AGENCY FOR INTERNATIONAL DEVELOPMENT

Washington, D. C. 20523

PROGRAM ASSISTANCE
APPROVAL DOCUMENT
(PAAD)

PHILIPPINES: Support for Development Program (492-0430)

July 31, 1989

Agency for International Development

Washington, D.C. 20523

PROGRAM ASSISTANCE APPROVAL DOCUMENT

SUPPORT FOR DEVELOPMENT PROGRAM

(492-0430)

Manila, Philippines

July 1989

Support for Development Program

TABLE OF CONTENTS

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CLASSIFICATION:

AID 11-20-1

PAAD

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT

1. PAAD NO. 492-0430
2. COUNTRY Philippines
3. CATEGORY Cash Transfer
4. DATE

5. TO: Malcolm Butler, Director
6. OYB CHANGE NO.
7. FROM: J.C. Stanford, Acting Deputy Director
8. OYB INCREASE

TO BE TAKEN FROM:

9. APPROVAL REQUESTED FOR COMMITMENT OF: $ 169,000,000
10. APPROPRIATION

11. TYPE FUNDING	12. LOCAL CURRENCY ARRANGEMENT	13. ESTIMATED DELIVERY PERIOD	14 TRANSACTION ELIGIBILITY
[ ] LOAN [X] GRANT	[X] INFORMAL [ ] FORMAL [ ] NONE	July 1989 and Jan. 1990	N/A

15. COMMODITIES FINANCED

16. PERMITTED SOURCE	17 ESTIMATED SOURCE
U.S. only:	U.S.:
Limited F.W.:	Industrialized Countries:
Free World:	Local:
Cash: $169,000,000	Other:

18. SUMMARY DESCRIPTION

The objective of SDP is to help the GOP ameliorate its balance of payments (BOP) and fiscal problems so that it can continue to provide essential services and to pursue its medium term structural adjustment program. SDP will help to relieve the GOP's financial problems by providing cash transfers on a grant basis. By providing budget support, SDP will encourage budgetary disbursements in such priority sectors as health, population and education. SDP will also encourage the realization of administrative reforms aimed at making the preparation and implementation of public investment projects more effective, and enable the GOP to continue to pursue economic reforms aimed at the creation of conditions which foster broad based, employment generating, private sector led development. The GOP will use the dollars to service official debt owed to multilateral institutions or such other uses as may be agreed to. Local currency will be used for budget support, monitoring and evaluation costs, and Mission local currency costs, or such other uses as may be agreed to.

19. CLEARANCES		DATE
RLA:BMMiller		7/26/89
DRM:JAPatterson	for	7/31/89
OD/PE:PRDeuster		6/24/89
ORAD:KAPrussner	KP	6/27/89
OCP:REJordan		7/28/89
OPHN:WHJohnson		7/29/89
EO:DFSutton	DFS	7-29-89

20. ACTION

[X] APPROVED [ ] DISAPPROVED

Malcolm Butler — AUTHORIZED SIGNATURE — 7/31/89 DATE

Director, USAID/Philippines

TITLE

CLASSIFICATION:

LIST OF TABLES

ABBREVIATIONS/ACRONYMS

ADB	Asian Development Bank
APT	Asset Privatization Trust
ARI	Acute Respiratory Infections
ARSP	Agrarian Reform Support Program
BIR	Bureau of Internal Revenue
BOP	Balance of Payments
BSP	Budget Support Program
BSP II	Budget Support Program II
BTr	Bureau of Treasury
CARP	Comprehensive Agrarian Reform Program
CB	Central Bank of the Philippines
CO	Capital Outlays
COA	Commission on Audit
COP	Committee on Privatization
CPI	Consumer Price Index
CSP	Child Survival Program
CY	Calendar Year
DA	Development Assistance
DBM	Department of Budget and Management
DECS	Department of Education, Culture and Sports
DOF	Department of Finance
DOH	Department of Health
DPWH	Department of Public Works and Highways
DSP	Development Support Program
ERL	Economic Recovery Loan
ESF	Economic Support Fund
FY	Fiscal Year
GDP	Gross Domestic Product
GFI	Government Financial Institution
GNP	Gross National Product
GOCC	Government Owned and Controlled Corporation
GOP	Government of the Philippines
IAD	Integrated Area Development
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund

JICA	Japan International Cooperation Agency
LGU	Local Government Unit
LOI	Letter of Intent
MAI	Multilateral Assistance Initiative
MCH	Maternal and Child Health
MEP	Memorandum on Economic Policy
MOE	Maintenance and Operating Expenses
MOU	Memorandum of Understanding
MTPDP	Medium Term Philippine Development Plan
MTPIP	Medium Term Public Investment Program
NDA	Net Domestic Assets
NDC	Net Domestic Credit
NEDA	National Food Authority
NFA	National Food Authority
NGO	Non-Government Organization
NPA	Non-Performing Assets
NTM	Non-Tariff Measures
ODA	Official Development Assistance
OECF	Overseas Economic Cooperation Fund
ORT	Oral Rehydration Therapy
PAAD	Program Assistance Approval Document
PAP	Philippine Assistance Program
PCGG	Presidential Commission on Good Government
PFC	Project Facilitation Committee
PSBR	Public Sector Borrowing Requirement
POPCOM	Commission on Population
RPMES	Regional Project Monitoring and Evaluation System
RPSP	Rural Productivity Support Program
SDP	Support for Development Program
SDR	Special Drawing Right
UNFPA	U.N. Family Planning Association
UNICEF	U.N. Children's Emergency Fund
UPPI	University of the Philippines Population Institute
VAT	Value Added Tax
WB	World Bank

