PHILIPPINE BALANCE OF PAYMENTS, INFLATION, AND MACROECONOMIC POLICY

IMPLICATIONS FOR CDSS

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Manila, Philippines

March 1982

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I. Summary

A sizeable deficit on current account has become chronic since 1974, rising to an estimated $2.7 billion in 1981, or 6.8 percent of GNP. This has been due mostly to four factors: 1) the precipitous rise in crude oil prices, 2) falling world market prices of and quantitative restrictions on exports, 3) strong import demand due to an import-dependent industrial sector, and 4) readily available international credit to finance an import surplus.

In 1979 and 1980 the previously moderate single-digit rate of inflation doubled to 17-18 percent annually,[1/] as cost-push factors temporarily exacerbated underlying conditions of excess demand. With the absence of further oil price increases in 1981, a tight monetary policy, and domestic economic slowdown, the rate of inflation was reduced to around 12 percent and is expected to moderate further in 1982. Inflationary pressures arise primarily 1) from poor tax performance in support of capital outlays of an ambitious, and largely commendable, development program and 2) from rising energy prices and legal minimum wages.

The chief causes of the trade deficit and domestic inflation also affect key areas of development concern to AID and other external donors. Rising costs of oil imports place a premium on energy conservation and the rapid development of domestic energy sources. Falling prices of primary export commodities require that domestic production technology, costs and marketing arrangements be reassessed if production is to remain competitive and poverty among producers is to be alleviated. Government policies that exacerbate poverty also need to be reassessed, such as the various agricultural tax and pricing policies that reduce farmgate prices, plans to subsidize the mechanization of agriculture which would displace labor, and legal minimum wage levels that reduce employment.

The GOP has recognized the need to reduce the import dependence of the industrial sector, which has been created by: (a) cascading tariff protection and other import controls, with lower duties on imports of capital equipment and intermediate inputs than on those of final goods, (b) subsidized interest rates on investment capital, and (c) an overvalued peso exchange rate that cheapens imported inputs relative to domestic labor and materials. The tariff structure and other import controls are being reformed, and most interest rate ceilings were abolished in 1981, as a part of the industrial structural adjustment program.[2/] This should help reduce the capital- and import-intensity of investment and encourage greater use of domestic inputs and labor, generating more employment. The peso exchange rate has become overvalued as a result of a sharp decline in

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1/ Consumer Price Index for the Philippines, Central Bank and NEDA.

2/ See Annex, Part I.

the Philippines terms of trade and the high levels of protection afforded by tariffs and import restrictions. Despite a steadily worsening trade deficit, the real, trade-weighted, effective peso exchange rate actually appreciated by 16 percent over the last three years. While real peso depreciation would have a short-term inflationary effect by raising prices of tradable commodities and would thereby adversely affect the relatively inefficient, import-dependent industries found mostly in Manila, which employ small numbers of workers, it would have a positive impact on rural incomes and provide stronger incentives for domestic employment generation, as well as for expanding non-traditional manufacturing export production. This would have positive multiplier effects throughout the rural economy and improve the equity of the Philippine development process.

The trade gap has been financed--and the officially floating peso defended--by heavy foreign borrowing[1/] to supply the foreign exchange demands of the industrial sector. Plans to continue borrowing to finance several large capital-intensive industrial projects in addition to the growing trade gap seem to contradict the need to direct scarce resources efficiently in support of a more equitable, employment-oriented development process.

The ambitious public infrastructure development program, much of which is rural, has received strong support from the major foreign assistance donors. However, while the tax revenue performance is much improved over the 1960's, it is still inadequate to finance the desired level of government investment. Planned government projects have sometimes been delayed for lack of funds. Since deficit financing is inflationary, the government has preferred to reduce or postpone expenditures in times of higher inflation. Local government resource mobilization for development is particularly inadequate.

Legal minimum wage levels are higher than market wage rates, the latter having suffered a significant decline in the 1970's due to the slow growth of productive employment opportunities. To the extent higher legal rates are enforced they reduce employment and add to cost-push inflationary pressures. Their effect on employment could be particularly adverse in the rural areas. The government, in recognition of this, has adopted the use of exemptions for "distressed" industries and differentially lower minimum rates for rural areas. The only effective way to raise real market wage rates, and thus alleviate poverty among significant groups of worker families, is to increase the aggregate amount of productive employment and thereby increase the demand for labor in the economy.

The basic causes of the negative balance of trade and price instability require solutions that can only be achieved in the long run. While the short-term adjustment costs of some of the required reforms may be dear to small, but politically articulate, groups, this seems to be outweighed by the cost of inaction to the majority of Filipinos--in terms of lack of jobs, low income, more costly commodities, and the consequent increased poverty. There are several program and policy areas with implications for the current AID assistance strategy, as articulated in previous CDSS documents; and there are several ways USAID can support GOP efforts to relieve the balance

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1/ In September 1981 total external debt amounted to $15.4 billion, 52 percent of which was public.

of payments and inflationary problems and to restructure the economy to provide more productive employment. Programmatically, AID can continue to utilize DA and ESF funds to support efforts in the following areas:

1. The experimental development of non-conventional, domestic sources of energy.

2. Research to develop and apply more profitable farm technology for rainfed and upland areas to improve agricultural productivity, including research to develop more commercial uses for key crops.

3. Generation of more off-farm employment.

4. Family planning efforts to help reduce the future need for jobs.

5. Better local government resource mobilization and a national government review of related policies.

In helping to reduce the inflationary effects of deficit spending, AID can also seek ways to make more of its project contributions available up front instead of toward the end of its projects, and should seek to maintain an average DA ratio of AID funding to total project cost of at least 60 percent, as agreed in the last Consultative Group Meeting on the Philippines.

In addition, several macroeconomic policy areas should be of concern to AID as it implements its assistance strategy in the Philippines:[1/]

1. Adjustments in the peso exchange rate and their effects on relative prices, resource allocation, production, employment, and income distribution.

2. Income and employment effects of agricultural pricing policies.

3. Rural and regional employment effects of legal minimum wage requirements.

4. Employment effects of subsidized mechanization of agriculture.

5. Employment impact of industrial investment.

Such policy issues as these are part of the broad environment in which AID assistance takes place and should therefore be followed closely. The nature of AID's program and our relationships with the GOP may not allow direct influence on these issues. However, they may form part of the informal dialogue we maintain in the course of designing and implementing our programs and interacting with counterparts. In addition, some issues should be part of the development assistance dialogue we have with other donors, especially the World Bank, IMF and the Asian Development Bank.

