ECONOMIC ASSESSMENT OF THE NEW SOCIETY AND KEY PROBLEMS AND ISSUES FACING THE NEW REPUBLIC OF THE PHILIPPINES

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Table of Contents

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SUMMARY: In 1981 the Philippines saw the official lifting of more than eight years of government by decree under emergency Martial Law powers. Marcos installed a new cabinet, including the country's first Prime Minister, following his own June 30 inauguration for another six years in office. This is an appropriate juncture for an assessment of the economic progress and government performance under the "New Society" program of the 1970's and a brief look at the key problems and prospects faced by the "New Republic."

A. Assessment of Progress and Performance: The Philippines achieved a strong record of overall economic growth during the 1970's, despite sharply deteriorating terms of trade. Self-sufficiency in the production of rice was attained. Energy dependence on imported oil was reduced somewhat, although it is still very high. The rate of inflation was moderate, except for two short periods following sharp increases in imported oil costs. Domestic resource mobilization has improved and is more equitable than before, although it is still short of requirements. While export growth has been strong, especially of non-traditional manutured items, it has few domestic linkages. The balance of trade has nonetheless worsened, due largely to rising prices of oil. Current account deficits and borrowing required to finance these deficits have become serious potential problems.

Health and education status improved but serious deficiencies remain. Much less progress in improving the income levels of the bulk of the poor was recorded. Actual real wages have declined, but so has the real cost of rice, an important wage good, thus reducing upward pressure on urban wages. The manufacturing sector still does not provide sufficient employment opportunities. The employment performance of the agricultural sector improved considerably, but productivity per worker remains low and the declining real price of rice has reduced incomes of some farmers. Environmental degradation is relentlessly destroying natural productive assets, and no significant progress has yet been recorded in reducing the highly unequal distribution of income. Economic growth rates in the poorer areas are still generally below those of Manila and Central Luzon.

Measured against key policy reforms and development programs recommended to achieve more rapid employment generation and rural development, the performance record is mixed. The family planning program has contributed to the reduction of the population growth rate from 3.0 to 2.4 percent. There has been considerable investment in large-scale rural infrastructure, especially roads, irrigation facilities and rural electrification; but less effort to help local governments build mini-infrastructure, nor has the extension of public social services yet reached rural households equitably. Land reform is bringing about a more equitable distribution of land and more secure tenure.

Considerable efforts to promote small- and medium-scale industries and industrial decentralization have not been very successful. The rural electrification program is proceeding rapidly, but roads and communication facilities are still unsatisfactory. There are as yet only three export processing zones in operation. Fiscal reforms to encourage smaller, more labor-intensive industrial firms have been implemented. The banking system has been expanded and branches established all over the country, but loan approvals and other decisions remain centralized in Manila. Interest rate ceilings were recently or are about to be lifted on all savings and loans except loans of one year or less. The government has moved slowly to implement needed tariff reform (now underway) and has not maintained a slightly undervalued peso exchange rate as recommended. A significant reduction in capital-use fiscal incentives has occurred, but the need for unified technical assistance for small- and medium-scale entrepreneurs has been neglected.

Development planning and administrative reforms have much improved the efficiency and development performance of the national government. While several efforts have improved the development planning and implementing capacity of local governments somewhat, local executives do not yet control sufficient resources to develop and utilize such capacity effectively.

B. <u>Key Problems and Issues Facing the "New Republic"</u>: While the Philippine economy has been growing at a satisfactory overall rate, the distribution of income has not significantly improved. Achieving a more equitable pattern of growth and income distribution has become the most serious challenge to the Philippine Government, with implications for the future political stability of the country. The most promising avenues for meeting this challenge are a more rapid rate of productive employment generation, particularly in the manufacturing sector, and successful development of the rural sector.

The promotion of small- and medium-scale industries is key to the success of the effort to provide more employment, and it will depend on more effective technical assistance, improved communications, truly decentralized banking services, and the full implementation of tariff reforms and import liberalization measures.

Efficient use of available capital resources to achieve the goals of employment and greater equity will require careful analysis into the employment effects of each of the proposed eleven major industrial projects.

The high rate of population growth will remain a problem of the first magnitude until more substantially reduced.

In rural development, it is essential for the government to devolve sufficient authority and resource control to local institutions to improve mini-infrastructure and local services and to improve local and national revenue generation. Degradation of the environment presents a serious challenge. In addition, a major effort is needed to improve the productivity of hitherto neglected rainfed and upland agricultural areas.

In rural enterprise development and the current livelihood program, "quick-fix" solutions are tempting, but more often than not they are designed and foisted on local governments from above and are ill-suited to the priority needs and actual economic conditions of the supposed beneficiary community. The potential for considerable waste of scarce resources is high, and accelerated implementation of untested approaches should be avoided.

Fiscal management will continue to be a problem area, since the burgeoning foreign project portfolio places heavy administrative and counterpart peso burdens on line ministries and the Treasury.

The now chronic balance of trade deficits will continue to constrain the development program. Foreign borrowing to reduce the balance of payments deficit has increased foreign debt, and debt service requirements are rising. While vital to the long-run success of export promotion and employment generation efforts, the short-run effect of the tariff restructuring and import liberalization program, in the absence of compensating exchange rate adjustments, will be to increase imports faster than exports, increasing the negative balance of trade.

Overvaluation of the peso vis-a-vis other currencies has been exacerbated by the sharp deterioration in external terms of trade, caused in part by rising petroleum prices and falling coconut prices on the world market. The heavy foreign borrowing required to finance the trade deficit also reduces pressure on the peso exchange rate. Unless a more substantial rate of peso depreciation is adopted, there may be increasing pressure, for balance of payments reasons, to retain the protective tariff structure and to continue the high level of foreign borrowing.

Liquid capital flight is a source of worry because it is thought of as essentially one-way. This need not be so, if the conditions that prompted it change. Unsettled economic conditions world-wide in the last several years have driven capital into more liquid holdings. These mobile funds could just as easily return if the attractiveness of liquid dollar investments wane and local opportunities improve. Net inflow of recorded short-term capital movements is expected to drop to about half its 1980 level, but nevertheless to remain positive. The net inflow of direct investment, on the other hand, is expected to rise (from 50 million dollars in 1980 to 290 million in 1981).

C. Economic Outlook: Solutions to the Philippines' economic problems will require a determined and consistent effort for many years. There are no easy answers in the short-run.

The economy will continue to be buffeted in the near future by large current account deficits, mounting foreign debt and debt service obligations, and an increasing number of business failures, the latter in part an expected result of dismantling the import-substitution and capital-use subsidy regimes.

High rates of underemployment and low worker productivity can be expected to intensify in the short-run, due to the continuing high growth rate of the labor force and minimum lead time required to increase productive jobs significantly.. Continued inflationary pressure can be expected from the high level of projected development expenditures and the government's limited ability to raise domestic tax revenues.

In the longer-run, resolution of these problems depends on whether the government succeeds in restructuring the industrial sector toward more labor-intensive lines of production, expanding manufactured exports, developing domestic energy sources, conserving on energy consumption, and mobilizing and developing the rural sector. END SUMMARY.

Economic Assessment of the "New Society" and Key Problems and Issues Facing the "New Republic" of the Philippines

I. Economic Priorities and Performance of Martial Law: A Brief Assessment of the "New Society" Program.

A. Philippine Economic Conditions of 1972: A Brief Review

Between 1950 and 1972 GNP grew at an average annual rate of 5.2 percent in real terms, while per capita GNP grew by 2.2 percent. This growth in income, however, was accompanied by a pattern of distribution that was already highly unequal in the 1950's and was becoming more so. The share of the poorest 60 percent of rural families dropped from 32.8 percent of total rural income in 1956 to only 27.2 percent in 1971, while the median income in rural areas, which amounted to only half the median urban income in 1956, grew more slowly than that of urban areas.

The economy was failing to provide more productive jobs fast enough to keep up with the growing labor force. While the labor force was growing, between 1960 and 1972, by an average of 3.2 percent a year, the agricultural sector was providing jobs for only 2.3 percent more workers a year and the more productive manufacturing sector for only 2.1 percent more. More and more workers were being forced to seek employment in low-productive jobs in the service sector -- in which employment grew by 6.6 percent a year and real productivity (net value added) per worker actually declined, by an average of 1.4 percent annually, throughout this period.

The increasing social unrest that marked the end of this period and helped trigger the declaration of Martial Law is a matter of public record..

Growth in output of the manufacturing sector during the 1960's was not remarkable, averaging only 5.3 percent in real terms.

The net value of manufacturing output rose from 17.5 percent of net domestic product in 1960 to only 19.1 percent by 1972, while the percentage of total employment provided by manufacturing fell from 12.1 to 10.5 percent. There were several key reasons for this poor performance. First, the import substitution policies adopted in the 1950's, similar to those of many less-developed countries in the 1950's and 1960's, had prevented the growth of manufactured exports, while encouraging a heavy dependence on imported, rather than domestic, inputs. In the 1960's the manufacturing sector relied almost totally on primary commodity export earnings of foreign exchange for their capital and intermediate good input requirements. The percentage of total export earnings accounted for by traditional primary commodities was still 85 percent in 1972, down only slightly from 95 percent in 1960. Agricultural growth was not rapid enough both to earn the foreign exchange needed to support more rapid industrial growth of such an import-dependent nature and to feed the rapidly growing population. In fact, the country was no longer self-sufficient in foodgrains, and cereal imports rose rapidly after 1970 from 3.0 percent of imports to 5.1 percent in 1975. Future prospects looked grim, especially since the total population was growing at an excessively high annual rate of 3.0 percent, placing increasing demands on domestic food supplies.

Secondly, although the peso was devalued in the early 1960's, and again in the early 1970's, and physical control of imports was cancelled, the retention of the highly protective tariff structure, enacted in 1957, prevented a substantial trade liberalization. The biases against industrial exports and in support of import substitution continued, perpetuating policies favoring large-scale, capital-intensive, urban-based industrial development with few productive linkages into the rural sector and retarding the growth of manufacturing employment opportunities.

Growth in agricultural output averaged 4.0 percent annually between 1960 and 1972, in terms of constant price value, while agricultural employment increased by only 2.3 percent per year. Most of the readily cultivable land had been bought under the plow in the 1950's and there was little room left for additional expansion into new land. By 1972 it was evident that cultivation and logging were proceeding apace in hilly, forested areas in an irresponsible manner, causing permanent damage to the fertility of steeper slopes from unchecked erosion. Future production and income gains in agriculture were dependent on improvements in yields per hectare rather than on the continued expansion of hectarage itself. The Philippines, however, was reporting about the lowest crop yields in Asia. Research to date had been concentrated on irrigated rice (and not on maize or upland rice), although the higher yields resulting therefrom had not yet been realized. Effective irrigation and other infrastructure facilities were concentrated in Central Luzon and had not been developed much in the poor regions. In addition, rural manufacturing and other non-farm, rural economic activities were not improving.

B. Development Analysis and Planning

There have been a succession of development plans since 1966, when President Marcos took office. The government was frustrated by the failure of the Congress to approve the tax reforms to generate the revenues necessary to finance the plans, particularly the costly rural infrastructure components. In 1972 the President requested a comprehensive employment strategy mission from the International Labor Office (ILO) World Employment Programme. With funding from the United Nations Development Programme (UNDP), a rather large, blue-ribbon team of economists, sociologists and statisticians, assisted by the technical experts, researchers and staffers of some ten other international agencies, worked on the study through the summer of 1973. The team was directed by Prof. Gustav Ranis, Director, Economic Growth Center, Yale University. (Sharing in Development, A Programme of Employment, Equity and Growth for the Philippines, ILO, Geneva and Manila, 1974.)