I. SUMMARY AND RECOMMENDATION

1. Program Title	:	Support for Development Program
2. Grantee	:	The Republic of the Philippines
3. Grant Amount	:	Life of Program: $218 million
4. Funding Source	:	Economic Support Fund (ESF)
5. Initial Obligation	:	FY 1989
6. Program Objectives	:	The objective of SDP is to provide balance of payments (BOP) and budget support to the Government of the Philippines (GOP). This will help alleviate the GOP's current BOP and budget difficulties and support administrative and economic reforms aimed at fostering broad based, private sector led development.
7. Program Description	:	A.I.D. will provide the grant in three tranches. The first tranche of $104 million will be transferred once standard provisions and conditions precedent have been met after grant signing. The second tranche of $65 million will be transferred on or after January 1, 1990; and the third tranche of $49 million on or after July 1, 1990; providing that other provisions mutually agreed to have been met, including specific objective performance criteria on implementation of reforms. In accordance with GOP preferences, the dollars provided to obtain local currency will be used for selected multilateral debt servicing or such other uses as may be agreed to. The equivalent local currency will be used to finance already budgeted (not additional) basic services in population, education and health, or other mutually agreed upon priority areas, during the GOP 1989 and 1990 budget years; monitoring and evaluation costs; and, local currency costs of the A.I.D. Mission.

8.	Estimated Completion Date	:	FY 1991
9.	Statutory Requirements	:	All statutory requirements have been met. (See Annex D.)
10.	Recommendation	:	That a $218 million ESF grant to the GOP be authorized, with $169 million obligation in FY 1989, based on terms and conditions described in the attached authorization Program Assistance Approval Document (PAAD).

II. OVERVIEW

Since 1986, when Mrs. Corazon Aquino came to power in the midst of a severe economic and political crisis, the Government of the Philippines (GOP) has restored democratic institutions and has stabilized the economy. Now the challenge is to create the conditions necessary for longer term, sustainable, and broadly based growth. This will entail the implementation of substantial economic and administrative reforms to address deep-rooted, structural imbalances which distort incentives, constrain innovation, sap scarce resources, and perpetuate an inequitable distribution of the gains of growth. The Aquino government recognizes the existence of such obstacles, has made commitments to address them, and has achieved important initial gains. However, sustained momentum is crucial. The Support for Development Program (SDP) will help the GOP to continue its reform efforts by providing balance of payments (BOP) and budget support to the GOP. This will help to alleviate the GOP's BOP and fiscal difficulties and will encourage further implementation of key economic and administrative reforms. Under SDP, subject to availability of funds, A.I.D. will provide a $218 million grant out of Economic Support Funds in three tranches over a two year period. The dollars provided by A.I.D. to obtain peso generations will help to alleviate the GOP's external debts servicing burden. The peso proceeds of the grant will support budgetary outlays in such priority sectors as population, education and health; monitoring and evaluation costs; and A.I.D. local currency operating expense costs.

At the time Aquino assumed the presidency in 1986, the Philippine economy had been in crisis for several years. In the early 1980s, rising interest rates abroad, higher fuel prices, and depressed commodity prices began to shake the country. The assassination of Benigno Aquino in 1983 triggered massive capital flight and an abrupt decline in foreign commercial credit, and accelerated an economic crisis which culminated in a debt moratorium in October 1983. Although the Marcos administration then implemented a stabilization program which successfully implemented some measures, reform efforts were limited and the political commitment to them was weak. By the time the snap presidential election was called at the end of 1985, real Gross Domestic Product (GDP) had been declining for two years and inflation was close to 50 percent.

With Aquino's ascension to office, the economy began to recover. In 1986, real Gross National Product (GNP) expanded slightly after eleven consecutive quarters of economic contraction, recording a 1.9 percent growth. GNP growth reached 5.9 percent in 1987 and 6.7 percent in 1988. Inflation was brought under control, registering less than one percent in 1986; 3.8 percent in 1987; and 8.8 percent in 1988. Substantial capital inflows enabled international reserves to increase from $615 million at the end of 1985 to over $1,900 million by the end of 1988.

The Aquino administration inherited a host of deep-rooted problems, including widespread poverty, high unemployment and underemployment, and a vastly inequitable distribution of wealth. These problems are at least in part the result of several decades of overly capital intensive, import substituting, urban biased and crony-oriented policies. Such policies resulted in a number of structural imbalances, including a manufacturing sector unable to compete in global markets; a weak financial sector; inadequate physical infrastructure, especially in rural areas; and a large public debt. In recognition of these problems, the new government embarked on a major reform program, which was embodied in the five year Medium Term Philippine Development Plan (MTPDP), which was finalized in 1987. The GOP has already achieved important reforms; for instance, the GOP has greatly liberalized imports; dismantled sugar and coconut monopolies, and adopted a major tax reform program.

More recently, however, enthusiasm for economic reform has waned. Domestic producers, long used to protection from foreign competition, are now lobbying strongly for maintaining import restrictions and the reinstatement of tax breaks. Implementation of the GOP's privatization program and the value added tax has run into major obstacles. The Central Bank, concerned about inflation, has effectively ended the debt equity swap program and intervenes regularly in currency and securities markets to defend the value of the peso.

The GOP and the International Monetary Fund (IMF) recently came to agreement in principle on an economic stabilization program in conjunction with a $900 million extended financing facility and an additional $400 million Compensatory Contingency Financing Facility (CCFF). A.I.D. believes that the IMF agreement will lend renewed vigor to the GOP's reform program, and the resources made available under the program will help to alleviate the government's balance of payments difficulties. In addition, the agreement will pave the way for a new round of rescheduling talks between the GOP and its official and commercial creditors.

