates, liquidity, credit conditions, and expectations in the economy. In the Philippines, monetary policy is conducted by the Bangko Sentral ng Pilipinas, or BSP, through the Monetary Board.

The BSP's primary monetary-policy objective is to maintain price stability that is consistent with balanced and sustainable economic growth and employment. Price stability does not mean preventing every price from changing. The prices of rice, fuel, rent, electricity, tuition, and other goods and services may rise or fall for different reasons. Rather, price stability means keeping the overall rate of inflation low and sufficiently predictable so that households and businesses can make economic decisions with greater confidence.

The Philippines uses an inflation-targeting framework. Under this approach, government announces an inflation target, while the BSP adjusts monetary policy to guide expected inflation toward that target over a policy horizon. For 2026 to 2028, the target is 3 percent, with a tolerance range of plus or minus 1 percentage point. This means that annual inflation between 2 and 4 percent is generally considered consistent with the target ("Republic Act No. 11211," 2019).

Monetary policy is not limited to controlling the amount of cash in circulation. Modern central banks mainly work by influencing the cost and availability of credit. Their decisions affect the rates charged on loans, the returns earned on savings, the willingness of banks to lend, movements in the exchange rate, and expectations about future inflation.

Why price stability matters

High and unstable inflation reduces the purchasing power of money. This is especially harmful to households whose wages, pensions, or other incomes do not rise as quickly as prices. A family may receive the same monthly income but be able to buy less food, transport, medicine, and electricity.

Inflation also creates uncertainty. A firm deciding whether to build a factory must estimate future wages, material costs, selling prices, and borrowing expenses. When inflation is unpredictable, it becomes harder to assess whether the investment will be profitable. Businesses may postpone investment, demand higher returns, or raise prices in advance to protect themselves from possible cost increases.

Very low inflation or deflation can also create difficulties. When prices are falling because demand is weak, households may delay spending, firms may experience declining revenues, and

unemployment may rise. Borrowers may also find their debt more difficult to repay because the nominal amount of debt remains unchanged while income and prices fall.

The objective of monetary policy is therefore not to eliminate all price changes. It is to prevent inflation or deflation from becoming so broad, persistent, and unpredictable that it disrupts economic activity and household welfare.

Interest as the price of borrowing

Interest is the payment made for the use of funds over time. For a borrower, it is part of the cost of obtaining money today and repaying it later. For a saver or lender, it is compensation for postponing consumption and accepting the risk that the borrower may not repay fully or on time.

The interest rate expresses this payment as a percentage of the amount borrowed or saved. If a person borrows ₱100,000 at an annual interest rate of 8 percent, the interest cost for one year would be approximately ₱8,000 before fees and other charges.

Interest rates affect many decisions. A family may reconsider buying a house when monthly loan payments increase. A farmer may delay purchasing equipment when agricultural credit becomes expensive. A company may cancel an expansion if the expected return from the project is lower than the cost of borrowing.

Higher interest rates generally encourage saving and discourage borrowing. Lower interest rates generally make borrowing more attractive and reduce the reward for holding savings. These changes affect spending, investment, employment, and ultimately inflation.

However, there is no single interest rate in the economy. Banks charge different rates depending on the borrower's income, collateral, credit history, loan duration, and risk. Large corporations may borrow at lower rates than small firms. A policy-rate reduction therefore does not guarantee that all borrowers will receive the same reduction.

The policy interest rate

The BSP's main monetary-policy signal is the target reverse repurchase rate, commonly called the policy rate. This is a short-term interest rate used to guide market rates and communicate the BSP's policy stance.

When the BSP raises the policy rate, short-term market interest rates generally rise. Banks face higher financing or opportunity costs and may increase deposit and lending rates. Loans for housing, vehicles, business expansion, inventories, and consumer purchases may become more expensive. Borrowing and spending then tend to grow more slowly.

When the BSP lowers the policy rate, market financing conditions may ease. Banks may reduce lending rates, and households and firms may become more willing to borrow and spend. This can support economic activity when inflation is low and demand is weak.

A change in the policy rate does not affect the economy immediately. It must pass through financial markets and the banking system before influencing household and business decisions. The BSP's February 2026 Monetary Policy Report emphasized that the pass-through from the policy rate to bank rates is important but is neither automatic nor uniform (BSP, 2026b).

How monetary policy is transmitted

The process through which a BSP decision affects inflation and economic activity is called the monetary-policy transmission mechanism. It operates through several connected channels.

The interest-rate channel works through the cost of borrowing and the return to saving. Higher rates may reduce spending on houses, cars, appliances, inventories, and business investment. Lower rates may encourage these activities.