The ILO effort was followed by the first Basic Report of the World Bank on the Philippines, completed in 1975 and early 1976 under the direction of Russell J. Cheetham and Edward K. Hawkins. (The Philippines, Priorities and Prospects for Development, World Bank, Washington, D.C. 1976). These two exhaustive reports are complementary, and together they have helped to provide the analytical basis for the economic development strategy and policies of the Philippine Government since the mid-1970's. They emphasized the importance of balanced rural mobilization together with stronger export growth. Rural mobilization meant increasing both agricultural production and rural non-farm enterprise. This would require heavy and sustained investments in rural infrastructure and other support activities which, in turn, would require stronger local institutional development, decentralization of authority and resource control, and greater efforts to mobilize domestic revenues and other financial resources needed for the task. This was to be accompanied by priority efforts to promote manufactured export growth, both to reduce the bothersome dependency on volatile primary commodity markets and to increase employment, since manufactured exports tend to be much more labor-intensive than the import-substitution industries.

The presidential authorities resulting from the imposition of Martial Law in 1972 and the rise of competent technocrats within the government provided a major new impetus to development efforts, not so much by redesigning the basic development plan, since its main outlines were present in the earlier versions, but rather by clarifying the priorities and utilizing the powers of decree to speed up improvements in revenue generation, funding and actual implementation.

C. National Development Goals and Progress, 1972-1980.

The key national development goals, as reiterated in successive development plans, are listed below:

"1) Promotion of social development and social justice through:
   - creation of productive employment opportunities;
   - reduction of income disparities;
   - improvement of the living standards of the poor; and
   - enrichment of social and cultural values.

2) Sustained economic growth.

3) Self-sufficiency in food.

4) Greater self-reliance in energy.

5) Stabilization of prices consistent with development, mobilization of domestic resources, and improvement of balance of payments position.

6) Upliftment of less developed regions especially rural areas.

7) Proper management of environment and improvement of human settlements.

8) Maintenance of internal security and harmonious "international relations."

Progress toward meeting these goals has been uneven and in some cases slower than planned, but nevertheless substantial when viewed relative to other developing countries and the economic setbacks of the decade. Let us examine each of these goals separately.

Goal 1. Progress toward the achievement of this first goal is difficult to measure in the short-run, partly since many of the programs and policy reforms required take several years to have much effect, and partly because of the technical difficulties of measurement itself and the time lags experienced in obtaining reliable data. The evidence that is available presents a mixed picture.

The percentage of the incremental additions to the labor force absorbed by the agricultural sector rebounded from an average of 12.5 between 1964 and 1971 to 59.3 between 1971 and 1976. This was enough to cover for a dismal employment performance by the industrial sector, which absorbed only 7.7 percent of the 1971-6 increment, compared with 20.3 percent between 1964-71. The proportion of new job seekers forced into the services sector dropped from 67.2 percent in the 1964-71 period to 33.0 percent from 1971 to 76. Open unemployment dropped from an average of 7.3 percent from 1960-71 to 4.7 percent from 1972-79. While the agricultural sector's ability to retain a sizeable share of new job seekers was restored, the manufacturing sector's ability to generate larger numbers of higher productive jobs was seriously eroded. (Comparable data for later years are not yet available.)

A recent study by the Ministry of Labor indicates that only 66 percent of those employed in 1977 worked 60 days or more during a three-month period, implying that more than a third of all workers did not work full-time. Only 60 percent of agricultural workers worked more than 59 days, compared with 74 percent of manufacturing workers. Underemployment together with the very low productivity of most jobs constitute far more serious employment problems than open unemployment per se.

Periodic family surveys indicate an improvement in both income and expenditure shares attributable to the bottom 20 percent stratum of families between 1971 and 1975. The expenditure share of these families reportedly rose from 5.9 percent in 1971 to 7.0 percent in 1975 while their income share rose from 3.6 to 5.5 percent. These results are of questionable validity, however, since the 1975 survey is suspected to have underestimated income and expenditures in the higher income strata more seriously than previous surveys. Contrary indications that the real incomes of low income groups actually declined between 1971 and 75 are found in the 1980 World Bank poverty study, which reported that the percentage of all families falling below urban and rural poverty lines, adjusted for inflation, rose from 36.1 percent in 1971 to 45.3 percent in 1975, and also in Central Bank, NCSO and Bureau of Agricultural Economics data, which show substantial drops in real wage rates and earnings between 1971 and the mid-1970's. In addition, the successful achievement of goal number (3) by increasing the production of rice and corn (by almost 50 percent between 1970/1 and 1978/9) has resulted in declining real prices for those two staple crops (by 24 percent for rice and 29 percent for corn in the same period). While higher yields have benefitted many farmers, those on more marginal (especially rainfed rice) land have seen the real cash value of their crops eroded.

On the other hand, non-monetary aspects of basic living standards have continued to improve. Life expectancy at birth rose from 57 in 1970 to 62 in 1980. Infant mortality dropped from 80 per 1000 live births in 1970 to 74 in 1975, and the crude death rate declined from 9.2 percent per 1000 population in 1973 to 7.0 in 1975. A 1978 nationwide survey showed some reduction in malnutrition rates over previous surveys, although the problem remains serious, especially among infants and pre-school children. The proportion of total population with access to satisfactory household water sources (public waterworks or tube wells) is steadily increasing. The elementary education system continues to enroll more than 100 percent of the school-age group as pupils each year, although the dropout rate is high and re-enrollment of older children is common. The adult literacy rate continued to rise, from 83 percent in 1970 to 89 percent in 1980. Enrollment rates in secondary school rose from 52 percent in 1972 to 66 percent in 1978. Despite these positive indicators of progress, access to quality education and health services remain heavily skewed against the poor, especially in rural areas.

<u>Goal 2.</u> The average annual real growth rate of GNP from 1972 to 1980 was 6.6 percent, well above the 5.1 percent level of the previous 12 years. Investment outlays for gross domestic capital formation increased substantially from 20.8 percent

of GNP in 1972 to an average of 29.0 percent in 1978-9. Government-funded construction activities expanded from 1.9 percent of GNP in 1972 to 5.7 percent in 1979. This represents a strong overall economic performance in a difficult decade.

Goal 3. Food self-sufficiency in rice, in terms of effective market demand, has been achieved. Real growth in agricultural production has averaged a remarkable 5.0 percent between 1972 and 1980, compared with 4.2 percent in the preceding five years. The growth in rice palay production has been especially strong, warehouses are bulging with surplus palay, and the country has gone from a net importer of rice between 1971-76 to small exports in more recent years.1/ Yields now compare more favorably with other countries of similar agroclimatic conditions.

Goal 4. Energy conservation measures have reduced the growth rate of energy consumption from an annual average of 5.8 percent during 1975-77 to 3.5 percent in 1978-80. The country's dependence on imported oil for its total energy needs has been reduced from 95.5 percent in 1973 to 83.3 percent in 1980. This has been accomplished in part by the recent (since 1977) development of domestic oil sources, which supplied 5.5 percent of total energy needs in 1980, and of geothermal energy, which supplied 3.9 percent.

Goal 5. After increasing an average of 25 percent a year between 1972 and 74, the Consumer Price Index (CPI) for the Philippines settled down to an average increase of only 8.3 percent for the next four years. In 1979 and 1980, though,

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1/ Rice(palay) is by far the most important agricultural crop in the Philippines, accounting for 4.7 percent of net national product (NNP) in 1979, compared with 2.2 percent each for coconuts and bananas, its two nearest competitors in comparative value of production, and 1.9 percent for corn. (All agricultural crops accounted for 18.5 percent of NNP.) According to the most recent agricultural census (1971), 42 percent of all farmers listed palay as their main crop, compared with 22 percent for corn and 18 percent for coconut. Over 62 percent of all farmers reported growing at least some palay, compared with 46 percent growing some coconut and 42 percent growing some corn.

prices again rose rapidly, by an average of 17.1 percent annually. Both of these periods of rapid inflation were related to sudden increases in the world market prices of oil and other essential imports, although pent-up demand inflation due to the high level of development expenditures certainly played a part. During the first six months of 1981 the same index increased at an annual rate of only 10.4 percent, while the Manila CPI rose at the even slower rate of 7.5 percent, so inflation is again being reduced to a more moderate level.

National government revenues (including social security contributions) increased as a percentage of GNP from 11.5 in 1970 to 16.6 in 1975, but fell back to an estimated 13.6 in 1980. Local government revenues have remained fairly constant as a percentage of GNP at around 1.1 percent. Revenue performance has not been very good, for either the national or local governments.

The balance of trade has been strongly negative since 1974, the annual deficits averaging almost 1.4 billion dollars during the last six years and rising to 2.2 billion in 1980. The primary cause of the deficits, in view of the strong growth of exports, has been the sharply rising price of crude oil, which rose by 134 percent between 1978 and 1980. While the volume of oil imports slightly declined in 1980 due to energy conservation measures, their dollar value rose by 0.9 billion dollars, or by 78 percent over 1979. Most of this deficit has been covered by heavy foreign borrowing, and total outstanding external debt as of December 1980 was 12.6 million dollars. Debt service payments in 1980 amounted to 18.7 percent of the previous year's foreign exchange earnings.

Goal 6. While all 13 regions of the country experienced positive average rates of growth in per capita GNP between 1971 and 1979, most of the poorer regions are still growing more slowly than the richer ones. The per capita growth rates of only four regions, Metro-Manila, Central Visayas, Western and Central Mindanao were above the national average of 3.8 percent, while that of Eastern and Western Visayas, Bicol, and Southern Tagalog were 2.5 percent or below. No significant reductions in regional disparities of production and income appear in the data. While it is believed incomes have improved in those rural areas benefitting from new irrigation facilities and/or roads, they have probably declined in rainfed areas due to declining real prices of such key products as rice, corn and coconut.

Goal 7. No significant progress has yet been made in managing the environment, although sanitation and water supplies have been upgraded in a number of cities and towns and some progress has been achieved in improving urban housing for the poor.

Goal 8. The overall law and order situation improved dramatically in the early martial law period, but some backsliding has occured in recent years. Muslim rebel activity in Mindanao has subsided, but the basic problem remains. The rural based communist insurgency movement continues to grow steadily. Greatest gains have occured in the remote, poverty stricken areas of Northeastern Luzon, Southern Tagalog and Bicol, Samar, and Eastern Mindanao. In international relations, the Philippines plays an important and active role in Third World affairs. As interlocutor with the U.S. in the Association of Southeast Asian Nations (ASEAN), the Philippines exercises a leadership role in this increasingly important regional.

D. Development Performance

Changes in goal-level indicators of progress are often difficult to measure accurately, especially in the short-term, and a sustained, long-term effort is often required for any significant improvement to show up in the data. In order to evaluate the short or intermediate term performance of the government in such areas, the actual policy reforms and development programs implemented can be compared with those recommended earlier as necessary to achieve the goals.

For the Philippines, an assessment of performance in implementing the major recommendations of the ILO and World Bank teams made in the mid-1970's are pertinent:

1. Reduction in the high rate of population growth was identified by the World Bank as the largest single impediment to raising the standard of living of the average Filipino. As a result of increasing efforts to control population growth throughout the 1970's, the rate of natural increase has declined from 3.0 percent between 1948-70 to approximately 2.4 percent in 1980.

2. Expanding public services and infrastructure. Providing greater access, especially among low income groups, to electric power, transportation, communication, irrigation, water supply, sewerage and urban housing (sites and services) facilities and to education, training, health and nutrition services, particularly in support of rural development and the promotion of small and medium scale industries,

was viewed as critical need. The ILO team emphasized the importance of mini-infrastructure programs at the barangay and sub-municipal level, with better-coordinated national agencies responding to local government priorities and assistance requests. Both teams stressed the importance of more investment in irrigation (especially communal irrigation) and further research on high-yield varieties of grain.