The GOP continues to experience severe financial problems. Although fiscal deficits have largely remained within targeted levels since Aquino came to office, this has only been possible because capital outlays have been low. The Philippines' tax base, at only 11 percent of GNP, is low relative to that of other Asian countries; this is exacerbated by poor tax collection efficiency. In 1987, the national government deficit came to ₱16.7 billion ($819 million); in 1988, tax revenue shortfalls resulted in a deficit of ₱25.6 billion ($1.2 billion). The GOP projects a national government deficit of ₱15.3 billion or 1.6 percent of GNP in 1989, even after allowing for U.S. assistance disbursement of $172 million. The magnitude of the GOP's task, especially in light of its limited financial resources, speaks to the importance and timeliness of the program.

Subject to the availability of funds, A.I.D. will provide the $218 million grant in three tranches. In consideration of the GOP's progress in 1988 and early 1989 in implementing selected policy reforms, the initial tranche will be disbursed immediately upon satisfaction of the grant's legal and administrative Conditions Precedent. These include legal opinion, signature certification, designation of additional representatives, designation of depository banks for the first dollar disbursement, peso and dollar implementation plans, Commission on Audit (COA) memorandum on preparation and submission of audited reports, operating expense agreement and scope of work for monitoring and evaluation services. Depending on performance, the second tranche, for $65 million, will be released in the first quarter of 1990; and the third, for $49 million, in the third quarter of 1990. The tranches are dependent on GOP attainment of established performance criteria in the selected policy areas as well as general compliance to the Grant Agreement's terms, updated dollar and peso implementation plans, designation of depository banks, and evidence on uses of the dollars.

General covenants include freedom from taxation or fees, audit rights, refunds, consultation provision, completeness of information, implementation letters, communications, representatives, nonwaiver of remedies, termination and restrictions on use of resources. These restrictions forbid resources are being used for (i) military, paramilitary or police purposes, (ii) equity transfers or subsidies to government-owned or controlled corporations, and (iii) consumer subsidy budget expenditures. Special covenants cover GOP commitments to disburse at least 125 percent of the amount of pesos released to General Fund for the eligible budget items in that budget year and to provide quarterly disbursement reports and semi-annual and annual reports audited by COA. Special accounts for both dollars and pesos will be used.

III. THE SETTING

A. Political Environment

On February 25, 1986, a popular and relatively bloodless revolution brought Mrs. Corazon Aquino into power. Since then, the political landscape in the Philippines has been fundamentally transformed. Senior judiciary figures were replaced; a series of military reforms were initiated; and democratic institutions were restored. In February 1987, Filipino voters ratified the new Constitution by an overwhelming majority. National elections for the bicameral legislature were then held the following May; provincial and municipal elections followed in January 1988; and barangay level elections in March 1989.

President Aquino's immense personal popularity made for a relatively receptive political climate for reforms in her first two years in office. The new government launched a major economic reform program, which greatly contributed to the economic recovery (see below). This program articulated the GOP's commitment to focus attention on rural development and poverty alleviation and to improve the delivery of basic public services such as education, public utilities, and basic infrastructure. In addition, the GOP agenda had a strong redistributive thrust; this was most clearly embodied in the Comprehensive Agrarian Reform Program (CARP), which was signed into law in June 1988.

The task now facing the government is to continue to translate announced intentions into action. To do so will not be easy. Since the Philippine Congress reconvened in July 1987, the Aquino government has had to share its decision- making authority. The expansion of democratic institutions is a welcome development, but the Philippines' often contentious legislative system greatly complicates the process of obtaining consensus on major reforms. Furthermore, two decades under the Marcos regime left a legacy of overcentralized decision-making and approval processes and administrative difficulties in getting resources to rural areas. Yet increased attention to these areas is imperative. Wide disparities between regions and between rural and urban areas in income and health indicators must be narrowed. Expenditures on social and economic services differ substantially between regions, and resources are concentrated in urban areas. The national government cannot afford to ignore increasingly vocal claims that rural areas continue to be neglected. Finally, the Aquino administration has to face the continuing pressures of the communist insurgency and the Muslim separatist movements.

B. GOP Development Strategy

In December 1986, the GOP launched a six year Medium Term Philippine Development Plan (MTPDP); the plan was since updated in July 1988. The Plan articulated GOP objectives and agenda through 1992. MTPDP's goals are to alleviate poverty, generate productive employment, promote equity and social justice, and attain sustainable economic growth. The plan's policy thrusts include: trade liberalization; decentralization in planning, implementation of infrastructure projects, and allocation of resources; and redistribution of assets and services, as illustrated by the Comprehensive Agrarian Reform Program (CARP), plans to expand low-income housing, and plans to expand social services including free secondary education.

Two recent documents lay out GOP's reform priorities for the remainder of Aquino's government. A Letter of Intent (LOI) outlining the terms of an agreement between the International Monetary Fund and the GOP has been signed by the GOP and the agreement itself has been approved by the IMF's Board of Directors. According to the LOI, the GOP will undertake an economic program for the 1989-92 period which includes stabilization measures and structural adjustment reforms in conjunction with a $900 million Extended Fund Arrangement and a $400 million Contingency Financing element. The program calls for GNP growth of 6.5 percent; inflation is to be held to an annual average of 6.4 percent; and the current account deficit is to widen slightly to 2.5 percent of GNP in 1990-91 before a gradual decline thereafter. The macroeconomic framework through which this will be accomplished includes both structural reforms and stabilization measures. Many of these measures are also affirmed in an economic framework in conjunction with the proposed Philippine Assistance Program/Multilateral Assistance Initiative, (PAP/MAI) which the GOP is now in the process of formulating. Planned reforms include:

Stabilization measures: In order to restrain fiscal expenditures, total personnel expenditures of the national government will be restricted to 10 percent growth, and new positions will be restricted to one percent growth. Broad money growth will be restricted to 10-13 percent; and base money growth to 11-14 percent. Foreign exchange rate policies will be guided by minimum targets for net international reserves, "with the aim to ensure external competitiveness."

Other financial measures: The GOP plans to implement measures to improve tax collection efficiency and to institute new tax measures after 1989. The debt equity conversion program, which was effectively shelved in 1987, will be reviewed and the GOP expects that a revised scheme will be in place by the end of 1989.