1/ See pages 7-8 of the USAID/Philippines FY 84 CDSS for a discussion of how such concern might be expressed and how the Mission can play a productive role in drawing attention to the implications of some of these policies.

II. Recent BOP and Inflationary Trends and Problems

A. Growth of BOP and Current Account Deficits. While the Philippine economy managed to grow at a moderate but respectable rate of 5-6 percent annually in the 1970s, its external current transactions have deteriorated sharply in recent years. The country's current account deficit has risen from an annual level of $752 million or 3.6 percent of GNP in 1977 to $2.07 billion or 5.9 percent of GNP in 1980. For 1981, the deficit is expected to have reached $2.7 billion, or 6.8 percent of GNP. The trade gap has been growing despite a strong 88 percent growth performance in export earnings over the last five years. Imports, on the other hand, have increased by 115 percent during the same period, resulting in a trade imbalance amounting to $1.9 billion in 1980 and about $2.5 billion in 1981. Similarly, a significant 120 percent expansion in service imports due to increased freight and insurance charges and higher interest payments also contributed to the current account deficit, notwithstanding a considerable hike in service receipts due to higher remittances of Filipino contract workers abroad. (See Table 1).

Most of the growing current account deficit, however, has been covered by a capital account surplus (which averaged about $1.0 billion each year during 1977-1980), as the Philippines continued to borrow heavily to maintain the level of imports essential to its own domestic production activities and to its economic development program. Net medium- and long-term loans and short-term capital inflows totalled $3.74 billion and $1.14 billion, respectively, from 1977 to 1980 as foreign borrowings financed 87.5 percent of the cumulative current account deficit during the period. About one fifth of gross long-term external borrowings have been carried out through the Central Bank's Consolidated Foreign Borrowings Program (CFBP) that is tasked with getting external financing at the most favorable terms in the international capital markets. Long-term borrowings under the CFBP amounted to cumulative $1.1 billion as of 1980. The Central Bank also floats government bonds and selects development projects for foreign financing. Government bond flotations reached $383 million in 1980.

There has also been a net inflow of direct investments of $536 million during the past four years, mostly in the form of reinvested profits, earnings, and technical fees which were channeled mainly to the manufacturing, mining and financial sectors. The Philippines likewise availed of IMF resources under the Extended Fund Facility as well as the Trust Fund Facility to partially offset the payments deficit. Total drawings against the IMF resources and the monetization of gold from 1977-1980 amounted to $259 million, or 4.6 percent of cumulative current account deficit during the past four years. Due to these sizeable flows of capital finance, the country's overall payments imbalance has been kept far below the deficit on current account, with the BOP deficit averaging some $335 million from 1978 to 1980, compared with a surplus of $164 million in 1977. In 1981, the annual BOP deficit is estimated to reach $560 million, or about $179 million higher than the previous year's level.

B. External Terms of Trade and World Market Developments. External terms of trade have turned sharply against the Philippines since 1974. Commodity structure and market concentration place the Philippines in the position of a price taker for most of its exports. Until fairly recently, a substantial share of the country's exports have been contributed by a few traditional products such as coconut, sugar, mineral and forest products. (These products still accounted for 47 percent of commodity export earnings in 1980.) Due to the lack of government encouragement, inward-looking industrialization policies, and long periods of overvalued peso exchange rates, export diversification evolved very slowly in the post-war period. It was only in the mid-70s that there was a significant increase in the exports of non-traditional manufactures, and export earnings from these have tripled, from $670 million in 1977 to $2.04 billion in 1980. The country's markets, however, have remained concentrated, with a high 60 percent of total exports in 1977-1980 going to the U.S. and Japan.

In the past, the prices of these traditional exports have generally followed the long-term demand trends in buyer countries and short-term stock-cycle movements. Short-term price declines were usually counteracted by increases in the volume of exports, enabling the country to enjoy relatively steady growth of total foreign exchange earnings. After a peak in 1973, however, prices of major commodity exports have deviated from their traditional behavior as serious recessions in the economies of major trading partners coincided with a supply glut in the world market. As a result, prices of major commodity exports have fluctuated violently in the last eight years, with the unit prices of coconut, sugar and copper products experiencing the strongest movement. Subsequent declines in the prices of these commodities, coupled with rising import prices, have led to a severe deterioration in the country's external terms of trade.

In 1980, the export price index was 44 percent higher than its 1977 level, but only 1.5 percent above the 1974 record. Import prices, on the other hand, have risen at an average annual rate of 9.2 percent since the mid-70s, pushing the 1980 import price index some 70 percent higher than its 1974 level. Consequently, the external terms of trade deteriorated from an index level of 114.5 in 1974 (1972 = 100) to 68.6 in 1980, indicating a 40 percent decline in the unit purchasing power of exports between 1974 and 1980.

In addition to adverse price movements, the international economic environment has been relatively unfavorable to Philippine exports. The imposition of quotas for sugar, the increasing protectionist policies in industrialized countries, and the growing number of cheaper substitutes for some of the country's major export commodities have prevented an increase in volume that could have helped to offset the effects of lower prices and thereby to reduce the trade imbalance. In the same manner, the worldwide economic recession is adversely affecting demand for non-traditional manufactured exports at a time when the productive capacities of various export industries are expanding, hindering the brightest prospects for the country's external sector.

The outlook for a substantial improvement in the country's terms of trade in the near future is gloomy. In addition to the slowness of the expected recovery of the world economy over the next couple of years and the Western protectionism that has been plaguing non-traditional exports, coconut product prices are not expected to recover much from their current slump. Although the Philippines accounts for more than 85 percent of the world supply of coconut oil,this commodity represents only about 4 percent of the total supply of vegetable oil, since substitutes like soy bean, corn, and palm oil abound. As for sugar, while the present international quota arrangements may assure a more stable market for part of the country's produce, it seems that sugar prices are still subject to fluctuations. Due to its own forward sales the country would stand to benefit less from higher prices, although it is partly protected from the adverse effects of lower prices. A more serious situation confronts coconut products. It is apparent that world demand for Philippine coconut products can be readily shifted to their substitutes.