Progress in the expansion of services was discussed above. Average annual national government expenditures (capital outlays) for infrastructure construction increased more than six-fold between the 1960's and 1973-78 -- in real, constant-price terms -- rising from below 17 percent to over 31 percent of the total budget, which itself increased more than three-fold in real terms, and from 1.5 to 5 percent of a growing GDP. Average real annual expenditures for highways and bridges from 1973 to 78 were 2.5 times as high as in the preceding six years, those for irrigation facilities 4.7 times as high and those for flood control and drainage 10 times as high. Of the pesos 19.1 billion (dollars 2.7 billion) invested over the six-year period between 1973 and 78, some 36 percent went for highways, bridges, seaports and airports, 31 percent for electric power generation, transmission and rural electrification, 25 percent for irrigation, flood control and drainage, 7 percent for municipal waterworks and 1.2 percent for national government buildings. (The so-called show-case projects in Manila -- tourist hotels, convention and exposition centers, a folk arts theater and a national cultural center in Manila -- were small expenditures compared with the main agenda items, even though there is a legitimate concern that the resources involved might have been more productively invested elsewhere.) Annual expenditures for the public infrastructure programs in 1979 and 80 reached dollars 1.47 billion and 1.86 billion (estimated), respectively, almost half of which went for power and electrification, 22 percent for transportation and communication and 23 percent for water resources.

The strong major infrastructure development drive has not been matched by a mini-infrastructure program at local government levels, as recommended by the ILO team. The construction and rehabilitation of irrigation facilities has received considerable emphasis, though, and the total area under irrigation has more than doubled from 719,633 has. in 1970 to around 1.32 million has. in 1980, with many projects still underway. Meanwhile, total kilometers of road increased from 87,042 in 1972 to 129,603 in 1980.

3. <u>Land reform</u>, for a more equitable distribution of income. As of December 1980 Certificates of Land Transfer had been issued to 374,196 rice and corn farmers, or about 94 percent of those eligible. This is the first step in a process that, when completed, is expected to result in the actual transfer of land ownership to the tenants. Written leasehold contracts were acquired by another 609,042 tenant farmers on holdings below the seven-hectare retention limit, virtually all of those eligible. Since rice and corn tenants initially comprised about 76 percent of all tenants, the completion of this program will be a major accomplishment toward greater equity in rural areas. Together with the provision of supporting services, more secure tenure should provide a long-term incentive structure more conducive to farm investment and income growth.

4. <u>Promotion of medium and small-scale rural industry</u>, directed both to local consumption and intermediate goods markets and to inter-regional production and trade, and even to international trade. Despite several programs and loan funds designed to do this, very little success has yet been achieved due to a wide range of problems and policy disincentives. Several of these are discussed under (5) and (6) below.

5. <u>Promotion of industrial decentralization</u> through rural electrification, decentralizing the banking system, reallocating the (then) highly concentrated infrastructure programs, fiscal reforms and industrial estates.

Around 38 percent of the total number of households in the country had access to electricity in 1980 compared to 28 percent in 1972. Nearly 1.6 million or 31.8 percent of the households in non-Metro-Manila areas have been energized as of 1980. Rural electrification has been a very rapidly implemented and successful program, and is on-going with World Bank support, after a decade of support from USAID.

The number of rural banks has expanded from 591 operating units in 1972 to 1,032 in 1980, due primarily to the strong push of the Central Bank's Rural Banking Expansion Program. Efforts to achieve a regional dispersal of financial institutions have resulted in the proliferation of branches of commercial and thrift banks and other financing companies in the provinces, particularly in the major population centers. Nonetheless, most of these institutions still cater largely to the financial needs of the urban sector to the detriment of rural-based entrepreneurs. Large-scale 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.

A growing share of public investments in physical infrastructure has been channelled into the outlying regions, that is, in provinces outside Metro-Manila, Central Luzon and Southern Tagalog. From 1973 to 1978, about 58 percent of the total GOP expenditures on major infrastructure were made in the non-central regions, where 66 percent of the population lived. Similarly, the GOP has formulated various fiscal incentives and regional policies with the intent of dispersing industries away from the Metropolitan Manila area. These included locational tax incentives, locational limitation and prohibition for some industries, industrial estates, financial assistance and management and technical assistance to industrial ventures in the regions. A nationwide network of industrial estates and export processing zones is being established to help develop decentralized growth poles for broader-based industrial complexes that can generate greater employment opportunities in the countryside. The three operating export processing zones (EPZ's) located in Bataan, Mactan and Baguio City had an estimated employment of over 60,000 direct workers in 1980. Plans call for the opening of 12 EPZ's around the country by the mid-1980's.

Thus while the actual growth of industries outside of Manila still appears to be proceeding slowly, much of the necessary groundwork is being laid.

6. Diversification of exports towards labor-based non-traditional commodities, with increased participation of small- and medium-scale firms more suited to such labor-intensive industries, by sharply improving the policy environment for such firms to prosper and grow. This was to be accomplished by:

A) Maintenance of a realistic or somewhat undervalued exchange rate. The ILO team considered the peso slightly undervalued in 1973 and advised it should remain so to encourage export industries. Indeed the peso/dollar exchange rate has been relatively stable since then, actually depreciating gradually by another 14 percent. However, the large and persistent balance of trade deficits of recent years, despite the highly protectionist tariff structure, indicate the underlying demand and supply conditions have changed so that the peso is presently rather overvalued.

B) Reform of interest rates to eliminate the distortions favoring large, urban-based, capital-intensive firms created by subsidized rates, which discourage household savings and reduce credit availability to smaller entrepreneurs. Interest rate ceilings on savings and one year time deposits were raised from 6 and 7 percent, respectively, in 1973 to 7 and 10 percent by 1976, and to 9 and 12 percent in 1979. Net domestic savings by households fell from 7.9 percent of GNP between 1973-1977 to an estimated 5.4 percent in 1980, however, and in July 1981 the ceiling on these interest rates was abolished completely. Maximum commercial bank lending rates for loans over 2 years were raised in 1976 from 12-14 to 19 percent, and in July 1981 this ceiling was also lifted. Ceiling interest rates on loans of less than two years were raised in 1979 from 12-14 to 14-16 percent, and the latter ceilings have been temporarily retained in order to make longer-term lending more attractive to the banks. Ceilings on loans over one year will be lifted on October 1, 1981. The short-term loan ceiling will probably still require the banks to ration available short-term credit arbitrarily among prospective borrowers, and this will continue to permit discrimination in making such loans against the smaller and more remote firms facing higher risks.

C) Tariff reform, import liberalization and adjustment assistance to eliminate the biases favoring protected, inefficient, import-substitution industries and discouraging labor-intensive export industries. Recognized as necessary in the early 1970's, serious steps to implement this recommendation came only in 1980 after much in-depth study and debate. 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 reform (which is being supported by a dollar 200 million structural adjustment loan from the World Bank) has already been implemented. Peak rates of 70 to 100 percent or more have been especially singled out for immediate reductions, with no rate to remain above 50 percent ad valorem by 1983. Fourteen priority industries are to be given time to readjust and will have the tariff rates affecting them reduced over a four-year period. The average EPR for all manufacturing industries is expected to be reduced from 44 to 29 percent by 1985. The average EPR for consumer goods will decline from 77 to 41 percent, while that for intermediate goods will rise from 23 to 29 percent.

Some highly protected industries are concerned about the negative effect tariff reform will have on their business, but there are others that see benefits to be gained. For example, the decrease in tariffs on raw and intermediate inputs of the textile and electronics industries will make the latter more competitive domestically and reduce incentives to smuggle non-taxed merchandise from Hongkong. In addition to reducing domestic demand, smuggling supports a lucrative currency black-market and deprives the government of tariff revenue. To the extent smuggling is replaced by legal trade, lower tariffs may well bring in more revenue than the higher tariff rates did.

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 the 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. Although somewhat belatedly, government efforts are now moving strongly in the right direction.[2/]

D) Unified technical assistance and adaptive technology research in support of small- and medium-scale industries. Efforts in this area 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.

E) Reduction of fiscal incentives favoring the use of capital instead of labor, such as accelerated depreciation, duty-free importation of capital goods, and reinvestment credits. The 1980 IMF report on "Recent Economic Developments in the Philippines" estimated that, indeed, over the period 1975-1980

2/ The net effect of the industrial structural adjustment policy package, according to the estimates of a USAID consultant, assuming it is implemented as planned and other things remain unchanged, would be to raise the share of manufacturing employment to total employment from 11 to over 14 percent by 1985.

the share in total benefits of cash equivalent benefits from capital-use related incentives declined markedly, from 83 to 27 percent, while the shares of export promotion and labor-use incentives rose from 12 to 32 percent and from 5 to 15 percent, respectively. (Other incentives that could not be classified also rose from 0.4 to 26 percent.) Together with the more recent tariff and interest rate reforms mentioned above, the unfavorable incentive structure is being decidedly altered away from its former capital-intensive bias.

The impact of these reforms on export diversification has already been fairly strong. The dollar value of non-traditional exports, composed mostly of manufactured items, increased 16-fold between 1972 and 1980, from dollars 171 million to 2.78 billion, an average annual growth rate of 42 percent. Its proportion of all commodity export earnings increased from 15 percent in 1972 to 49 percent in 1980. While this performance could perhaps have been improved upon if some of the more recent reforms had been implemented earlier, it nevertheless has been a good show during an economically troubled decade. The growth of manufactured export production has been mostly limited to the EPZ enclaves, however, with little linkage to the rest of the domestic economy. It has been heavily dependent on imported inputs, obtaining little more than labor from the Philippines. Domestic value-added is said to be only around 40 percent of total export value for these items.

7. Wage policies that (A) prevent further erosion of real wages (below their 1973 level), while avoiding legal minimum rates above actual prevailing wage levels (which would tend to reduce employment, to the extent they were enforced), and (B) maintain wage stability by operating mainly on the supply and prices of wage goods.

A) The data on real wages since 1975 are skimpy and of questionable reliability, but real wages appear to have suffered a further decline since 1973, as one would expect in the absence of a more rapid growth of productive employment in the manufacturing sector. Real legal minimum wages, on other hand, declined sharply between 1970 and 1975, but since then the government policy has been to prevent further erosion in real terms and to allow them gradually to recover the ground lost since 1970. In 1980 wage decrees restored the real effective minimum wage levels (including mandatory cost-of-living allowances) of Manila non-agricultural workers and other non-plantation workers roughly to their 1970 levels, while those for plantation workers were about 30 percent higher. The present legal minimum wage rates are considered somewhat higher than free market levels and, to the extent they are enforced and complied with, may limit employment to some degree. The GOP has demonstrated an awareness of the adverse employment effects of its minimum wage policy and has consistently kept increases to the lowest politically acceptable levels.

B) The government has moved vigorously on the supply side of wage goods. The annual rate of increase in rice and corn production averaged 7.0 and 5.4 percent, respectively, between the 1974/5 and the 1978/9 crop-years, and this permitted the real retail prices of those important food staples to decline, by 17 percent for ordinary rice and 21 percent for white, milled corn, during the same period. Thus, while the record on wage rates has been mixed, the rapid growth of foodgrain production has been one of the success stories of recent development performance.

8. <u>Major tax reform</u> to reduce revenue dependence on international trade, increase direct taxation and taxes on luxury goods and services, for reasons of both equity and the need to finance the development program. The government has implemented a series of tax reforms to (A) increase direct taxation of corporate and interest income and money market transactions, broadening the domestic tax base, (B) increase indirect taxes on luxury goods and non-essential commodities, and (C) improve enforcement of and compliance with existing direct income and property tax laws. These measures were successful in raising the total national government revenue ratio to GNP as noted above, but the performance (13.6 percent in 1980) has fallen considerably short of the 17.5 percent ratio targetted for 1980 in the Five-Year Development Plan.