Structural measures: In conjunction with a World Bank sector assistance program described below, the GOP intends to restructure the Philippines' government owned and controlled corporate sector. This will include both the reduction of the size of the sector through the privatization and dissolution of selected government owned and controlled corporations (GOCC's), and improving the efficiency of remaining GOCC's through increased transparency, measures to enhance cost recovery, and improved collection of user fees. The GOP also intends to deregulate the inter-island shipping industry and to institute financial sector reforms to enhance competition and to reduce intermediation costs. Finally, in trade, quantitative restrictions on 180 import items will be lifted by 1992 and replaced, where appropriate, with tariffs.

C. Mission Strategy and Programs

1. Mission Interim Strategy

In 1988, in recognition of the needs and constraints referred to above, A.I.D. developed an Interim Strategy Statement outlining the Mission's medium term objectives and programming principles. While A.I.D.'s strategic goals are broadly supportive of those of the GOP, the Interim Strategy Statement reflects A.I.D.'s resources and constraints, and articulates the priorities according to which A.I.D. intends to shape its portfolio. The goal of the A.I.D. program in the Philippines is to work with the Philippine public and private sectors to improve living standards in the country's rural areas. Specific objectives include: a strongly growing economy without policy biases against investment in rural areas or labor-intensive enterprises; sustained diversification and increased profitability in the agricultural sector and rural non-farm enterprises; increased coverage and effectiveness of basic social services; and improved management of the nation's natural resources, particularly tropical forests and coastal waters. These objectives will be pursued in accordance with three programming principles: policy dialogue, emphasis on the private sector, and decentralization. The Mission's framework for policy dialogue corresponds closely to the Interim Strategy, as is discussed in greater detail below.

2. Past Program Assistance

Between 1984 and 1987, the U.S. Government provided a total of four program grants to the Government of the Philippines. In 1984, the U.S. Government provided a $47.5 million ESF grant under the Rural Productivity Support Program (RPSP). In 1985 followed a $45 million ESF grant under the Development Support Program (DSP). Both RPSP and DSP provided balance of payments support to the Philippines. The generated pesos were to be used to provide additional GOP resources during the 1985 and 1986 calendar years to selected foreign-assisted projects whose implementation had been hampered by the critical lack of peso counterpart. Following the 1986 revolution, A.I.D. amended RPSP to allow the remaining RPSP balance to be used in 1986, and amended DSP to eliminate the additionality requirement so that DSP could supply the regular GOP counterpart resources for the selected projects from

March 1, 1986 through March 31, 1987 (later amended through December 31, 1987). The GOP has now completed peso disbursements under both RPSP and DSP. The GOP has submitted the audited peso disbursement reports for both RPSP and DSP.

In 1986, the U.S. government provided $300 million in ESF under the Budget Support Program (BSP) grant. In 1987 followed a $150 million ESF grant under the Budget Support Program II (BSP II). Under BSP II, ESF program assistance was tied to progress in implementation of important policy reforms. Both BSP and BSP II provided peso budget support to the GOP so that it could continue financing, in the midst of a severe budget crisis, basic services in the priority sectors of education, health and agriculture. The GOP has now completed peso disbursements under both BSP and BSP II. As of May, 1989, the GOP has still to submit acceptable audited disbursement reports for both programs.

Since the Aquino administration assumed power in 1986, the U.S. Government has provided around $185 million of pesos for budget support under various food commodity programs. The bulk of the pesos provided supported activities in agriculture. Support was also given to budget health, natural resources and transport for food feeding programs. These programs are: (i) the 1986 P.L. 480 Title I Sales Proceeds Agreement dated October 26, 1986; (ii) the Agricultural Commodity Grant Agreement dated June 16, 1987; (iii) the 1986 Section 416 Sales Proceeds Agreement dated May 8, 1987; (iv) the 1987 Section 416 Sales Proceeds Agreement dated May 11, 1988; (v) the Agricultural Commodity Grant Agreement dated May 23, 1988; (vi) the 1988 P.L. 480 Title I Proceeds Agreement dated April 19, 1988; and, (vii) Amendment No. 1 dated April 14, 1988 to the Agreement for Sales of Agricultural Commodities dated July 8, 1985.

3. Program Assistance Currently Under Design

The U.S. and Philippine Governments are now finalizing agreement on a $50 million ESF grant under the Agrarian Reform Support Program (ARSP). This program will assist the GOP to implement its planned Comprehensive Agrarian Reform Program (CARP) by providing financial assistance in support of agrarian reform efforts. Under ARSP, program support will be linked to physical performance in achieving mutually agreed upon targets which illustrate progress towards the achievement of CARP's objectives. A.I.D. expects that the ARSP grant funds will be available to the GOP for about 24 months after program initiation.

In addition, three more programs are currently under design. A.I.D. expects to provide a $50 million grant to support decentralization in the Philippines under the proposed Local Development Assistance Program (LDAP). This program will support the GOP's decentralization plans by providing program support and policy analysis, monitoring, evaluation, and auditing services. A.I.D. is also designing a child survival program (CSP) with a particular focus on maternal and child health (MCH). Under this program, A.I.D. proposes to provide a $50 million grant from Development Assistance (DA) funds to the Department of Health (DOH) to expand the program and coverage of MCH activities. A.I.D. has also begun design on a natural resources program to encourage better management of scarce and degraded resources.

D. Relationship to Other Donors

Since Aquino came to office in 1986, Philippine donors have vastly increased their total commitments of official development assistance (ODA) to the Philippines, and much of the increase has been in program form. Generally speaking, program ODA falls into two broad categories: programs which, like SDP, support overall macroeconomic reform; and sector-specific programs which focus more narrowly on the policy and resource constraints in a particular sector. The Philippines' major donors have provided a number of both types of program assistance in the last few years.