Meanwhile, it will be difficult to reduce the growth of imports below that of exports for the following reasons: 1) the high dependency of the industrial sector on imported raw materials, 2) the difficulty of achieving more than a gradual reduction of crude oil imports, despite the accelerated five-year energy program, 3) the increased import demand that will follow the scheduled import liberalization and tariff reductions, and 4) the apparent reluctance of the GOP to raise the price of imports substantially by permitting real peso devaluation.

C. Domestic Factors Contributing to the BOP Deficit. The process of capital formation and economic growth in the Philippines has been relatively import-intensive. As a result, the volume of imports has risen steadily by some six percent annually since 1974. Total imports in 1980 correspond to one-fifth of GNP and almost three-fourths of gross domestic capital formation (GDCF). Sustained increases in both import volume and prices in recent years have resulted in substantially higher import bills (around $7.73 billion in 1980 compared to $3.14 billion in 1974) and trade deficits.

Around one-third of the increase in the dollar value of imports is attributed to oil imports alone. Indeed, the Philippines is among those oil-importing developing countries most seriously affected by the steep rise in the international price of petroleum, as its oil import bill rose to $2.23 billion (29 percent of total imports) in 1980, 339 percent more than its 1974 level, owing largely to the 290 percent increase in prices during the period. A considerable share of the country's foreign exchange earnings are now absorbed by payments for crude oil imports--almost one-third of total commodity export receipts and about 24 percent of the combined earnings from exports of all goods and services. In terms of volume, however, there has been a four percent drop in oil imports between 1977 and 1980, reflecting the effects of the government's intensive energy conservation and domestic energy development programs to reduce dependence on imported fuels.

Strong demand from the economy's highly capital-intensive industrial sector has also kept imports at a high level, particularly for capital and intermediate goods and raw materials. For the past four years, imports of these items are estimated to have grown by an average of 6.5 percent annually in real terms, slightly higher than the GNP growth rate and roughly approximating the growth of industrial output. Their aggregate dollar values, on the other hand, rose by a hefty 21.6 percent yearly from 1977 to 1980. Specifically, the dollar value of capital good imports grew by 22.5 percent annually between 1977 and 1980 as industrial expansion activities and the government's public infrastructure program went into high gear.

The 20.5 percent annual growth of payments for imported intermediate goods and raw materials during this same period was attributable partly to the continuous high level of demand from the import-dependent chemical, iron and steel, and textile manufacturing industries, and partly to the rising demand for imported inputs coming from the new export-processing industries. The latter have been granted special duty-free privileges, and their payments for imports under these arrangements grew from $100 million in 1975 to an estimated $440 million in 1979, representing the most rapidly growing item in the country's import bill.1/

Given the scarcity of domestically available capital goods, the government itself also requires a substantial volume of imports to sustain its own development plans. Particularly large investments in direct support of the government's development program in energy, transport, irrigation and other infrastructure have contributed to increased demand for imported capital goods. The public sector's need for foreign exchange has been high throughout the 1970s, and its demands were met mainly through external capital financing and concessional loans from multilateral and bilateral institutions.

D. Domestic Price Inflation. After increasing by an average of 18 percent annually between 1970 and 1974 (rising to 35 percent in 1974), domestic consumer price movements were moderate in the succeeding four years (7-9 percent). During the past few years, though, inflation again rose to a double-digit level, with consumer prices increasing by some 17-18 percent annually in 1979 and 1980 and by around 12 percent in 1981.

Several factors, both external and internal contributed to the rapid inflation rates in the early and late 70s, factors such as higher cost of imports, particularly oil, consequent increases in costs of public utilities like power, fuel and transport, sharp increases in the statutory minimum wage, allowances and other pay adjustments conceded to persistent labor unions by both public and private enterprises, and the government budgetary deficit.

Increasing import costs of petroleum, transport equipment, fertilizers, chemical products and some essential consumer food items have generally pushed wholesale prices upwards, particularly during the last two years. Domestic price stability during the 70's, in fact, has been especially vulnerable to the continued escalations in crude oil prices, which have triggered waves of adjustments in the prices of oil-related imports, transportation costs, public utilities, and, consequently, in minimum wages and other production costs. In practice, the government initially absorbs any oil price hikes through the consumer's crude oil equalization fund in order to defer related price increases in commodities, transportation and labor costs. This fund is financed from a built-in tax on the domestic retail prices of oil products. But when the fund is depleted and the GOP is no longer able to absorb the additional costs of imported crude oil, retail prices of all petroleum products have been allowed to rise accordingly. The

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1/ Based on The Philippines: Domestic and External Resources for Development, IBRD, November 29, 1979.

statutory minimum wage rates and/or cost-of-living allowances have also been periodically increased, particularly since 1975.

Increasing government expenditures for economic and social development programs have resulted in significant budget deficits during the 70's that were covered mostly by public borrowings from both domestic and foreign sources, with an expansionary impact on money supply and prices. (The actual budgetary deficit in 1980, on an obligation basis, was ₱3.94 billion, or 10.2 percent of total expenditures and 1.5 percent of GNP.) The GOP has managed to keep the growth of current operating expenditures to a moderate level; but the higher level of public demand for funds to finance capital outlays has contributed to the rapid expansion of net domestic credits and money supply, which rose annually by 21.5 percent and 17.0 percent, respectively, between 1970-1980. While a large portion of the growth in credit demand occurred in the private sector, gross government borrowings from domestic sources reached ₱17.28 billion in 1980 and the outstanding public internal debt stood at ₱41.18 billion by year-end 1980, or nearly six times the 1970 level. The strong contractionary effects of the external transaction deficits prevented an even more rapid increase in domestic liquidity from further exacerbating price inflation during the 70s. It seems clear, however, that price escalation during the past decade has resulted from excess monetary demand as well as from cost-push factors.

III. Demand Management

A. Changes in Major Determinants of the Aggregate Income Level.[1/] In assessing Philippine demand management policies in recent years, it is useful to review the behavior of major determinants of the aggregate income level insofar as they contribute to inflationary and balance of payments conditions--the aggregate spending patterns of the private, the government, and the external sectors.