The credit channel works through the willingness and capacity of financial institutions to lend. Small businesses and ordinary households depend heavily on banks and other lenders because they cannot easily raise funds by issuing bonds or shares. Even when the BSP reduces its policy rate, credit may remain difficult to obtain if banks are concerned about defaults or if borrowers lack collateral.

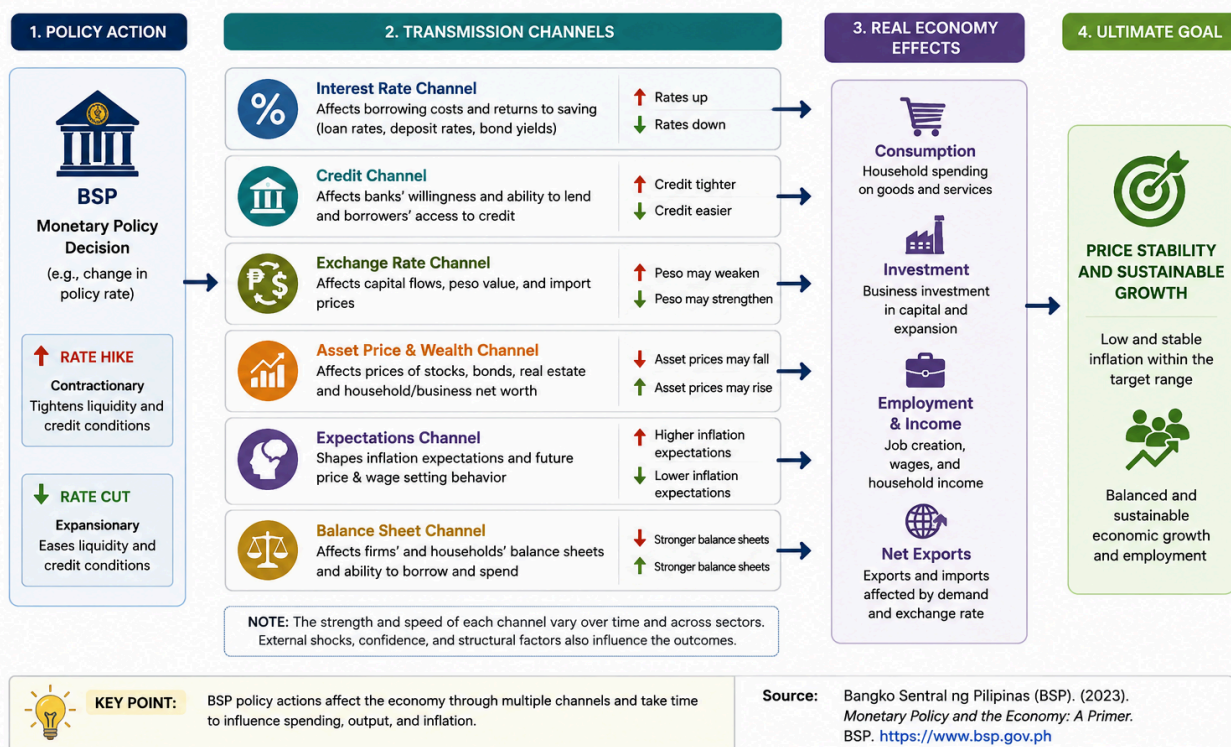
The exchange-rate channel works partly through the attractiveness of peso assets relative to foreign assets. Changes in Philippine interest rates can influence capital flows and the value of the peso, although many other factors also affect exchange rates. A weaker peso makes imported fuel, machinery, medicine, and raw materials more expensive. It may also increase the peso value of remittances and export earnings. A stronger peso makes imports cheaper but may reduce the peso value of foreign-currency income.

The expectations channel works through beliefs about future inflation and policy. If households and firms trust that the BSP will bring inflation back toward the target, they may be less likely to raise wages and prices repeatedly after a temporary shock. Credible communication can therefore affect behavior even before the full impact of an interest-rate change is felt.

The asset-price and balance-sheet channels operate through the value of property, bonds, shares, and collateral. Higher rates may lower some asset prices and weaken the financial position of borrowers. Lower rates may increase asset values and improve access to credit, but they may also encourage excessive risk-taking if maintained for too long.

THE MONETARY POLICY TRANSMISSION MECHANISM

How BSP policy actions influence the economy and inflation



Because these channels operate with delays, the BSP cannot base policy only on the latest inflation figure. It must assess forecasts, economic conditions, inflation expectations, financial risks, and the likely effects of previous decisions. The BSP generally aims to return projected inflation toward the target over a horizon of about two years, reflecting these transmission lags (BSP, 2020).