1. Macroeconomic Reform Programs

In 1986, the new government and the International Monetary Fund (IMF) agreed on an 198 million Special Drawing Rights (SDR) (approximately $242 million) Standby Arrangement. This agreement included specific targets for the public sector deficit and money supply growth as indicators of the GOP's overall success in achieving economic stabilization; exchange rate policy was also subject to program review. The program emphasized six main elements of policy reform and structural adjustment: tax reform, public expenditure program, public non-financial corporations, public financial institutions, trade liberalization and agricultural reform. With rescheduling, the GOP was largely successful in achieving the targets laid out in the Standby Agreement, and drew the final credit of SDR 35 million ($45.15 million) in August, 1988.

In 1987, the World Bank approved a $300 million Economic Recovery Loan (ERL). This program supports the GOP's reform efforts in the areas of tax reform, public expenditure program, public financial corporations, and trade liberalization. The GOP has already received two of the loan's three tranches; the release of the final tranche is expected this quarter, subject to acceptable progress in the implementation of the GOP's public investment program in the first quarter of 1989. The Japanese government has provided matching loans also in releases which are tied to the ERL tranches.

Recently the GOP and the IMF reached agreement on a new Standby Agreement ($900) and Extended Financing Facility ($400). The GOP has signed a Letter of Intent (LOI) which includes program targets and objectives. The program emphasizes monetary restraint, trade liberalization, and revenue enhancement. Tranche releases are conditional upon the GOP's performance in remaining within specified ceilings for public sector borrowing, money supply, new external medium and long term non-concessional lending, and short term external debt outstanding; and in achieving specified levels of net international reserves. The program calls for a total of five reviews, on a semiannual basis, between the time of agreement and the final review on December 31, 1991.

2. Sector Programs

The Philippines' major donors have also extended a number of "sector loans," which aim to address policy and resource constraints in a particular sector in an integrated fashion. In 1988, the Asian Development Bank (ADB) extended a $120 million loan to facilitate forestry development; the Japanese Overseas Economic Cooperation Fund (OECF) later agreed to co-finance an additional $100 million. The first $58 million tranche of this loan was recently released. The World Bank signed a $160 million housing sector project loan, which aims to improve the institutional and policy framework in the sector and to achieve greater efficiency in the use of public resources as well as to provide additional resources. In late 1988, the World Bank also signed a $200 million loan to support phased structural adjustment of government owned and controlled corporations (GOCC's). The program, which OECF agreed to co-finance for an additional $200 million, calls for three tranches, with tranche releases based on GOP performance in meeting policy and institutional conditions.

In 1989, the World Bank and the GOP have reached agreement in principle on two more sector loans. The $300 million Financial Sector Reform Program aims to strengthen the supervisory and regulatory framework for commercial banks, to improve the institutional arrangement for depositor protection, to reduce intermediary costs, and to improve the institutional framework for the mobilization and delivery of long-term credit. The World Bank also plans to provide $350 million, with Japan ExIm Bank co-financing another $250 million, under an Energy Sector Support Loan.

IV. THE ECONOMY

A. Fundamental Problems

For the Philippines the early and mid-eighties resulted in a lost decade of development. Because of the lack of progress and growth, particularly during the period 1983-85 when the Philippine economy suffered its worst recession, poverty and employment problems in the country deepened. Studies report that there are more poor people in the Philippine archipelago today than at any time in its recent history. But the economy since 1987 has recovered. It is indeed timely to devote greater policy attention and allocate more resources in the campaign to alleviate the country's poverty and employment constraints, while dealing with pressing, immediate balance of payments and budgetary problems.

1. Poverty

The declines in output in 1984 and 1985 coupled with sustained, rapid population growth caused a severe drop in per capita income, compounding already existing poverty problems. The pre-crisis level of $720 dropped to $536 during the crisis period of 1983-85. Per capita income prospects changed for the better after the economy's recovery in 1987. Strong growth of 6.7 percent in 1988 improved individual income further but the improvement was not yet significant enough to raise the current per capita income to its pre-crisis level.

In 1985, there were more families than ever living below the threshold poverty income as a result of slow economic growth, rapid population growth and the economic crisis in 1983-85. Official estimates show a poverty income level of ₱4764 in 1985. In the same year, 58 percent of the families surveyed were estimated to have incomes below the poverty line as compared to 49 percent in 1971. Translated into numbers of people, the findings suggest that more than 30 million people out of 56 million were mired in poverty. Between the urban and rural families, the former suffered a faster deterioration in their living standards. Fifty percent of the urban families surveyed were below the estimated urban poverty line in 1985. It was only 37 percent in 1971. While in the rural sector, it was 62 percent in 1985 as against 56 percent in 1971.

Since 1985, the recovery of the economy has improved the situation, but so far only marginally. Preliminary 1988 GOP data indicate a reduction in poverty incidence from 58 percent in 1985 to 49.5 percent in 1988. Family income has increased by more than 10 percent in real terms between 1985 and 1988. Particularly in the rural areas, wage earners have experienced an increased share in total income relative to other earners. Expenditure patterns have shifted from food and more basic items in favor of such items as clothing, footwear and other wear. The number of poor families appears to have declined between 1985 and 1988. However, at least 30 million people are still poor. Rural incomes remain only half the level of urban incomes.

Poverty incidence in some regions is still over 50 percent, and in at least three regions, over 60 percent. Families in the bottom quintile of the income distribution continue to dissave.

Unequal income distribution within the population is also a reflection of the grim poverty situation in the Philippines. In 1985, the top ten percent of the population had 15 times more income than the poorest 10 percent. Glaring disparities between rural and urban incomes also exist. Rural incomes are 47 percent of the average urban incomes in 1985. The disparity reflects the strong urban bias in the activities of the private and the government sectors. This skewed regional income distribution has not changed much from the record in 1971.