Total domestic investments in the economy have increasingly exceeded the level of domestic savings. The domestic investment-savings gap has been financed mainly by increasing net borrowing from abroad. (See Table 2.) Private sector investment activity appears to have had a weaker inflationary effect than the public sector. (The efficiency with which physical capital is used is of course another matter, as evidenced by increasing incremental capital-output ratios). Deducting government investment expenditures[2/] from total gross domestic capital formation, as in Table 3, reveals that, except for 1975 and 1976, private sector investment spending did not exceed the level of domestic savings. Not all private sector investment was financed

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1/ The period of analysis is 1974-1980 since it was in 1974 that the effects of the energy crisis started to be felt in the economy.

2/ Present data collection methodology only permits a distinction between private and government sector construction. However, it is estimated that over 90 percent of expenditures on durable equipment investment is private.

from domestic savings, since, as Table 4 indicates, considerable foreign capital has been tapped. A portion of public investment is also funded from domestic savings. However, as a percentage of net loan capital inflows, private sector external borrowing was smaller than public external borrowing. The persistent deficit position of the government (see Table 5 for actual receipts and disbursements) implies strong inflationary pressures from public sector activity. The relatively large share of the public sector in external borrowing has in fact in large part been used to finance these deficits. The balance of payments current account deficit is deflationary. However, its large size has not been sufficient to offset inflationary pressures arising from government and private sector spending. The government has been able, nonetheless, to reduce inflationary pressures from the demand side in years when cost-push factors were pronounced, thus preventing an even faster rise in prices, by cutting back and postponing government expenditures, both in the operating and capital outlay budgets.

B. Domestic Policies Affecting Demand. In general, GOP fiscal policy has targetted the two key objectives of price stability and economic growth. Deficit spending is curtailed during periods of high inflation and increased in periods of slow private sector activity. In recent years, however, the country has faced a slow-growth-cum-inflation situation which places GOP fiscal policy-makers in a quandary (similar to that faced in many other countries). The fluctuating size of the actual fiscal deficit demonstrates a heavy reliance on fiscal policy to achieve the stabilization and growth objectives, despite the government's strong commitment to public infrastructure development, but tax revenue performance has been poor. Recent reforms of interest rate and other banking policies should help better mobilize and allocate investment funds, once the world economy recovers from its current slump and the demand for Philippine exports improves. Tough energy price policies have helped reduce the growth of demand for imported oil. Import restrictions and tariffs have protected import-substitution industries and shifted domestic demand from imports of final goods to locally produced goods heavily dependent on "essential" imports of intermediate inputs. Recent wage agreements have increased legal minimum wage levels somewhat above current market rates, thereby reducing demand for labor and adding to cost-push inflationary pressures.

Given the government's ambitious infrastructure and industrialization program, deficit spending will continue to be a major inflationary factor unless government revenue generation efforts are satisfactorily improved. Government consumption and investment expenditures have averaged 14.3 percent of GNP during 1974-1980. This relatively low ratio is expected to be maintained for the country's new Five-Year Plan period of 1983-1987. Officials have stated the government's intent to phase out its involvement in business as well as to reduce subsidies. Nonetheless, the absolute increase in expenditures would still be substantial given the expected growth in GNP in current prices, while the income-elasticity of tax revenue generation has remained below unity (at .90), despite repeated reforms. Moreover, there is no assurance that domestic manufacturing will be expanding very rapidly in the short run, especially considering the initially negative effects of the present structural adjustment effort.

The need for greater domestic resource mobilization is evident. Despite a series of reforms, the percentage of GNP collected as tax revenue by the national government has remained almost unchanged (between 11 and 12 percent) in recent years, while taxes collected by local governments have remained between 1 and 2 percent of GNP. The GOP is reviewing the possibility of eliminating unnecessary or inappropriately designed fiscal incentives, which would not only result in increased public resource mobilization but would also contribute to improvements in the industrial structure. Efforts to improve tax assessment and collection procedures are being intensified, notably the adoption of the gross income taxation scheme starting January 1, 1982. These measures may not be sufficient to reduce the present shortfall in revenue by much very soon, however, given the slow pace of economic recovery expected during the next one or two years.

Monetary policy has been geared principally towards assuring liquidity for priority sectors and industries and to ensure a sufficient level of funds for continued growth, such as the selective allocation of credit during periods of inflation and recession. As part of the on-going structural adjustment program, a system of floating interest rates, allowing them to rise to positive real levels, has recently been introduced to stimulate more private sector savings and better allocate funds for investment. Open market operations were improved and the rediscount structure was rationalized to enhance their effectiveness as policy tools in monetary and credit management. A major financial scandal during the first half of 1981 was quickly remedied by the authorities, but not before creating substantial damage to a number of big business firms. Short-term capital flight in search of higher interest rates and other returns is also a minor problem at present. Appropriate measures have been instituted, but the situation is likely to persist until domestic economic conditions become more attractive for investors (as foreign interest rates drop and foreign demand for exports recovers from its current slump).

The GOP has adopted a policy of passing on to consumers the full increases in oil import costs. Thus, there were a number of price increases for oil products, public utilities, and transportation after each increase in OPEC oil prices. Effective prices for energy fuels have oftentimes varied with the lowest prices set for "poor man's" fuel--diesel--and highest for avturbo and premium gasoline. The increasing conversion to diesel engines, however, has caused GOP to review its fuel pricing schemes. Power rates are likewise subjected to socialized pricing with higher rates for industry and increasing surcharges for higher amounts of household consumption. Higher prices and increased conservation efforts have brought down the average annual growth rate of energy consumption to 3.5 percent in 1978-1980, compared to 5.8 percent during 1975-1977. The development of alternative sources of energy has reduced the ratio of oil consumption to total energy use from 94 percent in 1978 to 81.1 percent during the first nine months of 1981. Total energy consumption in the first three quarters of 1981 declined by 2.6 percent (to 67.9 million barrels of oil equivalent) from the same period last year, largely due to a 6.3 percent reduction in oil consumption. This present decline, however, is not a result of energy conservation efforts alone. It is also due to the presently slower rate of economic activity and the increasingly prohibitive cost of imported fuel. The accelerated five-year energy program, as planned, will require a considerable degree of technological readjustment in many sectors of the economy.