Revenue dependence on international trade has declined. The proportion of total national government revenue contributed by import and export duties and other taxes on imports fell from 41 percent in 1975 to 31 percent in 1979. The share of direct taxes to total taxes also dropped, from an average of 30 percent in the early 1970's to 26 percent at the end of the decade, due primarily to larger increases in indirect taxes on imports, businesses and luxury and non-essential goods. Direct tax revenue itself increased five-fold between FY 1972 and 1978, or by 135 percent in real terms. While revenue performance has been improving in the right direction, the improvement has been slow and has not contributed as much to the development effort as planned, nor has it much reduced conspicuous consumption by the wealthy.

9. Government administrative reform to achieve greater efficiency and to provide a greater role in implementing development programs to local governments. The National Economic and Development Authority (NEDA) was created by Presidential Decree in January 1973 as the central planning agency. Prior to that date economic planning was conducted by a Presidential Economic Staff and inter-departmental committees operating under the supervision of the National Economic Council. An Integrated Reorganization Plan, implemented about the same time, was designed to make the administrative framework of the government more development-oriented and to enable more vigorous and sustained implementation of development plans and projects. It included a Development Budget Coordination Committee and a new Department (now Ministry) of Local Government and Community Development (MLGCD) to assist local governments plan and implement local development programs. (In the current governmental reorganization, the Community Development part of MLGCD is being absorbed into the Ministry of Human Settlements.) Regional Development Councils, which include provincial governors, and Regional Offices of NEDA were established in the mid-1970's to coordinate and conduct local and regional planning activities and to monitor their implementation. A Provincial Development Assistance Program (PDAP), funded in part by USAID and implemented by MLGCD, has provided training and technical assistance to improve the capabilities of provincial governments in development planning and implementation. World Bank and UNDP have provided technical assistance to the regional and national planning efforts, which have involved provincial government staffs. Key ministries have established offices in the 12 regional centers.

The national government administrative machinery has been improved and development programs are more efficiently planned and implemented than before. The overall planning capability and development orientation of local governments have been noticeably enhanced; but as yet they have control over very limited investment resources and hence still have only minor influence in the actual setting of priorities or in the actual design and implementation of development projects.

II. Key Problems and Issues Facing the "New Republic"

A. Maldistribution of Income

While the Philippine economy has been growing at a satisfactory overall rate, the distribution of income, highly skewed since colonial times, has not significantly improved and a large proportion of households remain in poverty, particularly in rural areas. Achieving a more equitable pattern of growth and income distribution has become the most serious challenge to the Philippine Government, with implications for the future political stability of the country as well as for economic and social equity and, indeed, even for continued satisfactory rates of overall growth. The most promising avenues for meeting this challenge are a more rapid rate of productive employment generation, particularly in the manufacturing sector, and successful mobilization and development of the rural sector and the outlying regions. The significance of most other problem areas can be measured in terms of how they impact on these overriding requirements.

1. Employment Generation. The promotion of small- and medium-scale industries, including rural enterprise, is key to the success of this effort, since these tend to be more labor-intensive and therefore to provide more employment. More effective technical assistance to small entrepreneurs and other decentralized support services, in both the production and marketing processes, are vital, as are improved communications and truly decentralized banking services, with authority to approve (and the ability to appraise) loans at the local level. How fully the presently scheduled tariff reforms and import liberalization measures are actually implemented, without backsliding and dilution in the face of stiff opposition from vested interests of the old trade regime, will determine how favorable the underlying economic environment will be for the efficient growth of the more labor-intensive domestic industries.

A corollary issue is the most efficient use of available capital resources to achieve the primary development goals. Concerted government efforts to reduce capital-use incentives in order to stimulate a more labor-intensive pattern of growth seem to be contradicted by official plans to seek large amounts of capital for investment in large-scale, highly capital-intensive industries. While a few of the proposed eleven major industries can probably be justified on balance of payments ground (i.e. -- the copper smelter) and a few will provide more employment than others (i.e. -- the alcogas program), it does not appear that careful analyses into the employment effects of each project,on a per unit of investment basis as compared with alternative investments, has yet been undertaken. In a country where the manufacturing sector is already thought to be overly capital-intensive, at an average replacement cost of capital per worker of around dollars 20,000 (1980 prices), to pursue five of the proposed major industrial projects (petrochemicals, phosphate fertilizer, copper smelter, aluminum smelter and integrated steel mill -- which would cost an estimated total of dollars 3.4 billion) at an average capital investment of 500,000 dollars per job created raises questions about the actual priority given to employment creation and a more equitable pattern of development.

Continued pressure from politically vocal urban and plantation-based labor unions for higher minimum wage laws will also present a difficult choice for the government, since to acceed to such demands will reduce entrepreneurial incentives to hire more workers and thereby reduce employment. The higher wages, for those who are fortunate enough to have jobs covered by the decrees in the organized economic sector, are obtained at the price of fewer such jobs for other workers, and the latter are then forced in greater numbers back on the lower-income unorganized sector.

Underlying the urgency of the task of employment generation is the relentless pressure for more jobs created by high rates of growth of the population and its labor force. Despite the success in reducing population growth from 3.0 to 2.4 percent, it is still far too high for a country pressing the outer limits of its resource base, and it will remain a problem of the first magnitude until a near-zero rate of growth is achieved. In this regard, it is encouraging that President Marcos recently (in his July 1981 Inaugural Address) listed reduction in population growth for the first time as a major economic goal of his New Republic administration. Before, it had only been referred to obliquely as a subsidiary goal in the text of various planning documents; but this time it was not only listed as a primary goal but given first place on the list. Progress in this critical problem area will remain vital to the ultimate success of the development program.

2. Rural and Regional Development. Based on its past record of good performance, the national government can be expected to continue its high level of investment in major rural infrastructure projects and to carry through with its recent decision to provide more support for research, extension and marketing services for rainfed farmers, as it has been doing among irrigated rice farmers with considerable success. It is not so clear, however, that it will be able to overcome its own strong centralizing tendencies and devolve sufficient authority and resource control to local institutions to permit satisfactory improvement of the mini-infrastructure and local public services needed in every locality. Both local and national tax reforms to improve revenue generation of the resources necessary to finance such projects will also prove difficult to accomplish, though vital to a successful development effort.

A problem of the utmost importance to the welfare of every Filipino, but affecting the poor the most adversely, is the relentless degradation of the environment presently being inflicted on the hillsides and in the waterways. Forest denudation, resulting in serious loss of soil fertility, downstream silting and flooding, lower dry season water availability, and the steady destruction of coral reefs and other natural fishing grounds through siltation, is presenting a challenge of the first magnitude to the Philippine society. The problem is a tangle of legal, cultural, social and economic complexity and will be extremely difficult to solve.

In its efforts to pursue the enormous task of rural and rural enterprise development, it will be difficult for the government to avoid the temptations to apply "quick-fix" solutions, designed and foisted on local governments from above and, more often than not, ill-suited to the priority needs and actual economic conditions of the supposed beneficiary community. The Philippine government seems to be particularly prone to this trap, perhaps due to the combination of paternalistic traditions and a plentiful supply of bright, well-educated, energetic and impatient young leaders in the national government, whose personal experience in rural areas is limited. The BLISS program, while at least in part springing from genuine humanistic concern and idealistic motivations, suffered from unrealistic planning in its earlier stages, particularly in its housing activities. It remains suspect today, although its present focus on "livelihood" activities would appear to support the primary need for employment generation discussed above. The potential for considerable waste through misallocation of scarce resources is high, and accelerated implementation of untested approaches should be avoided. This program is discussed in more detail in Annex A.

A continuing problem for the GOP will be in the area of fiscal management. Since 1978, operating deficits on a cash basis have increased from pesos 2.2 billion to a projected 11.1 billion for FY 1982. Over the same period foreign borrowings will approximately triple, financing just over half the operating deficit. Part of the large deficit positions in 1980-1982 is the result of strict government budget-cutting measures undertaken in 1979 to bring increased costs of capital projects and operating expenses under control. This resulted in substantial delays of many foreign assisted projects and, hence, increased costs. The brunt of these increases are being felt in budgets of subsequent years and must be added to the requirements of additional projects being undertaken by the GOP. Managing this burgeoning foreign project portfolio remains a serious problem since the GOP has continued to receive official development assistance in the form of discrete projectized loans, which place heavy administrative and counterpart peso burdens on line ministries (from the standpoint of operating expenses) and the Treasury (from the standpoint of local counterpart financing). Moreover, the GOP does not provide adequate guidance on project design and development for line ministries to keep project budgets in line with available resources.

B. Balance of Payments

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 that worries many observers, and debt service requirements are rapidly approaching 20 percent of foreign exchange earnings. While a high level of borrowing can be justified to finance a prudent development program, its use to finance inputs for an inefficient and capital-intensive manufacturing sector is less defensible. The government has launched an intensive energy conservation and domestic energy development program to reduce oil imports. It is stepping up its promotion of manufactured exports, building on its recent success in this area; but it will have to reduce the import dependency of those very exports for maximum effect on the trade balance and more employment generation. The government has decided to implement a major tariff restructuring and import liberalization program, in order to increase competitive pressures for more efficient production in the manufacturing sector and to encourage exports and a more labor intensive pattern of industrial development (and this is vitally important). However, the short run impact of such reforms (in the absence of exchange rate adjustments) can be expected to increase consumer imports, increasing the negative balance of trade.

Overvaluation of the peso vis-a-vis other currencies has been exacerbated by the sharp deterioration in external terms of trade, caused in part by rising petroleum prices and falling coconut prices on the world market. The heavy foreign borrowing required to finance the trade deficit also reduces pressure on the peso exchange rate. While officially the peso exhange rate is floating, the government has used its access to both official and commercial credit to keep the rate of depreciation low so as (1) to reduce the inflationary impact of rising import prices and (2) to reduce the adverse economic impact of depreciation on the import-dependent manufacturing sector, which is already suffering from rising cost and recessionary demand conditions.

Although there have been economic and political reasons for defending the peso temporarily, depreciation would be expected to help discourage the use of imported inputs, reduce consumer imports (especially as tariff rates decline), and provide further impetus to manufactured export growth. It would also increase the peso income accruing to primary commodity export producers facing fixed dollar world market prices, thus to some extent reducing poverty among such poor groups as the small coconut farmers.

A more flexible use of the exchange rate is needed to help achieve a better balance of trade and a better allocation of incentives and resources among domestic producers. Without a more substantial rate of depreciation the government will face increasing pressure, for balance of payments reasons, to retain a more protective tariff structure and to continue a higher level of foreign borrowing to cover wider foreign trade deficits than would otherwise be the case.

Liquid capital flight is a greater source of worry to the Central Bank because it is thought of as essentially one-way. This need not be so, if conditions which prompted its transfer change. The unfavorable economic conditions in 1981, beginning with the liquidity squeeze in January and running through the slow but steady depreciation of the peso vis-a-vis the dollar (from 7.59 at the end of 1980 to 7.95 in mid-June, a decline of 4.7 percent), have favored increased capital flight. Quick and decisive action by the Central Bank did much to reestablish banking stability earlier in the year, but the economy has remained in the doldrums, exhibiting few investment opportunities. Because of the steady, though small, deterioration of the peso, many people have become convinced that a sharp devaluation, or at least a continued slide, could bring the dollar value of the peso noticeably lower by the end of the year. Such speculation increases capital flight into dollars, which can be held at very advantageous interest rates until the peso adjustment has run its course. Probably largely because of this, the Central Bank has reacted by maintaining the peso steady at about 7.95 since mid-June. It also brought pressure on nine commercial banks, reportedly mostly Chinese, to repatriate about dollars 500 million which were invested in the short-term U.S. money market. These dollar holdings were perfectly legal; but by being outside the country and having been bought with pesos, they were helping to contract the domestic money supply and adversely affect domestic credit creation. To reinforce its "moral suasion," the Central Bank threatened a denial of access to its rediscount window if the commercial banks did not repatriate the dollar funds. The banks acquiesed. In effect, these actions have helped slow down speculative dollar flight.