Malnutrition and poor health are conditions bred by poverty. The average per capita intake per day of energy and of protein in the country declined between 1982-85. Malnutrition, as indicated by the proportion of children below the weight-for-height standards, increased from 10 percent in 1982 to 14 percent in 1985. Despite a per capita income which is relatively high by comparison with the per capita incomes of the other countries in the region, the Philippines lags behind in terms of improvements in the quality of life. Among the ASEAN countries, including China, the Philippines has the lowest calorie supply per capita and the second highest infant mortality rate next to Indonesia.

There are three factors that explain the exacerbation of poverty in the Philippines. The first has to do with the structural and/or institutional factors that would breed further inequity if left unattended. In the Philippines, the major factors are the unequal asset ownership (e.g. land), population growth and lack of productivity growth. The distribution of land in the Philippines is more skewed than the income distribution. Fifty percent of the farms in 1985 occupied 16 percent of the lands for farming, while less than 4 percent controlled over one fourth. A high proportion of the land operators are tenants and not land owners.

Entrenchment of poverty could also be traced to the perverse effects of the major policy decisions of the previous regime. These policies with an anti-poor bias are price controls on basic commodities; the creation of agricultural monopolies; duties and taxes on exports; and pro-capital incentives on trade, investment and finance. The Aquino administration has adapted the reforms aimed at undoing the damage caused by the first three. Presently it is struggling to continue with the reforms needed to eliminate the distortions in the country's incentive system.

Poverty was severely affected as well by the economic adjustment program in 1984-85. The Marcos government focused to a large extent on stabilization objectives neglecting the policies that could have stimulated the supplyside of the economy. The latter could have rendered more tolerable the contractionary monetary and fiscal policies enforced in the adjustment period.

2. Unemployment and Underemployment

Lack of employment opportunities and rapid labor supply growth in the Philippines is at the heart of the poverty problem. The cumulative decline in output of roughly 10 percent during the crisis in 1983-85 reduced the labor absorptive capacity of economy and seriously aggravated unemployment and underemployment problems. In 1984, the unemployment rate was estimated at 10.6 percent with the urban sector suffering the most. Underemployment for the same year was measured at 17.6 percent. Compounding the effects of the crisis was the continued expansion of the nation's labor supply at 3.2 percent in 1984-86. Every year, 700,000 new entrants into the existing labor force are expected.

Labor content of growth had been severely affected by the shifts in the sectoral composition of output and by the increases in the relative cost of labor. Policies that discriminated against agricultural activities reduced the sector's capacity to absorb surplus labor. While the protected industries also availed of labor resources, their intensity, however, was relatively lower than the labor intensity of the agricultural sector. Cheapening the use of capital mirrored the effect of raising the relative cost of labor. As a consequence, the agriculture and service sectors, which were regarded then as the largest employment generators, created jobs equivalent to less than two years of new entrants to the labor force during the 1980-86 period. Productivity declines in manufacturing over the past two decades made the situation worse.

Surplus labor eventually found its way into the urban informal sector and into subsistence agriculture, which only raised further the underemployment rate. Defining the underemployed as those working less than 65 days in a quarter and reporting their willingness to work additional time, underemployment in the 1980s more than exceeded the rate in the 1970s. The less educated and the elderly in the urban sector suffer most from underemployment. Findings showed that the family of the average underemployed person lives below the poverty line. In 1984-86, only those families headed by underemployed college graduates were above the poverty line.

Between 1960 and 1980, real wages for both the urban skilled and unskilled workers fell at a rate of about 3 percent per year. Rural wages fell as well but not at a rate as fast as urban wages since the absorption rate in agriculture was higher than in manufacturing and industry. The decline in real wages could be attributed to the rapid growth of labor supply. There are research findings that showed the decline in total factor productivity in the manufacturing sector as the main reason why labor demand from the manufacturing industries failed to match the expansion in labor supply. The decline, largely felt in the 1970s, could be traced to the shifting of resources to inefficient industries mostly located in the intermediate and capital goods sectors. Another source of decline in real wages was the rapid rise in the general level of prices particularly during the adjustment period.

Exacerbation of poverty in the Philippines could be explained by the labor market trends. Depressed family income in the recent years resulted from higher unemployment and underemployment combined with falling real wages. The distribution of poverty in the labor force would show that poverty is concentrated in agricultural, self-employed and unskilled workers. Another implication is that poverty is basically a rural phenomenon. Evidence shows that poverty is highest among wage earners in the agricultural sector. Finally, the poorest income households are headed by unskilled workers.

3. Rapid Population Growth and Degraded Environment

The country's high population growth has been identified as one of the major factors responsible for the worsening poverty and underemployment. Current population growth of roughly 2.4 percent per year, the highest among the ASEAN, brought about a labor surplus condition that depressed real wages. It also imposed tremendous pressures on the utilization of the country's resources. In rural areas, the income-generating activities of poor but large households contributed to the destruction and spoilage of forestry and aquaculture resources. To address the needs of a growing population, more of the government resources will have to be allocated to basic and social services, instead of infrastructure. High population growth could also reduce labor's share to output. In the past, wage legislation that artificially propped up labor earnings reinforced the bias for capital and deepened labor market distortions. To raise the amount of resources essential in supporting an annual growth of 4 percent in the number of productive jobs will require an extraordinary amount of effort in savings mobilization and in the improvement of the technological base.

The slow decline in fertility and the constancy of death rates explain the persistent rise in the country's population. Crude birth rates increased from 34.8 per 1000 in 1975 to 36.3 in 1980. Crude death rates, on the other hand, fell from 10.8 per 1000 in 1970 to 8.7 in 1975, hovering at around 8 thereafter. Consistently high birth rates were directly related to the increase in the proportion of women in child-bearing ages, the decline in the mean age at marriage and the slow decline in marital fertility. The slow change in marital fertility could be traced to the decline in the use of contraceptives (or contraceptive prevalence rates) by married couples particularly in the 1980s.