Considerations of the country's capacity to import and the perceived need to promote certain industries underlie the restrictions on certain commodity imports. Worsening trade deficits since 1974 resulted in import controls which required prior referral to the Central Bank of an increasing number of import commodities. Favored industries were accorded special treatment, including tourist and export-oriented enterprises. While the sectoral allocation of imports may have changed significantly, there has been no major shift in the consumption of imports according to end use, with "essential" producer goods accounting for 72.3 percent of total imports in 1980. The government increasingly resorted to direct control of imports in reaction to the persistent trade deficit, until the import liberalization reforms recently announced as part of the structural adjustment effort discussed below. In recent years the GOP has intensified its efforts to promote the diversification of export markets and import sources, in response to the trade fluctuations confronting the economy. In part due to favorable political developments, some headway has been gained in developing trade relations with communist countries and in exploring various areas of trade cooperation with other ASEAN members and Third World countries, although the actual volume of trade with these countries is still fairly small compared with U.S., Japanese and West European trade.

Even prior to the recent lifting of martial law and the strike ban, the GOP had to concede some of the demands of organized labor to raise the minimum legal wage levels, primarily in response to inflationary increases in oil prices. There has been a consistent decline in real wages through the years, indicating that the demand for labor has not kept up with its supply and that the overall productivity of labor in the economy remains quite low. The present legal wage rates are considered somewhat higher than free market levels and, to the extent they are enforced and complied with, themselves limit employment. The present economic slowdown has taken a minor toll on employment, with some 72,000 urban workers reportedly laid off their jobs in 1981 (representing 0.4 percent of the 19 million-man labor force). More lay-offs are expected in early 1982. Moreover, a recent GOP study (Mijares and Samson, 1980) has found that a general wage increase in all sectors is more inflationary than a proportional hike in the price of petroleum products.

C. <u>External Borrowing and Debt Management</u>. The now chronic balance of trade deficits will continue to constrain the development program until they are substantially reduced. The foreign borrowing required to reduce the overall balance of payments deficit has increased outstanding foreign debt to a level ($15.8 billion as of December 31, 1981) that worries many observers. In response to severe imbalances in current account transactions since the first energy crisis, the Central Bank has also maintained a high level of international reserves as a protection against speculative activities in the floating exchange rate market. This meant an even heavier reliance on external financing both from the IMF and from private sources.

The external borrowing program for 1981 reflected the decision to accelerate investment in the energy sector and major industrial projects. Limits under the IMF stand-by credit authority on new external debt approvals in the 1- to 12-year maturity range incorporated a substantial allowance for this programmed investment. The basic limit on the new approvals was raised from $1.2 billion under the 1980 program to $1.7 billion, and an additional special tranche was introduced for approvals of $350 million for the nuclear power projects. The debt service ratio* rose from 13 percent in 1977 to 19 percent in 1980 and was expected to reach 21 percent in 1981. Higher interest payments accounted for 75 percent of the increase. If fully implemented, the higher level of planned foreign borrowing for the accelerated investment and energy program could lead to an even higher debt service ratio through the mid-1980s. The relatively modest rise in amortization payments over recent years reflects not only the impact of past restructuring and refinancing operations but also the success of GOP efforts to control medium and long-term borrowing. Short-term debt, however, increased rapidly from 1977 to 1980. The GOP recognizes the potential problems posed by the mounting volume of short-term debt and has tightened the criteria for short-term loan approvals.

Due to the prevailing high interest costs on foreign loans, the Central Bank decided to decrease the country's international reserves from an equivalent of seven months of import payments in 1980 to about four month's equivalent in 1981. This move was expected to save the country about $48 million a year, assuming an annual interest rate of 18 percent and the current level of imports. Prime Minister Virata recently expressed concern over the terms of foreign borrowing, in view of the relatively bleak outlook for exports and of the effects of fluctuating interest rates on the country's ability to borrow. These developments underline the importance of maintaining a cautious external debt policy and of ensuring that foreign borrowing is directed to the highest priority projects.

IV. Supply Management

A. International Competitiveness. While the overvalued exchange rate and recent increases in minimum wage levels work to the competitive disadvantage of Philippine exporters, current reforms in the tariff structure and import controls are designed to force domestic import substitution industries to become more competitive, and thereby more efficient in their use of productive resources. The total factor productivity of the industrial sector did not significantly improve in the 1970's, in part due to the inefficiencies protected by the trade regime, but also due to lack of attention.

The GOP has cautiously moved towards a policy of greater exchange flexibility. While from early 1976 until November 1979 the nominal exchange rate of the peso to the dollar fluctuated only within a narrow range, the peso has depreciated versus the dollar by 2.8 percent from December 1979 to December 1980 and a further 7.1 percent from December 1980 to December 1981. The real, trade-weighted, effective exchange rate index (adjusted for changes in relative consumer prices) indicates an appreciation of the peso of some 16 percent between 1978 and mid-1981, however, returning to its 1975 level, despite the large and worsening imbalance of trade.1/ Thus, the peso appears

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*IMF definition.

1/ IMF, "Philippines--Stand-By Agreement--Review and Modification," Report EBS/81/160, July 30, 1981, p. 16, Table 8.

to be strongly overvalued and more rapid downward adjustments are needed to restore balance, especially in the face of a significant reduction in tariffs and import controls and in a situation where the terms of trade seem to have taken a permanent turn for the worse. This would also enhance the competitiveness of Philippine exports. (See Annex, Part III.)

Despite some reduction in the margin of competitive advantage in recent years, mainly because of major wage adjustments, labor costs in the Philippines are still substantially below those of most competitor countries. This was reflected in the good performance of manufactured exports throughout the 1970's, following a substantial devaluation of the peso in 1970.

Concerted efforts to improve the policy and institutional climate for exporting have been directed in particular to non-traditional manufactured exports, which expanded at a very rapid rate during the seventies. In the case of traditional exports, which account for about half of Philippine export earnings, the policy response to external instability has taken the form of greater government intervention in the market, which the broad powers of martial law facilitated. Given the current slump in world trade and increasing protectionism among the major developed countries, substantial effort is still needed to diversify into products that would be less vulnerable to changes in world demand as well as to strengthen trade agreements that would assure steadier markets. The emphasis should be on the more labor-intensive light-manufactured goods, wherein the country has comparative advantage, and further capital-intensive investments should be discouraged, except for cases with particularly strong justifications on energy or foreign exchange earnings grounds.