There is little, however, that the Central Bank can do to influence determined capital flight, if underlying conditions encourage it. To reverse such monetary transfers the unfavorable conditions themselves will have to be changed. The economy must improve, investment opportunities must be more evident and political uncertainty has to be dispelled. Such objective observers like the Center for Research and Communications (CRC) are giving an uncharacteristically optimistic economic forecast for the near future. Their thesis is based on the slowing of inflation in the U.S. and an anticipated strength in the industrial countries starting in 1982 that will cause an economic upturn in the Philippines by the second half of 1982. Other observers tend to agree with this assessment, since after hitting bottom one can only move upward. Even the Asian Wall Street Journal has commented on the good prospects for the stocks of some well-run Philippine companies at current depressed prices. Unsettled economic conditions world-wide in the last several years have driven capital into more liquid holdings -- witness the dramatic rise of the money market funds in the U.S. These mobile funds could just as easily return if the attractiveness of dollar investments wane and local opportunities improve.

Recorded short-term capital is still expected to show a positive net inflow of some 390 million dollars in 1981, however, or about half the 1980 figure. Direct foreign investment interest in the Philippines remains strong, with a net inflow of 290 million dollars expected in 1981, based on the experience of the first six months. This represents a substantial increase over the 1979 and 1980 net figures of 99 and 50 million dollars, respectively.

III. Economic Outlook

The Philippines is facing a troublesome set of economic problems for which there are no easy solutions in the short-run. The solutions will require a determined and consistent effort for several years in order to change successfully the course of development against countervailing forces.

The economy will continue to be buffeted in the short-run by large current account deficits, mounting foreign debt, burdensome debt service obligations, and increasing business failures, the latter due not only to management incompetence and financial anomalies, but also to significant changes in both the price matrix and the rules of the game, as the import-substitution and capital-use subsidy regimes are dismantled. Such failures are an expected product of the industrial structural adjustment program, which is designed to withdraw tariff protection and access to subsidized capital from firms that have relied on such props for a considerable length of time.

High rates of underemployment and low worker productivity can be expected to intensify in the short-run, due to the continuing high growth rate of the labor force and the long period it will take to increase productive jobs significantly. Continued inflationary pressure can be expected from the annual budgetary deficits resulting from the high level of projected developed expenditures in comparison with the government's apparently limited ability to raise domestic tax revenues. While depreciation of the peso would raise relative prices of imported inputs, thus adding to inflationary pressures, this effect would be partially neutralized by the reduced prices of final consumer goods subject to lower tariffs.

In the long-run, if the government is able to maintain the course it has set to restructure the industrial sector toward more labor-intensive lines of production, to continue expanding manufactured exports, to develop domestic energy sources and conserve on energy consumption, and to mobilize and develop the rural sector, these problems will be solved. This process must take place in an atmosphere of political stability which itself will depend on economic performance and continued progress in achieving development goals. In short, the Filipinos have a very difficult course ahead of them. The problems are of such an ingrained nature that quick and easy solutions simply do not exist.

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BLISS

(1) The Bagong Lipunan Sites and Services (BLISS) Program was launched in February 1979 and quickly became the keystone of the Ministry of Human Settlements (MHS) development program. Conceived as the programmatic expression of Mrs. Marcos' "eleven basic needs of man," its early focus was as a housing and community settlement activity. The other facets of the program -- e.g., employment -- would be taken care of through the initiative of the community residents. There were to be three levels of BLISS communities: BLISS I, a simple housing cluster of 50 families; BLISS II, an agro-industrial center built around a local agricultural college, and drawing upon the populations of several communities for both the labor and raw material inputs for the center; and BLISS III, a community of up to 500 families, with its central activity being development of an energy plantation and ecologically sound water management. By 1985 it was projected there would be 1500 BLISS I communities completed, 81 BLISS II and 457 BLISS III at a cost of pesos 11.1 billion (dollars 1.4 billion).

(2) Planning for these activities was centered in MHS, while other line ministries and local governments were called upon to implement the program and provide budget support. The construction of the first few Level I communities was completed in July 1979. By late 1979, however, the program encountered delays caused by a growing antipathy on the part of local officials and intended BLISS residents who, in many cases, moved out of the communities. Local officials objected to the additional demands on their staff and budgets, and development professionals in the GOP pointed out that those in need of housing -- the poor -- could not affort the high amortization costs. MHS attempts to correct these deficiencies in 1980 resulted in establishment of some small community enterprises and a marketing corporation to purchase what was produced. Both ended up as ill-fated ventures. However, in the process, MHS has come to dominate or exercise considerable influence over the National Housing Authority and National Cottage Industries Development Association to strengthen its housing and livelihood activities.

(3)By the end of 1980 approximately 500 Level I communities had been built (including those in Metro Manila). Thirty Level II communities and only one Level III community were functional. MHS had taken up direct implementation responsibility of a few BLISS projects to determine the nature of the problem. From that experience, a decision was made to restructure the program away from a primary emphasis on housing, to an emphasis on strengthening local employment generation. The first formulation of this program in early 1981 reflected a broad-based program of government-owned enterprises with a vertical structure of product development, credit and marketing. Designation of communities as BLISS I, II and III with government aid focussed on shelter was dispensed with in favor of a livelihood focussed program. Where shelter may fit into the new program is unclear; it is apparent MHS intends to continue building 50-family community clusters through 1981 in order to utilize its large capital outlay budget of pesos 333 million (dollars 41.6 million). But with that housing now costing pesos 30,000 per unit and up, those communities with families most in need of housing must wait progress in the livelihood area.

(4) As of now, the program planning for the livelihood effort is currently underway. The only field activity related to the program is a pilot being financed in Region VIII (Leyte, Samar) by ESF funds. MHS hopes to use the pilot as a blueprint for its overall livelihood program; however, given the pilot's timeframe, articulation of that program may wait another year. This would change, of course, were the Office of the President to absorb the program into its recently published Kilusang Bayanihan. The details of the latter program have not yet been publicized. The name has recently been changed to Kilusang Kabuhayan at Kaunlaran (KKK) (Movement for Livelihood and Progress).

assistance strategy. One way perhaps to accomplish this would be to assist the GOP conduct a professional study into the likely positive and negative effects of a faster rate of peso depreciation on agriculture as well as manufacturing, on employment, and on specific poor groups.

4) The availability of large amounts of foreign credit derives from the reasonably high credit rating and relative stability of the Philippine government, as well as from the highly liquid state of the international capital market. It is unfortunate that most of this credit has been utilized to support the development and continuing import requirements of a relatively inefficient, capital-intensive industrial sector that has had such a disappointing record of employment generation. Current GOP plans call for continued borrowing of large amounts from international sources to finance, in addition to the current trade gap, several large-scale, capital-intensive industrial projects. (See Annex, Part II.) In view of the critical need for faster employment generation in the industrial sector, and of the CDSS focus on productive employment as the key to poverty alleviation, AID is concerned about the development and equity implications of policies which continue to use large amounts of limited foreign exchange credit for further investment in capital-intensive industries, rather than in those industries that generate more employment and are more appropriate to Philippine factor endowment realities. Project feasibility and appraisal criteria should include the employment effects per unit of investment cost before final consideration of a project for approval. This issue could be raised in discussions with the GOP and at the next World Bank Consultative Group Meeting on the Philippines.

B. Inflationary Pressures. The strong development orientation of the government enhances the planning and successful implementation of development projects, benefitting both AID and other donor programs. But in the face of poor tax performance, this ambitious development program creates strong demand-pull inflationary pressures that underlie and exacerbate the cost-push pressures of rising energy prices and higher wage agreements. While the tax performance has improved since the 1960's, its continued inadequacy makes it difficult for the government to provide advance peso counterpart funds to cover the foreign donor-funded portion of a project as well as to finance its own contribution. This is especially true for local (provincial and municipal) governments. AID projects have not suffered from funding delays as much as the larger projects funded by the World Bank and the Asian Development Bank, but the problem remains acute. AID can help in this area by continuing to assist local governments improve their mobilization and efficient utilization of tax and other local resources, both financial and manpower, for development purposes, leaving national resource mobilization to be assisted by the World Bank and IMF. Development and ESF assistance to local governments should be provided in such a way as to encourage greater resource mobilization of their own, and the national government should be encouraged to review the effects of its policies on local government revenue generation and utilization. There appears to be considerable scope for rationalization or improvement in several related policy areas.1/ AID

1/ Reference can be made to the findings and suggestions of the June 1981 report of the Local Revenue Administration Project, The Maxwell School of Citizenship and Public Affairs, Syracuse University, "Strengthening the Fiscal Performance of Philippine Local Governments: Analysis and Recommendations," which is available in S&T/RAD,AID/Washington.

can also seek ways to provide more of its own project contributions up front, instead of requiring the GOP to budget the peso cost of the whole project in advance and wait for project component or sub-project completion before receiving the AID contribution. AID should also seek to maintain an average ratio of at least 60 percent of its own funding to total project cost, as agreed in the 1981 Consultative Group Meeting.

The implications for AID of rising energy prices were discussed above in relation to the trade deficit.

In the face of a more rapid growth of labor supply than of productive jobs and the resulting decline in the real, market-clearing wage rate, higher legal minimum wages, to the extent they are enforced, merely reduce productive employment offers and add to cost-push inflationary pressures. If enforced in the smaller cities, towns and rural areas where AID is planning to support rural enterprise development, higher minimum wages could adversely affect the intended impact of such enterprises on employment generation and could even threaten the financial viability of some of the enterprises themselves. Labor Minister Blas Ople recently suggested that rural areas should be exempted from minimum wage requirements, a suggestion that naturally triggered strenuous objections from labor union leaders. AID should probably consider suggesting an adjustment in the legal minimum wage for non-agricultural workers outside Manila in connection with the design of the rural enterprise project, since even small firms accepting government assistance are required to abide by official rules and regulations.

In view of the critical importance of more productive employment to the success of poverty alleviation and long-run, stable economic growth in the Philippines, however, AID should continue its efforts to assist the GOP improve and maintain agricultural and fishing productivity and to generate off-farm employment, despite the current policy obstacles. Higher productivity is one of the best anti-inflationary devices, and more productive jobs will eventually allow real wage rates to rise without causing inflationary pressures. In addition, AID should continue its DA support of family planning efforts to help reduce the future supply of labor and the resulting need for more jobs, thus helping to halt the decline in real wage rates and reduce the inflationary impact of higher minimum wage legislation.

Table 1

Philippine Balance of Payments, 1974-1981
(in Million US dollars)

		1974	1977	1978	1979	1980	1981 (estimate)
I.	Current Transactions						
	Merchandise Trade	-418	-764	-1307	-1540	-1940	-2490
	Exports	2725	3151	3425	4601	5788	5910
	Imports	3143	3915	4732	6141	7728	8400
	Non-Merchandise Trade	-34	-248	-178	-390	-555	-700
	Inflow	834	1048	1413	1576	2075	
	Outflow	868	1333	1591	1966	2630	
	Net Transfers (Donations, etc.)	276	260	313	355	422	500
	Net Current Transactions	-176	-752	-1173	-1575	-2075	-2690
II.	Non-Monetary Capital						
	Long-Term loans	145	662	891	1151	1032	1370
	Inflow	456	1242	1850	2111	1579	
	Outflow	311	580	959	960	547	
	Direct Investment	28	216	171	99	50	290
	Inflow	92	236	205	225	271	
	Outflow	64	20	34	126	221	
	Short-term Capital	231	312	168	-49	712	390
	Inflow	1138	2475	3442	4231	7432	
	Outflow	907	2163	3274	4280	6720	
	Errors and Omissions	-118	-274	-143	-266	-258	-77
	Net Non-Monetary Capital	286	916	1087	935	1536	1973
III.	Monetization of Gold	-	-	32	41	128	130
IV.	Allocation of SDRs	-	-	-	28	29	27
V.	Balance of Payments Surplus (Deficit)	110	164	-54	-570	-381	-560

Source: Central Bank, except the 1981 estimates of merchandise trade, which were taken from Business Day. The 1981 BOP deficit estimate is from the Central Bank governor's Report to the President, "Economic and Financial Developments in the Philippines for 1981," January 13, 1982, and the other 1981 estimates are found in "Philippines-Standby Arrangement-Review and Modification," IMF, July 30, 1981, Table IV, p. 34, citing the Central Bank as source.