The BSP's monetary-policy tools

The policy rate is the BSP's main signal, but it is not its only instrument. Open-market operations involve transactions that add or remove liquidity from the financial system. The BSP may use reverse repurchase transactions, term facilities, or its own securities to influence the amount of central-bank money available and to guide short-term market interest rates toward the policy rate. BSP securities are specifically used for monetary-policy implementation and liquidity management (BSP, 2026a).

Reserve requirements specify the proportion of certain bank deposits and liabilities that financial institutions must hold as reserves rather than lend. Lower reserve requirements release funds

that banks may use for lending or investment. Higher requirements restrain the amount of funds that can support credit expansion. Because changes in reserve requirements can have large effects on banking-system liquidity, they are generally used less frequently than routine market operations.

Standing deposit and lending facilities allow banks to place excess funds with the BSP or borrow overnight when they face temporary shortages. These facilities help create an interest-rate corridor around the policy rate and reduce excessive volatility in overnight market rates.

Communication is also a policy tool. Monetary-policy statements, reports, press briefings, forecasts, and explanations help households, firms, banks, and investors understand the BSP's assessment of inflation and economic risks. Clear communication can reduce uncertainty and strengthen the expectations channel.

Expansionary monetary policy

Expansionary monetary policy is intended to support economic activity by lowering interest rates, increasing liquidity, or improving credit conditions. It is usually considered when inflation is subdued, economic growth is weak, private spending is falling, and unemployment or unused productive capacity is high.

Suppose businesses are postponing investment, households are reducing major purchases, and banks are cautious about lending. The BSP may reduce the policy rate. Lower financing costs can encourage firms to rebuild inventories, purchase equipment, or expand production. Households may find housing or consumer loans more affordable. These decisions can increase demand and employment.

The BSP may also reduce reserve requirements or inject liquidity so that banks have greater capacity to lend. During periods of financial stress, it may provide temporary facilities to ensure that otherwise sound banks and markets continue operating.

Expansionary policy is not the same as giving money directly to households. It works indirectly through banks, credit markets, and expectations. A person with no income, collateral, or access to a bank may receive little immediate benefit from lower interest rates. This is why monetary easing cannot substitute for fiscal measures such as cash assistance, unemployment support, health spending, or public employment.

Expansionary policy also has limits. Firms may not borrow when demand is weak, even if credit is cheap. Banks may refuse to lend when default risks are high. Highly indebted households may use lower rates to repay existing obligations rather than increase spending. Maintaining very low rates for too long may also encourage excessive borrowing, asset-price inflation, or risky financial behavior.

Contractionary monetary policy

Contractionary monetary policy is intended to restrain inflationary pressure by raising interest rates, reducing liquidity, or slowing credit expansion. It is considered when demand is growing faster than the economy's capacity to produce, when inflation is broad and persistent, or when temporary price shocks threaten to affect expectations and wage- and price-setting behavior.

When the BSP raises the policy rate, borrowing becomes more costly. Some households postpone buying houses or vehicles. Businesses may delay expansion, reduce inventories, or cancel projects with low expected returns. Slower credit and spending reduce pressure on prices over time.

Higher rates may also support the peso by making peso-denominated assets relatively more attractive, although exchange rates are influenced by many domestic and international factors. A more stable currency can reduce imported inflation, especially in an economy that imports fuel, machinery, medicine, and production inputs.

Monetary tightening has costs. Higher loan payments can burden households and firms. Small businesses may face greater difficulty obtaining working capital. Construction, housing, and investment may slow. Employment may weaken if firms reduce production. The BSP must therefore balance the risk of allowing inflation to become persistent against the risk of weakening economic activity more than necessary.

The terms expansionary and contractionary describe the expected effect on credit and aggregate demand. They do not imply that one policy is always desirable and the other always harmful. A rate increase may be necessary to protect purchasing power and prevent a longer inflation problem. A rate cut may be inappropriate when inflation expectations are rising or when credit growth is already excessive.

Case Studies: Monetary policy during the COVID-19 shock The pandemic created both a health crisis and a collapse in economic activity. Monetary contractions reduced production, employment, consumption, and investment. Financial markets also faced uncertainty and the risk that banks and borrowers would experience severe liquidity problems.
basis points (BSP, 2024).