With phased implementation that began in January 1981, the current tariff reform program calls for a total restructuring of the tariff system to reduce the effective protection rates (EPR) affecting domestic industries and to reduce the rate disparities among different industries. Prime targets for reduction are the manufacturing industries which have hitherto enjoyed "excessive" protection, while tariff rates are being raised for some capital and intermediate goods. The first phase of the tariff reforms (which is being supported by a $200 million structural adjustment loan from the World Bank) has already been implemented. (See Annex, Part I.) The successful implementation of these reforms will depend partly on the degree to which adversely affected vested interests are overcome, but the net long-run effects are expected to be significantly positive.[1/]

Corollary to the tariff reform, the GOP (through the Central Bank) has taken steps to liberalize import licensing and to simplify import procedures for non-essential consumer and unclassified consumer items. This is an important component of the industrial restructuring program, since exposure to foreign competition is considered a prerequisite to improving the efficiency of local industries and increasing the relative attractiveness of investment in export and other more labor-intensive home industries.

1/ See Richard Hooley, "An Assessment of the Macroeconomic Policy Framework for Employment Generation in the Philippines," USAID/P, April 1981.

Limited analysis has been undertaken with respect to trends in total factor productivity in the country, partly due to data constraints. After 1970, productivity in agriculture rose rapidly due to the technology introduced by the Green Revolution. In industry, productivity levelled off or declined slightly as the effects of inappropriate import substitution policies became fully manifest. The domestic and foreign terms of trade, which turned against agriculture during the decade, and the failure of manufacturing productivity to grow at a satisfactory rate have not only reduced labor absorption in general but have also had depressing effects on wage income in the rural areas. Technical assistance and adaptive technology research in support of small and medium scale industries have increased since 1972, but they have been neither very unified nor very effective in most of the country, except perhaps in the relatively small handicraft sector.

B. Mobilization of Domestic Savings for Investments. In response to the need to mobilize domestic resources to support the massive investment requirements of the development process, the government has implemented several measures to increase private voluntary savings. As a result, savings performance in the Philippines has improved during the last six years, although not by as much as anticipated. Gross domestic savings now averages about 14-15 percent of GDP, compared with an average of 10-11 percent in the late 1960s and early 70s. The ratio of household savings to GDP increased from 7 percent in 1970 to 10 percent in 1977, but then dropped to 4 percent in 1980 and 81. Corporate and government savings, on the other hand, increased from between 2 and 3 percent each during most of the 1970's to more than 5 percent each from 1979 to 1981.[1]

In view of the sharp decline in household savings against the increased national need for investment funds, policies with respect to interest rates and credit have become increasingly important. When inflation and taxes are taken into account the interest rates of return on savings deposits have been negative much of the time. The Central Bank has continually adjusted the interest rate structure in an attempt to provide positive real incentives to savers and to make long-term financial assets more attractive. Interest rate ceilings on savings and one-year time deposits were raised from 6 and 7 percent, respectively, in 1973 to 9 and 12 percent by 1979. Maximum commercial bank lending rates for loans over two years were raised from 12-14 percent in 1976 to 19 percent in 1979, while those for less than two years were raised to 14-16 percent in 1979 from 12-14 percent.

In mid-1981, however, as growth in household savings slackened, the Central Bank abolished ceilings on interest rates on deposits and deposit substitutes and on loans maturing in one year or more, thus allowing banks to charge rates based on market forces. The ceilings on shorter-term loans (less than one year) remain at 16-18 percent. This is intended to make the rates more closely reflect the real opportunity cost of capital and to make more domestic credit available for long term loans and investments. Higher interest rates should compel firms and banking institutions to use funds for higher priority purposes, stimulating greater capital efficiency in industries and a more rational allocation of domestic credit by the financial sector. A

1/ National income accounts, NEDA. 1981 figures are advance estimates.

major objective of the interest rate reform is to eliminate the distortions created by subsidized rates favoring large, urban-based, capital-intensive firms, discouraging household savings, and reducing credit availability to small entrepreneurs. The short-term loan ceilings, however, to the extent they induce a larger demand than supply, will still require banks to ration available short-term funds, which are in high demand for operating capital, etc., among prospective borrowers. This will permit continued non-market discrimination in making such loans against the smaller and rural firms facing higher risks.

The government has also stimulated the expansion of banking facilities and services in the country-side, where a sizeable network of rural banks has been created. Nonetheless, institutional and internal problems continue to deter the flow of funds into the rural sector through the banking system. For instance, the country's rural banks are plagued with problems of loan arrearages that have been incurred mostly in connection with GOP-sponsored food production programs such as Masagana 99 for rice and Maisagana 77 for corn. Private commercial banks and other similar institutions, on the other hand, cater largely to the financial needs of the urban sector, to the detriment of rural-based entrepreneurs. Large industrial firms and the higher-income families in Metro Manila and other major urban areas continue to get the bulk of the banking system's credit resources. Small firms and borrowers, in both urban and rural areas, have found it difficult to borrow at reasonable rates of interest and are either excluded from credit markets altogether or forced to borrow from non-institutional sources at much higher rates.

C. <u>Allocation of Investment Resources to More Productive Sectors</u>. The unbalanced pattern of sectoral development and the uneven distribution of the benefits of growth among the population, which have characterized Philippine development for the past three decades, are closely linked to resource management and allocation policies such as tariff rates, fiscal and other capital-use incentives, price and wage controls. The limited access of small-scale and rural firms to investable resources and the concentration of investment in large-scale enterprises have reinforced the highly skewed pattern of asset ownership and income distribution that has existed since the colonial period. And although the aggregate level of resources available for investment has been increasing in recent years, output and employment growth have been disappointing, due to a decline in the overall efficiency of capital investment. As a result, the average incremental capital-output ratio[1/] in the Philippines has risen from 3.4 in the early 70's to 4.2 during 1978-1980. Though there is a dearth of data that could pinpoint the sectors and the reasons for this, the bulk of fixed investments has been concentrated in manufacturing projects whose impact on output and employment has been relatively small. This can to a large extent be attributed to past industrialization and trade policies conferring inducements and subsidies (through fiscal incentives) and heavy protection (via tariffs and

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1/ The incremental capital-output ratio is defined as the ratio of fixed capital formation in the current period to the increase in current GDP over the previous year.

import and exchange controls) to import-substituting, large-scale and capital-intensive industries producing mostly consumer goods, while export and backward-integrating, small- and medium-scale, labor-intensive industries have been discriminated against. High levels of protection notwithstanding, the development of import-substituting industries failed to reduce imports because of the large import component of their own inputs, the high import content of new capital investment, and the higher level of import demand generally associated with an overvalued exchange rate.