Table 2

Investment, Savings and Net Borrowing
From Abroad, 1974-1981
(in million pesos, current prices)

Year	Gross Domestic Savings (1)	Gross Domestic Capital Formation (Investment) (2)	Investment Savings Gap (3)	Net Borrowing from Abroad (4)
1974	25,571	26,832	(1,261)	957
1975	29,634	35,705	(6,071)	5,836
1976	33,133	41,053	(7,920)	7,820
1977	39,379	44,251	(4,872)	4,810
1978	43,321	51,706	(8,385)	8,375
1979	54,638	65,313	(10,675)	10,672
1980[p]	65,740	80,625	(14,885)	14,882
1981[a]	77,254	94,246	(16,992)	16,990

p/ Preliminary estimates as of January,1982.
a/ Advance estimates as of January, 1982

Source of Basic Data: National Economic & Development Authority

Table 3

Private Sector Investment and Savings, 1974-1981
(in million pesos, current prices)

Year	Gross Domestic Savings (1)	Private Gross Domestic Capital Formation (Gross Domestic Capital Formation Less Government Construction Expenditures) (2)	(1)-(2) (3)
1974	25,571	23,978	1,593
1975	29,634	31,337	(1,703)
1976	33,133	34,625	(1,492)
1977	39,379	36,126	2,105
1978	43,321	41,446	1,875
1979	54,638	52,735	1,903
1980[p]	65,740	65,280	460
1981[a]	77,254	75,909	1,345

p/ Preliminary estimates as of January, 1982.
a/ Advance estimates as of January, 1982.

Source of Basic Data: National Economic and Development Authority.

Table 4

BOP Capital Account Flows (Net), 1974-1980
(million US dollars)

Year	Total	Direct Investment	Private Loan Capital	Public Loan Capital
1974	428	28	288	112
1975	491	125	135	231
1976	1087	144	240	703
1977	1189	216	429	544
1978	898	171	169	558
1979	1201	99	114	988
1980	1793	50	1208	535
Average Share (%)		11.8	36.4	51.8

Source: Central Bank of the Philippines.

Table 5

Current Transactions of the National Government, 1974-1981
(in million pesos)

Year	Receipts (R)	Disbursements (D)	(R-D)
1974	17,722	15,154	2,568
1975	21,426	22,152	(726)
1976	21,027	23,048	(2,021)
1977	24,781	26,768	(1,987)
1978	29,804	31,364	(1,560)
1979	35,259	34,750	509
1980	45,816	46,911	(1,095)
1981 1/	32,266	43,190	(10,924)

1/ January to November only.

Source: Central Bank of the Philippines.

REVIEW OF SELECTED MACROECONOMIC POLICIES AFFECTING CDSS CONCERNS

The Government of the Philippines (GOP) has received relatively high marks for its economic management through the difficult 1970's. Despite sharply deteriorating terms of trade and a high rate of worldwide inflation, the Philippines achieved a strong record of overall economic growth, although its performance in providing employment for and alleviating poverty among major groups of its population has been mixed.[1/]

The USAID/Philippines Country Development Strategy Statements (CDSS) have reported our analysis of the conditions and incidence of poverty in the Philippines. It has identified the three largest poverty groups as 1) rainfed farmers, including rice and corn farmers, coconut farmers and upland shifting cultivators, 2) landless agricultural workers, including sugar plantation workers as a particularly important group, and 3) artisanal fishermen. The current AID assistance strategy, designed to assist the Philippine government in its efforts to implement an equitable development program, focusses on providing more productive employment for these groups. Three regions of the country, two of which are among the poorest, have been selected for initial attention. The USAID/P Mission is presently engaged in several project design efforts with various elements of the Philippine government to implement this strategy. This work is generally proceeding satisfactorily. The Mission has been pleased by the support its new programmatic focus has received from the Government. The Mission's Economic Support Fund (ESF) program, while originally designed outside the CDSS strategy framework, shows an increasing convergence with that program's rationale.

Several macroeconomic policies that will affect the degree of success ultimately achieved by this program of assistance can be identified, however. The USAID Mission and the Philippine government must consider not only what project interventions can be logically designed toward their development goals, but also what are the effects of various policies upon prospects for achieving these goals. Such policy considerations are taken up in various contexts and venues. Policies that are directly relevant to the success of particular projects are often considered in conjunction with project design. Technical assistance is sometimes provided as part of a project to assist in the analysis of policy impacts and the formulation of alternative policies where needed. Macroeconomic studies on particular problems or trends may identify the need for policy changes or reform.

This Annex will take a closer look at five selected macroeconomic policy areas that seem to have an important impact on the key areas of CDSS concern, i.e., employment generation and the income of important poverty groups: 1) the structural adjustment program, including tariff reform, import liberalization, and reforms of the financial sector and interest rate structure, all of which are proceeding smoothly and should have positive long-run effects on

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1/ For further discussion of recent economic performance in the Philippines, see C. Stuart Callison, "Economic Assessment of the New Society and Key Problems and Issues Facing the New Republic of the Philippines," USAID/Manila, Oct. 1, 1981. A discussion of the current economic situation and macroeconomic framework in the Philippines appears in "Philippine Balance of Payments and Domestic Price Stabilization," to which this paper is attached as an Annex.

employment and the profitability of the agricultural sector, 2) the promotion of major industrial projects, several of which are particularly capital-intensive and seem to indicate a contradiction of the development priority of employment generation, 3) the foreign exchange rate policy, which has allowed the peso to become strongly overvalued to the detriment of employment generation, the peso earnings of exporters, who include poor coconut farmers and the sugar plantation owners, and the relative profitability of farming in general, 4) agricultural pricing policies, in particular the controversial coconut levy which, for all its original good intentions, has actually exacerbated the poverty of one of the poorest groups of farmers in the country, and 5) the mechanization of agriculture, such as the proposed subsidized mechanization of the sugar industry, which would reduce the employment of landless plantation workers.

The Annex seeks to summarize these particular policy issues and discuss their relevance to areas of USAID development concern.1/ USAID will want, as a minimum effort, to monitor GOP deliberations and policy decisions in these areas in the coming months and years. It might also desire in some cases to explore the possibilities of providing technical assistance to the GOP for professional analysis of the effects of current policies and their alternatives, or perhaps even project assistance to help implement a change of policy. How USAID might address these issues and in what manner make its concern known to the GOP is discussed briefly in the CDSS and will evolve over time out of further discussions within the Mission and with the GOP.

I. Structural Adjustment Program

The Philippine government's structural adjustment program is designed to encourage a more efficient use of resources and to make the economy, particularly the industrial sector, more competitive internationally. Of particular interest to USAID are the effects of these reforms on manufacturing employment generation, which are expected to be very positive, after an initial period of adjustment, thus reversing the disappointing employment performance of the industrial sector during the last decade. As noted in the recent study by Prof. Richard Hooley, the implementation of the Structural Adjustment Program is evidence of a commitment by the GOP to the achievement of a policy environment more favorable for efforts directed at employment generation,2/ such as those proposed for support by the CDSS.

The policy reforms are being carried out with the help of IBRD structural adjustment loans, and extended credit made available by the IMF has helped to permit a gradual and phased approach to the need for potentially disruptive adjustments. The first loan of $200 million was obtained in 1980, of which $195 million was used to pay for the importation of industrial raw materials, intermediate and capital goods and spare parts and the remaining $5 million was appropriated for technical asssistance in training, industry restructuring and development, and the establishment of international trade centers. A second

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1/ Other policies related to agriculture, and in particular agricultural pricing policies, are discussed in Dr. Cristina David, "Analysis of Agricultural Policies in the Philippines," report prepared for USAID/P, February 10, 1982.

2/ Dr. Richard Hooley, "Assessment of the Macroeconomic Policy Framework for Employment Generation in the Philippines," USAID/P, April 1981, p. 61.

$200 million loan is presently being negotiated by the Philippine government with the World Bank and will probably be made available in 1982.

A. Tariff Reforms. The current four-year tariff reform program is designed to reduce the effective protection rates[1/] affecting domestic industries and to minimize the rate disparities. It is a key instrument of the structural adjustment program, since it will substantially reduce the relative attractiveness of imported capital and intermediate goods, thereby encouraging investment in more labor-intensive production processes and the greater utilization of domestic inputs. In the long run this should result in increased domestic employment and reduced pressure on the balance of payments for so-called "essential" industrial imports, although, without a proportionate peso depreciation, it could also result in increased consumer demand for imports of final goods, especially in the near-term.

The first part of the reform involved the reduction of all peak nominal tariff rates (i.e. rates higher than 50 percent) to no more than 50 percent in two stages that started January 1, 1981. A phased reduction over the next four years in 688 tariff lines in 14 priority industries began in March 1981. The last component of the tariff reform, which will include other sectors, including the import-intensive chemicals industry, is now in the final stages of review and is scheduled for implementation in 1982. In addition to a reduction of high tariff levels on final goods, tariffs on capital and intermediate goods are being increased from zero or very low levels. It is anticipated the average effective protection rate (EPR) provided all industries will be reduced from 44 to 29 percent by 1982. For consumer goods the average EPR will decline from 77 to 41 percent, while that for intermediate goods will rise from 23 to 29 percent.

Although some highly protected industries are concerned about the negative effect the tariff changes will have on their business, there are others that see benefits to be gained. 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 of the tariff reform and import liberalization program, discussed below, are expected to be significantly positive.[2/]

B. Import Liberalization. Import liberalization is an essential component of the industrial restructuring program. Exposure to foreign competition will help improve the efficiency of local industries and increase the relative attractiveness of investment in export and other more labor-intensive industries. It will thereby reduce the windfall profits that import substitution industries obtain from tariff protection and raise the relative returns to the use of labor.

1/ This is accomplished by increasing nominal tariff rates on capital and intermediate goods as well as by decreasing them on final goods.

2/ Ibid.

In mid-1980, there were 1,306 tariff items in the three less essential categories of imports that were subject to prior approval of the Central Bank. Imports in these categories have generally been restricted or effectively banned. As an initial step in a phased liberalization of exchange restrictions on imports, to be implemented in tandem with the tariff reform discussed above, agent banks were authorized to sell foreign exchange freely for 263 of the 1,306 tariff items, effective January 1981. An additional 610 items are scheduled to be liberalized in 1982, and 87 items in 1983. The liberalization on the remaining items subject to exchange restrictions, as well as items subject to trade restrictions, is being reviewed. Limits on purchases of foreign exchange for travel abroad were also raised substantially.

It is recognized that the liberalization of import licensing may adversely affect the country's balance of payments position if not properly planned and implemented. The government has, therefore, chosen to liberalize import licensing first for producer goods and goods presently subject to high tariffs, saving consumer and low-tariff goods for later. Real, effective depreciation of the peso will nevertheless become more important, to regulate import demand by raising the peso price of foreign exchange, as this program proceeds, particularly in conjunction with the scheduled reduction of tariffs.