High fertility rates were recorded in the poorest regions, the rural areas, among less educated mothers, among manual laborers and in the agricultural households. In the National Capital Region, the estimate is half the rate of the poorest region. Among the poor households, there is a high proportion of women who were not using contraceptives, but did not want more children. Lack of access to family planning services created the discrepancy between fertility desires and contraceptive practices.

The activities of local, impoverished and expanding populations are largely responsible for the degradation and the depletion processes of the country's natural resources. The situation is compounded by poor public management as evidenced by the declines in forestry and the spoilage of marine life despite the thicket of laws and regulations and a bureaucracy tasked with enforcement. As a consequence of the decline in real income per capita and the weak enforcement of resource laws, public lands and coastal waters are regarded as open access resources. Logging, legal or illegal, encouraged by the underpricing of the rights to harvest the public forest, caused the old-growth forests to shrink from 10 million hectares in the 1950s to only one million hectare presently. Out of 450,000 hectares of mangroves estimated to exist in 1950, only 150,000 hectares are probably in existence today due to the conversion of mangrove areas to brackish water fishponds and the accelerated cutting for fuelwood. Harvesting of coral for export and certain fishing techniques have damaged/destroyed 70 percent of the country's coral reefs.

4. Structural and Institutional Weaknesses

An Inefficient Industrial Sector

The Philippines has had a long history of protectionism. From the fifties to the seventies, a protectionist regime prevailed, although there were years when attempts were made at reforms (decontrol period in 1962, 1973 tariff code, and the tariff reform of 1980). Trade protectionism largely through high tariff walls were complemented by import restrictions that limited foreign competition and eventually coddled the resulting inefficiency among protected industries.

The resulting inefficiency in manufacturing industries is reflected in the discrepancy of growth trends between capital-labor ratios and gross value added per employee in the sixties and in the eighties. Information on factor proportions and on labor productivity showed rising trends. Although higher capital-labor ratios are associated with higher value-added per capita, the latter, nonetheless, has grown much less than the former. Between 1960 and 1980, only in 6 industries out of the 24 that make up the manufacturing sector registered increases in labor productivity faster than their respective capital-labor ratios. This suggested on the average, higher capital utilization among industries but with barely a commensurate increase in output. Others claimed that productivity of the manufacturing sector was on the wane since the sixties. Estimates of total factor productivity growth (represents the total contribution to output of all factors of production, after adjusting for changes in their utilization) from 1956 to 1980 show a predominantly negative pattern. There was one study which estimated total factor productivity growth to have declined by 1.2 percent between 1971 and 1980. Moreover, capital formation in manufacturing implied a ratio of fixed assets to gross value added rising from 1.42 in 1965 to 3.11 in 1975. While there were long-run investments in the manufacturing industries, output was not being produced at an efficient rate. The proportion of capital to labor was observed to be quite dispersed among industries as well. The disparity increased between 1960 and 1980. The maximum value of the capital-labor ratio was 47 times more than its minimum value in 1960. It was over 112 times in 1980. Trends in factor productivity and utilization, therefore, confirm the gross inefficiency among manufacturing industries brought about by nearly three decades of policies that held back foreign competition and nurtured a bias for capital.

The high cost of power was another major influence on industrial inefficiency. The existing system provided a subsidy to residential consumers through higher rates imposed on industrial users. Electricity costs in the industries exceeded the electricity rates in the industries of the country's major competitors. In December 1987, electricity rates to industrial users in Indonesia were 57 percent lower than the rates in the Philippines.

Protectionist policies were hardly effective in preventing imports from rising. The composition of imports, however, favored raw materials and capital goods. As a share of total imports, imported raw materials in 1960 were 45 percent, increasing to 56 percent by 1980. The share of imported capital goods to the total value of imports reached a high of 39 percent in 1960 only to settle at 25.7 percent in 1980. Exports failed to march in step with imports since the former were often characterized by low or inelastic supply elasticities. Since most of the country's exports were unmanufactured items, export prices on the average did not rise as fast as the prices of the country's imports. The terms of trade (unit export value divided by unit import value) declined consistently in the past three decades. In 1967, the index was valued at 127. It was 119 in 1970, 88 in 1975, 69 in 1980 and 56 in 1985. Manufactured exports were concentrated in only two or three products (electronics, garments and handicrafts). This clearly reflected the narrow base of the country's exports and the internal market flavor of the trade and investment regime. Manufactured exports also grew on a thin-value added basis particularly in the 1970s. The domestic market orientation of manufacturing industries made it difficult to establish a strong linkage with the exporting industries. The current account balance, therefore, was in the red most of the time. The deficits reached the billion dollar level in the early eighties. As a ratio to GNP, the current account deficit was 0.6 percent in 1960, 0.7 percent in 1970, and 5.4 percent in 1980. Financing the current account gap via external borrowings served to overvalue the currency. Between 1979 to 1982, the real exchange rate appreciated by roughly 2 percent per year. The overvaluation of the currency further undermined the competitiveness of exports and lured the economy into an unsustainable debt position. Postponing the required exchange rate adjustment in response to the second oil price hike hastened the foreign exchange crunch. Currency devaluation seems to be a policy move only when it became unavoidable.

The viability of these protected industries were put to a test in the crisis period (late 1983-85). Majority of these industries folded up after the debt-bubble burst. Their vulnerability to foreign exchange shocks and their lack of long-run comparative advantage were finally confirmed the hard way.