The adverse effects of these policies are gradually being reversed by the government's policy reforms to restructure the industrial sector and make it more competitive and more efficient. The fiscal incentives system (mainly in the form of tax concessions and exemptions, as well as tax credits and subsidies) has generally had a capital-cheapening impact and, consequently, has had a significant effect on the nature of industrial production and employment. Since the mid-1970's several modifications of the incentives system have been introduced to increase the attractiveness of new investments in export-oriented and labor-intensive industries. These have included the exemption of export enterprises from payment of customs duties and sales taxes for intermediate inputs, tax credits for labor costs and the use of domestic raw materials, and additional incentives for "pioneer" firms that introduce either new products or labor-intensive processes, or that can show 50 percent of sales were for export. Several measures have also been adopted to encourage export infrastructure development and the generation of more employment. Three export processing zones have been established, and others have been planned in selected growth centers. Over the period 1971-1979,[1] the share of total cash equivalent incentive benefits derived from capital-use related incentives declined markedly, while the shares derived from export promotion, labor-use and other incentives rose substantially and are expected to continue increasing in future years.

The GOP imposes price ceilings on selected basic commodities and services like rice, milk, sugar, meat, canned fish products, transport and power; but, as a matter of policy, it has periodically adjusted such ceilings to maintain production incentives and avoid supply shortages. As a result, the prices of most of the regulated items are not thought to be far from market-clearing levels. Agricultural product prices are kept low, however, and in real terms have fallen, in an effort to favor consumers. With real input prices rising, producers are caught in a cost/price squeeze that hampers adoption of more productive technology in traditional farming systems.[2] The adverse effects of these policies are amplified by the price distortions of the protectionist trade regime which, since it is designed to raise the prices of imported manufactured goods, skews the entire price matrix against agriculture, depressing production and income in the rural sector. Through the negative multiplier effects of depressed consumer demand, the adverse effects pervade the rural

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1/ See "Philippines - Recent Economic Developments," International Monetary Fund, SM/80/183, July 24, 1980, p. 23.

2/ For more detailed discussion of agricultural pricing and other policies see Cristina David, Analysis of Agricultural Policies in the Philippines, February, 1982.

service and industrial sectors, as well. The price effects of the overvalued peso exchange rate also favor the import-dependent industries, employing a small number of workers, over the export-oriented agricultural and non-traditional manufacture producers, who employ a substantial percentage of the labor force. (See Annex, Part III.)

The minimum legal wage rates and cost-of-living allowances of workers in industries and agricultural plantations have created artificial wage differentials that reduce incentives to hire labor. In 1980, wage decrees restored the legal real effective minimum wage levels of industrial workers in Manila and non-plantation workers to their 1970 levels, while those for plantation workers were about 30 percent higher. While the legal minimum wages for non-plantation agriculture are substantially below those for workers in Manila (by 37-39% in August 1980), those for non-agricultural workers outside Manila are only slightly below Manila levels (4%). This places non-agricultural wages outside Manila much higher than agricultural wages (by 54-59% in August 1980), and the latter are already above actual rural wage rates. This places any producer outside Manila who must abide by minimum wage laws at a distinct disadvantage competitively with one who is able to avoid them, and it makes investment in labor-intensive activities outside Manila look less attractive. Even though the government has allowed exemptions for financially distressed firms, the impact of these laws, to the extent they are enforced, will be to reduce employment, especially in non-agricultural enterprises outside Manila. The government is aware of the adverse effects of high wages on employment and on investment in labor intensive industries and has generally kept increases to the lowest politically acceptable levels. This has become more difficult as the capital-intensive bias of most domestic industrial investment has resulted in a low rate of growth in the demand for labor by the manufacturing sector, contributing to the fall of real (actual) domestic wage levels in non-regulated activities.

D. Domestic Energy Program. The Philippine government has been pursuing an active energy policy in recent years and, as articulated in its latest national energy program (1981-1986), envisions steady progress toward greater energy independence through expanded exploration and development of domestic energy resources, as well as through energy conservation.

Domestic oil production started in 1979 at the Nido Field and amounted to 7.7 million barrels, accounting for 8 percent of total annual energy consumption. However, owing to technical problems, local oil output started to decline beginning 1980 and is estimated to reach only 1.88 million barrels in 1981, or about 2.2 percent of total annual energy demand. A new oil field (Cadlao) commenced production in late 1981 and another (Matinloc) is expected to go onstream in early 1982. These should raise domestic output to an annual rate of 5-6 million barrels in the next few years and help reduce dependence on imported oil from 81 percent of total energy supply in 1981 to 71 percent in 1982.

Significant progress has been made in developing other domestic sources of energy. Geothermal energy production started in 1979 and was able to meet 3.8 percent of the total energy consumption in 1980. Having a geothermal production capacity of 446 megawatts, capable of displacing 4 million barrels-of-oil equivalent (MBOE) a year, the Philippines is now the world's second largest producer of geothermal energy, the United States being the first. Hydropower generation, coal and non-conventional energy (biomass, solar, etc.) production are being accelerated, and their contribution to total energy supply is targetted to more than double in 1982, rising from 7.2 percent of total energy consumption in 1980 to 15.2 percent. Thus, the share of domestic energy output in total energy consumption is expected to increase from 16.7 percent in 1980 to 18.7 percent in 1981, and to a much higher 28.7 percent in 1982.

Owing to strict energy conservation measures by the government, and partly due to the slowdown in economic activity, total energy consumption in the Philippines for the past three years increased by an annual rate of only 2.3 percent, or from 82.8 MBOE in 1977 to 88.6 MBOE in 1980. A key element of the energy conservation program is the official policy of adjusting domestic retail prices of fuel products to reflect changes in import prices of crude oil. The cumulative increases in the domestic retail prices of gasoline, diesel and kerosene products from 1973 to 1981 have been 863 percent, 648 percent and 701 percent, respectively. In addition, other measures adopted in recent years to encourage energy conservation in both the government and private sectors have included: (a) new energy taxes on oil products, on motor vehicles, and on the consumption of electricity by households in excess of 200 kwh per month; (b) a requirement for the public sector to reduce its consumption of oil products and power by 10 percent; (c) higher sales and registration taxes on larger gasoline-powered passenger cars to discourage their use. Incentives are also being provided certain industries to encourage them to shift from imported fuel oil to domestic sources of energy.