C. Financial Sector and Interest Rate Reforms. A number of important changes in the financial sector have been instituted to improve the efficiency of financial intermediation in the country and to raise interest rates on and thereby to increase the availability of longer-term funds, while at the same time reducing interest rate subsidies on capital investment. The reforms covered the restructuring of the financial system, introducing expanded commercial banking, and the adoption of a more market-oriented interest rate structure. Higher interest rates should encourage higher rates of household and corporate savings and, by making capital-intensive investments more costly, should help encourage more labor-intensive and employment oriented development of the manufacturing sector. By helping to equate the demand for investment funds with the supply of savings, they will also permit market forces to allocate available credit so that smaller entrepreneurs facing riskier situations will gain greater access to it than when banks are permitted to ration scarcer, subsidized credit to preferred customers. This should also help generate more employment, since the smaller firms tend to be more labor-intensive.

Commercial banks (called unibanks) have recently been allowed to engage in domestic and international banking, underwriting securities dealership and equity investments in allied and non-allied activities. Permissible activities of other banks have likewise been broadened upon their meeting the prescribed capital requirements. Thrift banks and other similar credit institutions may qualify for a "full range of domestic banking parcels" which would include, among others, the acceptance of demand deposits and Negotiable Order of Withdrawal (NOW) savings deposits; investment houses have been permitted to engage in trust functions and foreign exchange operations; while nonbanks with quasi-banking functions have been given access to Central Bank (CB) facilities. Rural banks have been given broader banking powers and unrestricted lending coverage, but activities which are not relevant to their countryside operations, like domestic letters of credit, are still disallowed. These reforms are intended to improve the performance of the Philippine financial system and help augment the flow of domestic resources to support the restructuring of the industrial sector.

Moreover, the Central Bank in 1981 abolished the ceilings on interest rates on deposits and deposit substitutes and loans with maturity over one year, allowing banks to peg the rates to market forces. Interest rate ceilings on short-term loans, however, remain regulated (See Part IV, B of main report).

The abolition of most interest rate ceilings was designed to make the rates more reflective of the real opportunity cost of capital, while mobilizing more domestic credit for long-term loans and investments. A major objective of the interest rate reform is to eliminate the distortions created by subsidized rates,which have long favored large, urban-based, capital-intensive firms, but which discourage household savings and reduce credit availability to small borrowers.

Presently, most banking institutions prefer short-term lending, considering the relatively lower risks and higher yields involved compared to long-term loans. The CB hopes to turn this around by encouraging financial institutions to shift to long-term lending which, under the new interest rate policy, would have higher yields than short-term loans. The continued lower interest rate ceilings on short-term credit will tend to discourage banks from giving out such loans and favor higher-yielding long-term lending, since they have to pay higher rates on their sources of funds. The short-term loan ceiling would still require the credit institutions to ration limited short-term funds, which are in high demand, among prospective borrowers, however, still permitting discrimination in making such loans against the smaller and rural firms facing higher risks.

While the structural adjustment program could cause some financial anguish for particular firms in the short-run, probably resulting in some production cutbacks, employee layoffs, and even a few bankruptcies, the firms that survive will have done so by becoming more efficient (or because they were more efficient in the first place) and, what is more important, the financial incentive structure will have been more closely aligned with the underlying factor endowments and actual economic conditions facing the Philippines. This should direct future private sector investments into activities that will more fully and productively utilize Philippine factors of production, particularly its own land and labor resources.

II. Major Industrial Projects

The government has identified eleven major industrial projects (MIP's) it would like to see implemented during the 1980's as part of its industrialization program, to develop backward linkages from consumer industries to intermediate and primary goods industries.[1/] Four of the projects (the copper smelter,

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1/ These 11 MIP's are a copper smelter, phosphate fertilizer plant, aluminum smelter, heavy engineering industries, petro-chemical complex, integrated steel mill, alcogas program, integrated pulp and paper mill, diesel engine manufacturing, cement industry expansion, and coconut industry rationalization.

heavy engineering industries, diesel engine manufacturing and, partly, the cement industry expansion) are projected to be operational by 1983. The rest are expected to go onstream by 1985. The MIP's are to be located in different sites around the country and are intended to provide basic industrial inputs for smaller manufacturing and service projects. Studies on the foreign exchange requirements and expected earnings indicate that most of them could generate or save enough foreign exchange over time to offset their dollar costs. Moreover, while the projects themselves are heavily capital-intensive, the GOP expects more labor-intensive industries to be established downstream once they are fully underway.

Nonetheless, the use of such large amounts of investment capital and foreign exchange[1/] to finance capital-intensive stages of production contradicts other government policies designed to reduce the capital-bias of the industrial sector and to utilize scarce capital resources to stimulate a more labor-intensive pattern of growth. Five of the projects, requiring initial investments totalling more than $2.8 billion, will cost an enormous $500,000 per job created. This raises puzzling questions, in view of official statements that employment generation is a top priority of the government, as to whether a thorough and objective analysis into the employment effects of each project, compared to alternative investments, has been undertaken. If productive employment generation is a factor of critical importance to equitable economic growth, poverty alleviation, and even future social stability, as recent analyses by the ILO, World Bank, USAID, and the GOP indicate, then the more capital-intensive stages of production should be avoided for now by importing their outputs, and the available capital and foreign credit should first be utilized as efficiently as possible to generate jobs in the more labor-intensive stages of production.[2/] Capital-intensive investments should generally be postponed until a later stage of development, when the human labor force is more satisfactorily employed. The only exceptions to this should be those cases where other economic benefits are clearly dominant, such as the potential earnings of foreign exchange from a copper smelter processing domestic ore or the alternate energy potential of a coco oil refinery.

III. Foreign Exchange Rate Policy

All indications suggest that the peso is now strongly overvalued. In a recent study of the exchange rate, E.M. Medalla estimated the tariff and tax regime resulted in an overvaluation of the peso by 32 percent in 1974 compared with a free trade situation and by 16 percent compared with an "optimal" tariff regime. These estimates assumed a balanced trade situation. To reduce the 1974 current account deficit (which was a relatively small $176 million) to zero in a free trade or optimal tariff regime would have required another 5 percent depreciation, in addition to the 32 or 16 percent just mentioned.[3/] To reduce

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1/ Currently estimated as almost $4 billion, a third less than the initially estimated cost of $6 billion, but still a large amount.

2/ For more discussion of the disappointing employment performance of the Philippine manufacturing sector, see Richard Hooley, op. cit., pp. 1-17.

3/ Erlinda M. Medalla, "Estimating the Shadow Exchange Rate Under Alternative Policy Assumptions," in Romeo M. Bautista and John H. Power, Industrial Promotion Policies in the Philippines, Philippine Institute for Development Studies, Manila, 1979, pp. 81-125.

the present $2.5 billion deficit to a more manageable level will require a larger additional adjustment in real terms. (Time does not permit its calculation for this paper, but the methodology and formulas for doing so are spelled out in Medalla.[1/]

In the Philippines, as discussed in a paper by Dr. Cristina David,[2/] one effect of the overvalued peso has been to reduce returns to farmers producing agricultural export crops, such as coconut and sugar. Since it makes duty-free or lightly-taxed capital equipment and other imported inputs artificially cheaper to buy, relative to domestic inputs and factors of production, the overvaluation also encourages more capital-intensive and import-dependent production processes, thereby reducing demand for domestic labor and home-produced inputs and lowering the economic returns to the more abundant domestic factors of production (i.e.--reducing employment, wages, and income from other domestic sources such as farmland).[3/] Its effects on the areas of CDSS concern are, therefore, strongly negative. The success of GOP employment, rural development and poverty alleviation programs is being seriously hampered by the effects of the overvalued current exchange rate.

While officially "floating," the peso has been supported by large loans of foreign exchange to fill the growing gap between demand and earnings. There is apparently strong pressure from the industrial and banking sectors to avoid peso depreciation, since this would raise the peso cost of imported inputs and create additional cost-push inflationary pressures among traded commodities, and since most of the intermediate inputs are considered "essential" imports vital to the continued health of domestic industries. Higher costs for these inputs could cause some firms to fail. There is also a perception that the dollar earnings of traditional export products would not be much affected by a decline in the exchange rate, since foreign demand for some of these primary commodities is limited by quantitative restrictions and/or supply is relatively price inelastic for any given year.

On the other hand, the very import-dependency of the industrial sector is at issue, together with its failure to provide a respectable contribution to domestic employment and to develop linkages to domestic sources of input supply. More costly (in peso terms) imported inputs would provide a stronger stimulus to develop and utilize domestic input sources and more labor-intensive production

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1/ Ibid., Appendix B. pp. 114-120.
2/ Dr. Cristina David, op. cit.
3/ The foreign exchange rate is a price relationship that should, among other things, roughly balance the supply of foreign exchange from those purchasing Philippine exports with the domestic demand for foreign currencies to purchase imports from abroad. In so doing, it affects the relative prices of tradable commodities versus non-tradable domestic goods and services by translating world market prices into domestic currency. If the exchange rate is allowed to deviate from a balanced, market-clearing position, not only will balance of payments difficulties ensue, but the relative prices of tradable and non-tradable commodities and of factors of production (land, labor and capital) will also deviate from their true values to the domestic economy, altering relative returns among different productive factors and causing a misallocation of investment resources toward less productive activities.

processes. A strong argument can be made that those industries unable to compete on these terms should not be allowed to continue using up scarce foreign exchange and credit. The inflationary pressures that would follow peso depreciation would result from the rising prices of tradable commodities and those with substantial imported inputs, thus causing relative prices of non-exportable domestic goods and services, both intermediate and final, to fall. Such price adjustments should be very healthy for the domestic economy in the long run, since they would increase relative demand for domestic goods and services.

While the dollar earnings of certain primary commodities might not increase with a depreciation, they certainly would not fall; and the peso earnings of the export commodity producers would rise, thus alleviating poverty among certain significant groups now facing hard times. Furthermore, the performance of the non-traditional, mostly manufacturing, exports (particularly garments and electronics) since the devaluation of the early 1970's has demonstrated that these relatively labor-intensive exports are indeed sensitive to price differentials and that their dollar earnings do increase in response to peso depreciation. These products presently comprise nearly half of all export earnings and offer the greatest potential for future export growth. They also employ more people per unit of investment than the more capital-intensive import-substitution industries do. A lower peso exchange rate would encourage them to expand, to hire even more Philippine labor and, more importantly, to utilize more domestic inputs, rather than importing everything but the labor. Since their basic earnings are in dollars anyway, a higher peso cost of dollars would not affect their own ability to import inputs that cannot be produced locally, since it would be matched by an equally higher peso value of their earnings.

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.

IV. Agricultural Pricing Policies

Agricultural product prices have been declining in real terms, while farm input prices have been increasing. This adversely affects the profitability of farming and reduces incentives to invest in more productive technology in rainfed, as well as other, farming systems. Government interventions to control agricultural prices for the benefit of consumers and/or to nationalize production and marketing of plantation crops reduce the returns to producers. Dr. David has demonstrated that the negative price effects of government tax, tariff and price policies, effects amplified by the overvalued exchange rate, have been most severe with respect to coconut and sugarcane, followed by rice.1/ Of particular concern to AID is the millgate price effect of the coconut levy, in view of its negative income effects on a significant portion of the rainfed farmers in two of the three regions of our program concentration.

1/ Dr. Cristina David, op. cit.

The currently depressed world market price for coconut products has focused attention in the Philippines on the coconut industry. About 278,000 or 4.4 percent of all families in Philippines depended on coconut farming as their main source of income in 1971 (10 percent of all those dependent on farming). Of these, some 57 percent fell below the poverty line.1/ Due to the rapid growth of coconut production in the early 1970's these proportions may be somewhat higher now. A much larger proportion of farmer families and about a third of all Philippine families derive some income from coconut,2/ however, and it is relatively even more important in two of the three regions of current AID focus: Bicol and Eastern Visayas.

The fall in world market prices for coconut products is attributable mostly to the ready substitutability of other vegetable oils for coconut oil in most uses, and the excess supply of those substitutes, particularly soybean and corn oil. Declining dollar prices, especially viewed through a fixed exchange rate against the background of rapid domestic inflation, has exacerbated the plight of the coconut farmers.