Monetary policy, banks, and ordinary borrowers

A BSP policy decision affects people unevenly. A household with a new variable-rate housing loan may feel a rate increase relatively quickly. A borrower with a fixed-rate loan may not be affected until the loan is refinanced. Savers may receive higher deposit returns, although banks may adjust deposit rates more slowly than lending rates.

Large firms often have more financing options, including bonds, retained earnings, and foreign loans. Small and medium-sized firms depend more heavily on banks and may face higher risk premiums. Informal workers and microenterprises may rely on cooperatives, finance companies, digital lenders, or informal credit, where rates may not closely follow the BSP policy rate.

This unequal transmission has distributional consequences. Higher rates may benefit savers with financial assets while burdening indebted households and firms. Lower rates may benefit borrowers but reduce returns for retirees and others who depend on interest income. These effects do not determine the policy decision by themselves, but they should be considered when fiscal authorities design complementary support.

The relationship between monetary policy and the exchange rate

The BSP does not normally use a fixed exchange rate as its primary monetary-policy target. The peso is allowed to move in response to market conditions. However, exchange-rate movements matter because they affect inflation, debt costs, trade, remittances, and financial stability.

A rapid peso depreciation can raise the peso price of imported fuel, food, equipment, and raw materials. It can also increase the burden of foreign-currency debt for borrowers whose income is mainly in pesos. The BSP may consider these effects when setting monetary policy.

However, raising rates solely to defend a particular exchange-rate level can impose significant costs on domestic demand and employment. The BSP must assess whether currency movements are temporary, whether markets remain orderly, and whether depreciation is likely to create persistent inflation or financial instability.

Foreign-exchange intervention and monetary policy are related but different tools. The BSP may buy or sell foreign currency to reduce disorderly market conditions, while the policy rate is primarily directed toward inflation and macroeconomic stability.

What monetary policy cannot do

Monetary policy cannot directly increase the production of rice, electricity, housing, medicine, or fuel. It cannot repair roads, ports, irrigation systems, or supply chains. When inflation is caused mainly by shortages, monetary policy can limit wider demand and second-round effects, but the

underlying supply problem requires fiscal, regulatory, agricultural, energy, competition, or infrastructure policies.

It cannot target support to a particular household, sector, province, or occupational group with the precision of a fiscal program. A rate cut affects financial conditions broadly, while cash transfers, subsidies, or public services can be directed toward specific beneficiaries.

It cannot guarantee that banks will lend or that households and firms will borrow. Monetary policy can change incentives and liquidity, but credit decisions still depend on risk, collateral, income, expectations, and the condition of the banking system.

It cannot solve structural problems such as low productivity, job mismatch, unequal access to education, weak public transport, limited competition, or poor governance. These require reforms and public investments that change the productive capacity and institutions of the economy.

It cannot eliminate every temporary change in inflation. Attempting to offset each short-lived increase in food or fuel prices through aggressive interest-rate changes could create unnecessary instability in output and employment. The relevant concern is whether shocks are becoming widespread, persistent, and embedded in expectations.

Limits and risks of monetary policy

Monetary policy operates with long and uncertain lags. By the time the full effect of a policy-rate increase appears in spending and inflation, economic conditions may have changed. This creates a risk of doing too little or acting too late, but also a risk of overtightening.

Transmission may be weak or uneven. Banks may not pass policy changes fully to deposit and lending rates. Borrowers with weak credit histories may face high rates even during monetary easing. Regions with fewer banks and firms with limited collateral may benefit less.

The central bank must make decisions using incomplete information and forecasts. Inflation data describe what has already happened, while policy must respond to what is expected to happen. Forecasts may be wrong because of unexpected weather, wars, commodity-price changes, exchange-rate movements, or domestic policy decisions.

Monetary tightening can reduce inflation but also weaken investment and employment. Monetary easing can support activity but may increase debt, financial risk, asset prices, or exchange-rate pressure. The appropriate policy is therefore rarely costless.

Central-bank credibility is also important. If the public believes that the BSP will tolerate persistently high inflation or change policy for political reasons, expectations may become

harder to control. Independence must be accompanied by accountability, clear communication, publication of evidence, and explanation of the trade-offs behind decisions.

Evaluating monetary policy

A monetary-policy decision should not be judged only by whether the BSP raised or lowered the policy rate. A more useful evaluation asks what problem the BSP was addressing, whether inflation was caused mainly by demand or supply, how persistent the pressure was expected to be, and whether expectations remained anchored.

It should also examine whether the size and timing of the adjustment were appropriate, how the decision affected borrowers, savers, firms, the exchange rate, and financial stability, and whether fiscal and structural policies were addressing the underlying causes of inflation.