V. Implications for AID Assistance Strategy

AID and other development donors have strong reasons to seek ways they can help the GOP reduce its trade deficit and rate of price inflation. In addition to this, however, the root causes of the Philippines trade deficit and inflationary problems have important implications for the relative success of certain development efforts and the possible contributions of foreign aid to their long-run solution. The effects of these causes go beyond inflation and the balance of payments into other areas of development concern, as well.

The large surplus of imports over exports makes it necessary for the Philippines to borrow heavily from foreign sources to finance the resulting current accounts deficit. To the extent such foreign credit is limited or the ability or willingness of the Philippines itself to service a larger foreign debt is limited, such borrowing to cover current trade deficits reduces the availability of similar funds for more development-oriented investments. This can result in a slower development process. AID and other sources of development assistance obviously play an important role in providing investment funds specifically earmarked for development activities.

The effects of inflation on project costs and on the ability of the host government to finance peso counterpart costs of development projects are well known. Estimates of future cost escalation are routinely included in new project budget proposals; but these are often far from the mark due to the unpredictable nature of inflation, and project implementation has frequently been delayed due to insufficient funds to cover escalated costs.

A. Causes of Foreign Trade Deficits. The causes of the chronic foreign trade deficit significantly affects areas of AID development concern and provide opportunities for assistance. The four major causes are: 1) the precipitous rise in crude oil prices, 2) falling world market prices of and quantitative restrictions on traditional exports, 3) strong import demand due to an import-dependent industrial sector, and 4) readily available international credit to finance an import surplus.

1) The high and rising costs of energy place a premium on the more efficient use and conservation of energy, on seeking less energy-intensive production technology, and on the rapid development of lower-cost domestic energy sources. Most foreign donors are attempting to assist the government implement its energy program. AID can perhaps best assist, as it is currently planning to do in both the DA and ESF programs, by supporting the experimental development of non-conventional sources of domestic energy, leaving the more costly investments in conventional energy sources to the larger donors.

2) Falling international prices of such primary commodities as coconut and sugar, to the extent attributable to lower cost competition or substitutes from elsewhere rather than to a temporary surplus of supply, are grounds for a careful reassessment of domestic production costs, technology and marketing arrangements. Marginal coconut lands could probably be interplanted to annual or perennial crops or eventually converted to other, more lucrative crops, for example, while coconut production technology in areas better suited to coconut could be upgraded in order to lower costs per kilo and make it more competitive with other vegetable oils. Much more research needs to be done for upland areas to develop and apply more profitable farm technologies and also to develop more commercial uses for key crops. AID can usefully support efforts in these areas with DA and ESF assistance.

In the meantime, the current government policy of imposing a heavy tax on coconut exports reduces the millgate price of copra and exacerbates the impoverishing effects of low productivity, low world market prices and an overvalued peso exchange rate on small coconut farmers, already one of the largest poverty groups in the country. In view of our concern with the coconut farmers as a key group of development assistance focus, the impact of the coconut levy on their income and on rural demand and employment in those areas is a matter of direct interest to AID. (See the Annex, Part IV, for further discussion of this issue.)

With respect to sugar, the vacillating world market price of recent years, especially when viewed through an overvalued peso exchange rate, puts pressure on plantation owners to reduce costs. This should also be a matter of careful reassessment. One option currently being proposed for foreign donor funding is the mechanization of sugar plantation operations presently performed by more labor-intensive methods. That this option looks more financially attractive to the larger-scale sugar planters than it looks socially and economically attractive to a nation with surplus labor is due largely to artificial price distortions: the overvaluation of the peso, duty free importation of and subsidized interest rates for the capital equipment, and the legal minimum wage decrees which force plantation owners to pay higher than market wages for workers (to the extent they are enforced, mostly on the larger plantations). The sugar planters are no doubt also interested in ways to reduce their own problems with labor unrest, since it is easier to deal with machines and a smaller workforce than with large and sometimes unruly unions. If they solve their own financial and labor problems by reducing employment, however, they will simply increase the incidence of poverty and social unrest in the society at large. Project proposals that would subsidize agricultural mechanization and prematurely displace labor should be a matter of policy concern in AID, especially if such projects would affect the landless worker group in one of the CDSS regions. (See Annex, Part V, for further discussion of the sugar industry mechanization issue.)

3) The import dependency of the industrial sector has been created by (a) cascading tariff protection and other import controls with lower duties on imports of capital equipment and intermediate inputs than on final goods, (b) subsidized interest rates on investment capital, and (c) an overvalued peso exchange rate that artificially cheapens duty-free imported equipment and other inputs, are matters of development concern since they also result in lower wage and farmer income and lower rates of domestic employment generation, the primary focus of our Philippine country development strategy. As reported above and in the Annex, Part I, the GOP is satisfactorily implementing a reform of its protectionist tariff structure and other import controls under the World Bank supported industrial structural adjustment program. Also, as of 1981 all interest rate ceilings were abolished except for those on short-term loans of less than one year. This should help reduce the relative attractiveness of capital equipment and intermediate good imports which has created such a pronounced dependency on imports in the industrial sector.

The peso exchange rate has yet to be significantly altered, however. (See Annex, Part III.) AID's concern with employment generation and poverty alleviation in rural areas leads to a considerable interest in the positive effects a peso depreciation would have in these areas, particularly since we are focussing our assistance on some of the groups that would be affected. In addition to the higher earnings of coconut and sugar exporters, at least some of which should filter down to the small-scale farmers and landless workers, the peso value of other tradable commodities such as rice would also be affected, to the extent domestic price comparisons and movements are related to world market prices. Higher prices for such products would increase incomes, production and employment in the agricultural sector, with positive multiplier effects in the rural economy due to increased farmer demand for locally produced goods and services. This has important implications for efforts to assist the development of the rural economy, especially in the field of rural enterprise. In addition, to the extent peso depreciation reduces the attractiveness of capital-intensive technology by raising the cost of imported equipment, investors will be encouraged to invest in more labor-intensive production processes, thus generating more employment. AID should, therefore, encourage the government to focus attention on the implications of an overvalued peso on the achievement of its development objectives, since this is of particular relevance to the success of our