Foremost in the coconut controversy is a levy, which is essentially an indirect tax on farmers' sales of their coconut products and which averaged between 31 and 46 percent of the millgate price between 1974 and 1981, in some months rising above 60 percent, except for 1979, when it dipped to 15 percent due to exceptionally high prices. In absolute terms the levy has fluctuated from ₱15 per 100 kg. in 1973, all of which was used to subsidize consumer prices, to ₱100 in 1974, when prices were the highest. Until its reduction to ₱32 in January 1982, it remained above ₱60 since 1977 and was raised to ₱76 in 1980. It was first suspended and then shortly reinstated at ₱50 in 1981.

This levy was initially intended to fund a subsidy program to ensure the provision of basic coconut-based consumer products and to defray the costs of other specific programs implemented for the industry (such as a much-needed replanting program). Unfortunately, the bulk of benefits from these programs has not gone back to the coconut farmers. The replanting program is not expected to benefit the bulk of small farmers for many years, if ever, since it is expected to take up to 40 years to complete and the larger farms will be easier and cheaper to replant first. A GOP study3/ has disclosed that the United Coconut Planters' Bank (UCPB) is actually owned and controlled by big planters, middlemen, and people other than the small-scale coconut farmers as originally intended. The small-scale farmers receive little more than the scholarship and insurance benefits,

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1/ 1971 Family Income Expenditure Survey, NCSO, as reported in World Bank, Aspects of Poverty in the Philippines: A Review and Assessment, December 1, 1980, Vol. II, p. 155, Table 1.2.

2/ Forty-six percent of all farmers reported growing some coconut in 1971, although it was given as the main crop by only 18 percent.--1971 Census of Agriculture, NCSO, Manila.

3/ The Government Programs in the Coconut Industry: Who Pays, Who Benefits, Institute of Labor and Manpower Studies, Ministry of Labor and Employment, April 27, 1981.

which represent a small part of the whole benefit package. Furthermore, many of the farmers do not fully understand the program and do not know how to apply for the benefits they are legally entitled to. The GOP study recommended:

1. Suspension of the levy and reprogramming of the funds generated.
2. Suspension and review of the government programs for the industry.
3. Introduction of the levy under some restrictions for use only in (a) the subsidy program and (b) the welfare program.
4. The levy should be collected only in a bullish market and suspended automatically in a bearish market. It has been shown that farmers are spared of payment in a rising market.
5. Because of the modest cost of the programs mentioned in point 3, the levy rate should be greatly reduced.
6. In the review of the programs, a serious look should be taken at crop diversification. Coconut farmers are less vulnerable to market fluctuations with diversified farming.

In general, rather than helping to improve the income of coconut farmers, the government interventions have been exacerbating the poverty caused by low productivity, low world market prices, lack of infrastructure and small farm size. The basic problem is almost entirely political, however, as the industry is controlled by a small and influential group. The same group that controls the United Coconut Planters' Bank reportedly also controls the Philippine Coconut Authority, the Philippine Coconut Producers Association (or COCOFED, which is officially recognized as the only legitimate organization of coconut farmers), the United Coconut Oil Mills (UNICOM, which, after buying several large mills in 1979 and 1980, now reportedly accounts for 80 to 90 percent of the country's coconut oil milling capacity and for 80 percent of coconut oil exports), and even the replanting program.1/

When the levy was temporarily lifted in September last year, copra trading stopped completely as UNICOM ceased to buy. A demonstration of COCOFED members was organized to petition for restoration of the levy on the spurious grounds that the cancellation of the ₱76/100 kg. levy itself had caused millgate prices to fall from the subsidized price of ₱200 to between ₱40 and ₱80/100 kg. As a result, the levy was restored at two-thirds of its former rate (₱50/100 kg.), and millgate prices rose back to around ₱150 (as UNICOM once again started to buy at a lower, unsubsidized price). A top-level, eleven-man, special committee was created to address these issues.

On January 19, 1982, upon recommendation of the special committee, the President announced that the levy would henceforth follow a sliding percentage scale based on the world market price of coconut oil, ranging from 11 percent to 23 percent of the world market price. It is to be suspended completely when the price goes below 20 cents per pound.2/ Collections in excess of ₱50 for

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1/ Ibid., and Guy Sacerdoti, "Cracks in the Coconut Shell," Far Eastern Economic Review, January 8-14, 1982, and accompanying articles, pp. 42-48.

2/ The average world coconut oil price declined from 42 cents per pound in 1979 to 26 cents in 1981. As of January, 1982, it was 25 cents per pound. The last time it went below 20 cents per pound was in November 1977.

every 100 kilos will be put into a coconut reserve fund to be used only during periods of depressed prices. Levy collections will continue to be used to finance the major programs in the coconut industry in proportions determined by the Philippine Coconut Authority, subject to the approval of the President.

While this compromise offers some relief when prices are low, the levy remains a relatively heavy explicit tax on production, additional to the implicit tax imposed by the effective tariff and exchange rate structure.[1/] At the current depressed price of U.S. 25 cents per pound of coconut oil, for example, which equates to ₱281/100 kg. of copra, the 11 percent levy equals ₱31 per 100 kg. of copra, compared with the former ₱50 charged. This translates into 21 percent of the current millgate price of ₱150/100 kg. and an even higher percentage of the producers' net income, since harvesting and transport costs alone are substantial. Thus the levy is still a large tax on a depressed industry. It is also a regressive tax rate on a relatively poor segment of the population, in view of the national average tax performance of 11-12 percent of GNP. The monopolistic situation in the coconut industry seems to be working against efficiency as well as against equity. As long as the farmers bear the burden of the present levy, given the bleak outlook for coconut oil prices, the incidence of poverty will increase, consumer spending in coconut areas will be dampened, rural business will stagnate, and instigators of political instability will have an easier task, as evidenced by steadily growing unrest in the predominantly coconut areas.

V. Mechanization of Agriculture

There is a tendency to subsidize the mechanization of agriculture as a way to increase productivity. Dr. David found that duty-free importation of large tractors has placed local producers of smaller tractors and rototillers at a distinct disadvantage.[2/] There is a legitimate need to improve farm productivity *per hectare*. Specific pieces of machinery can be very important in this effort and can even increase the utilization of labor per hectare of land, as, for example, when mechanical plowing and irrigation enables the farmer to plant two crops of rice instead of only one. The use of machinery to increase the productivity *per farm worker*, however, by reducing the manhours of work required per hectare, is likely not only to be an inappropriate waste of capital resources in a labor surplus economy, but also to increase social tension and unrest by displacing workers and increasing the level of underemployment. Proposals to subsidize mechanization or to permit it in an environment of distorted price and wage relationships should be subjected to careful scrutiny. A current example of this issue, which could affect landless workers in one of the regions

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1/ It is estimated that the average nominal protection rate imposed by the tariff and tax policies on the coconut industry from 1970 to 1980 was -22%, compared with -8% for all agricultural crops and +44% for manufacturing, assuming the foreign exchange rate is at an appropriate level. Since the peso is actually overvalued, the effective protection rate for coconut is even more negative.-- See Dr. Cristina David, *op. cit.*, pp. 5-19.

2/ Cristina David, *op. cit.*

of USAID focus, Western Visayas, is a proposal to subsidize the mechanization of the sugar industry with a multilateral development bank loan.

Half a million workers are directly employed by the sugar plantations and the mills, providing livelihood for 3 million dependents (1980). An equal number of people also depend for their livelihood on sugar-based industries and auxiliary support industries.[1/] Poverty incidence among sugar workers has been estimated to be as high as 90 percent in the mid-1970's.[2/]

Mechanization in the sugar industry was proposed as early as 1976, when the world price of sugar dropped below the domestic production cost in peso terms, as viewed through the distorted foreign exchange rate. It is seen primarily as a way to improve productivity and reduce costs. Renewed attention was focussed on this issue in 1980 and 81, as certain industry leaders again announced plans to pursue mechanization in order to reduce costs, despite its obvious labor displacement effects. While it is important to seek economical ways to improve production efficiency, reducing employment on sugar plantations prematurely (before alternative employment opportunities of at least equal productivity exist and before mechanization itself is economically feasible) could have serious consequences on the incidence of poverty among landless workers now so employed.

Sugarcane farming is already considered to be the most mechanized sector in Philippine agriculture, although this mechanization is limited mostly to land preparation such as plowing and harrowing. The industry is still largely dependent on manual labor for planting, crop care, weed and pest control, drainage, irrigation, harvesting and loading. It is estimated that complete mechanization would displace 58 percent of the present sugar workforce. The Ministry of Labor and Employment (MOLE) considers this the principal constraint to the plan. Other constraints include: high initial investment, small land size, agronomic problems, increased energy demand, and difficulties with mechanical harvesters.

In view of these problems, a MOLE study[3/] concluded in 1976 that any mechanization process should at least proceed gradually (the timetable recommended was 10 to 15 years), with a system of priorities and with provision for absorbing displaced labor. A possible solution advanced for labor displacement is intercropping, yet little has been done to address this. The first priority was given to land preparation and the last to harvesting, since harvesting has the highest labor displacement rate. To assist with the financial requirements of the mechanization of land preparation, a tractor pool project has been proposed by the GOP for Asian Development Bank (ADB) funding. Payment for tractor services will be assisted by supervised credit or crop loans for land preparation. However, when fitted with accessory implements these tractors could also perform other functions for other major phases of sugar agriculture. One firm

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1/ <u>Economic Monitor, Sugar Industry Supplement</u>, March 16-22, 1981, p. 22.

2/ FY 82 CDSS, USAID/P

3/ "Mechanization and Labor Displacement in the Sugar Industry," Institute of Labor and Manpower Studies, Ministry of Labor and Employment, Manila 1976.

has reported a sale of 8 units of Australian harvesters, each displacing 500 laborers.

Recent statements by a key Philippine Sugar Commission (PHILSUCOM) official, however, seem to contradict the priorities suggested above by supporting the mechanization of the harvesting activity to reduce the need for migratory workers.1/

The problems cited in the 1976 GOP study remain to be satisfactorily addressed. More specifically, the high cost of mechanization has caused some officials to doubt its financial viability, especially with the currently higher costs of oil products and the country's not too happy experience with crop production loans. The tractor pool proposal seems easier to implement physically, but the use of harvesters will be constrained somewhat by the small average size of sugar farms, although most of the sugar land area is contained in large farms where mechanization will first be introduced.2/ To be feasible, according to dealers familiar with the machine, a harvester has to be operated in a farm with a minimum size of 200 hectares. The alternatives of land consolidation has been suggested, but some officials doubt the social feasibility of this option.

Plans for sugar mechanization should be re-examined, particularly with respect to its labor displacement implications. Specifically, a careful economic feasibility study should be undertaken, using appropriate shadow exchange rates in calculating the costs of the imported equipment and operating fuel, shadow (opportunity cost) wage rates for present labor costs, and proper discount rates to measure the true opportunity cost of capital. It is possible that the use of an appropriate set of shadow prices would demonstrate that the true economic cost of the machines is so much higher than the cost of labor as to resolve the issue in favor of labor. Plantation owner complaints about high wages could also be partly due to their concern about labor unrest and agitation. It is easier to deal with a machine than with a labor union. On the other hand, the GOP should be careful not to let a solution to the sugar planters' labor problem--mechanization--waste capital resources and at the same time increase unemployment, poverty and social unrest for society as a whole.

1/ See, for example, "Benedicto Talks on Sugar Industry Growth," Bulletin Today, August 4, 1980.

2/ In 1971, 71 percent of sugarcane farms were less than 5 hectares in size, but these comprised only 12 percent of the total sugarcane farm area, while 66 percent of the area and only 5 percent of the farms were accounted for by farms of 50 hectares or more.--1971 Census of Agriculture, NCSO, Manila.