The success of monetary policy should be assessed over time. Inflation may remain temporarily above target after a rate increase because existing food or energy shocks cannot be reversed immediately. The relevant questions are whether projected inflation is returning toward the target, whether expectations remain stable, and whether the policy avoids unnecessary damage to output and employment.

Key Idea: Monetary policy influences the economy mainly through interest rates, liquidity, credit, exchange rates, and expectations. It can help stabilize inflation and economic activity, but it cannot directly solve shortages, deliver public services, or protect specific households. Its effectiveness depends on accurate diagnosis, credible communication, functioning financial markets, and coordination with appropriate fiscal and structural policies.

C. How to Evaluate Fiscal and Monetary Policy

A policy should not be judged only by whether spending increased, taxes fell, or interest rates changed. The following questions provide a better framework:

1. Objective: What specific problem is the policy trying to solve?
2. Diagnosis: Is the problem caused mainly by weak demand, limited supply, inequality, financial stress, or a structural constraint?
3. Instrument: Is the chosen tool suited to the problem?
4. Timing: Will the measure arrive while it is still needed?
5. Targeting and distribution: Who benefits, who pays, and who may be excluded?
6. Scale: Is the measure large enough to matter but not so large that it creates new risks?
7. Implementation: Do agencies, banks, and local governments have the capacity to carry it out?
8. Sustainability: Can the measure be financed and maintained without creating unmanageable debt or inflation?
9. Accountability: Are decisions, beneficiaries, costs, and outcomes transparent?
10. Exit or adjustment: Under what conditions should the policy end, expand, or change?

D. Comparing Fiscal and Monetary Policy

• Fiscal Policy vs Monetary Policy •

Comparison Category	 Fiscal Policy	 Monetary Policy
 1. What it is	Government decisions on spending, taxation, and borrowing to influence the economy.	Central bank actions that influence interest rates, money, and credit in the economy.
 2. Main goal	Promote growth, provide public services, reduce inequality, and stabilize the economy.	Maintain price stability, manage inflation, and support sustainable economic growth.
 3. Main actor	National government (President, Congress, Department of Finance, DBM).	Bangko Sentral ng Pilipinas (BSP) and the Monetary Board.
 4. Main tools	Government spending, taxation, transfers, and public borrowing.	Policy interest rate, reserve requirements, and open market operations.
 5. How it works	Directly affects demand by changing government spending and people's disposable income.	Indirectly affects demand by influencing borrowing, lending, saving, and investment.
 6. Expansionary policy	Increase spending or reduce taxes to stimulate the economy.	Lower interest rates or increase liquidity to encourage borrowing and spending.
 7. Contractionary policy	Reduce spending or raise taxes to slow inflation or reduce deficits.	Raise interest rates or reduce liquidity to slow inflation.
 8. Typical example	Cash aid, infrastructure spending, school and health budgets, tax reforms.	BSP raising rates to fight inflation or cutting rates during an economic slowdown.
 9. Common limits	Can be slowed by politics, budgeting delays, and rising debt.	May take time to affect prices and may be less effective if supply shocks drive inflation.
 10. Key idea	Uses the national budget to shape the economy.	Uses the cost and supply of money to shape the economy.



Both policies can work together. Fiscal policy acts through the budget. Monetary policy acts through money, credit, and interest rates.

E. Let's Review

- Fiscal policy uses government spending, taxation, transfers, and borrowing to allocate resources, redistribute income, and stabilize the economy.
- A deficit can be useful when it finances productive investment or crisis response, but persistent borrowing creates future costs.
- Expansionary fiscal policy supports demand; contractionary fiscal policy restrains it. Good design may change the composition of spending and taxes even when the overall fiscal stance is unchanged.
- Monetary policy influences interest rates, liquidity, credit, exchange rates, and expectations. The BSP's primary objective is price stability.
- Higher policy rates generally restrain borrowing and demand; lower rates generally support them. The effects are delayed and uneven.
- Interest-rate policy cannot directly solve supply shortages or deliver social services. Fiscal and structural policies are necessary for those tasks.

- The appropriate policy response depends on the source of the problem. Weak demand requires a different response from food shortages, high inequality, or low productivity.
- Fiscal and monetary policies should be evaluated by their objectives, timing, targeting, implementation, distributional effects, and sustainability.

F. Key Takeaway

Fiscal and monetary policies are not simply switches that make the economy grow faster or slow down. They are tools with different strengths, limits, and effects on different groups. Sound policy begins with a correct diagnosis of the problem, chooses an appropriate instrument, and adjusts when evidence shows that the policy is not working as intended.

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