Inefficient and Inappropriate Government Operations

Despite efforts at government reform, public sector efficiency is still low and remains too involved in the economy. As a consequence, there are gaps between the government's plans and performance and unnecessary constraints on the private sector. In 1986 and 1987, the tax effort (tax/GNP) was estimated at 10.3 percent and 12.2 percent, respectively. In 1988, preliminary estimates suggest a lower tax effort at 11.2 percent despite an expanded tax base and no change in tax rates. Poor enforcement and inadequate staffing were identified as the main causes of the declining tax effort. Tax buoyancy deteriorated during the period of the crisis. Revenue growth was less than the growth of the economy. From 0.7 in 1984, the tax buoyancy estimate improved to 1.9 in 1986 and 2.2 in 1987. While there were considerable improvements in the government's present tax performance relative to its performance in the pre-crisis period, the efforts were not enough to put the government's tax performance at par with the other countries in the region. Inadequate tax compliance had been cited as the major reason for the low tax effort and low buoyancy. A tax system complicated by piecemeal adjustments to raise revenues provided opportunities for underreporting and evasion of income tax payments. The severity of the economic crisis in 1983-85 also had an adverse effect on the government's tax performance.

Further pressure on fiscal revenues are exerted by the government's absorption of the nonperforming assets of the two specialized government banks, namely the Development Bank of the Philippines (DBP) and the Philippine National Bank (PNB) and by an overgrown public corporate sector. From roughly 30 government corporations before martial law, the number expanded to 285 corporations and subsidies by 1985. Private companies were acquired by the government in the 1980s as a consequence of either a government bailout or a default on a government guaranteed loan. Six commercial banks were rescued from financial collapse by loans from government institutions. These loans were eventually converted into equity. In the 1980s, the DBP and the PNB suffered from a massive deterioration in the quality of their loan portfolios. These two banks were the conduits of behest loans--government loans to favored borrowers--as well as credit for many public and private projects under martial law. Over half the assets of PNB and almost 90 percent of the assets of DBP were nonperforming by 1985.

Having assumed all these liabilities coupled with swelling deficits resulted in the expansion of the public sector's debt outstanding from ₱539 billion at the end of 1985 to ₱757 billion at the end of 1987. External debt comprised 60 percent of the total. Domestic debt expansion, however, was faster. At the end of 1987, public sector debt is 107 percent of GNP. Monetary and fiscal coordination is expected to become more difficult due to the large public debt and the burden of interest payments. Much of the government's external debt is subject to fluctuating interest rates. A one percentage point rise in foreign interest rate could increase the national government's deficit by 20 percent or add about ₱3.8 billion to expenditures.

The high level of cash deficiency of the public corporations further contributed to the deterioration of the public sector deficit in the early eighties. Heavy capital spending without adequate capabilities to generate cash through their internal operations resulted in massive deficits. In 1982, the overall cash deficit of the public corporations amounted to ₱11.1 billion, peaking at ₱16 billion in 1983 and declining thereafter. In 1987, the budget gap of government corporations was limited to ₱3.2 billion. Although the government since 1983 has kept existing public corporations on a short leash, internal cash generation for most of these institutions continue to be a major problem. Pricing of their services barely reflect the scarcity costs of the resources they utilize. Adjustment for inflation in their pricing policies is seldom practiced. Cross-subsidies, common in the setting of rates for power and water consumption, complicate the task of pricing for these enterprises. The delivery of services or operation efficiency, common to the water and irrigation agencies, leave much to be desired. Another important issue is the collection efficiency for receivables. Arrearages frequently occur most specially in the power sector, irrigation and waterworks and sewerage. Raising prices to make up for their collection inefficiency penalizes the good clients while further subsidizing the delinquent users.

The actual level of public investment as a share to GNP was far below the target rate of 4 percent of GNP. In 1987, only 45 percent of the public investment target or 2.5 percent of GNP had been met. The reasons were largely due to the delays in project implementation, the inadequacy of feasibility studies and the difficulties with the "bottom-up" project approach at the regional development committee level. Major bottlenecks in project implementation were attributed to the weak implementation of the line agencies, the centralized administrative machinery and the reorganization of key government agencies and departments. As a consequence, the government has a backlog worth $4 billion in its pipeline of official credits and grants.

Effective power has not been surrendered by the national government to the local government units despite recent efforts at decentralization. Regional development councils lack the staff and the control over actual expenditures. In 1988, local government units control roughly 4 percent of the total public investment program. Many expenditures of local governments are still mandated by law, reducing their flexibility in reallocating resources between different functions. Autonomy of the local governments is also hampered by their inability to develop independent sources of revenues. In 1987, over 70 percent of local government revenues were provided by the national government through a scheme of revenue sharing and grant assistance. Income, in particular the real property tax collections, within their capacity to generate are often times far below the potential due to faulty administration, low tax rates and outdated assessments. Estimates show that real property taxes collected by local governments are 55-65 percent below potential.

Many government monopolies, originating from the Marcos period, had been dismantled. Price ceilings on basic commodities had been lifted. Likewise, caps on all types of interest rates had been removed. But the remaining regulations are still a major source of structural weakness in the economy. In the inter-island shipping industry, government regulation raised industry costs to users to an uncompetitive degree. Because of the quasi-monopolistic stevedoring and arrastre contracts awarded by the Philippine Ports Authority (PPA), port charges tend to be high and thus, loom as a major source of high costs. A comparison of the port charges incurred by private and public ports show that the handlers of private ports are able to survive on thinner spreads. Revenue per ton of cargo net of taxes and PPA charges was approximately ₱91.95 for the handling entity in a public port as against only ₱16.00 in the private port. The difference is mainly due to the quasi-monopolistic structure of port handling charges in public ports. The Maritime Industry Authority (MARINA), on the other hand, sets the rates on shipfreights using distance as the main basis without taking into account the economies and diseconomies of routes. Besides neglecting the load factor, cross-subsidization increases the costs for certain routes. Private estimates show that 27.1 percent of the total revenues of the inter-island shipping industry were in the form of operating surplus. Thus, deregulation of the industry would allow further reduction of charges on routes with high load factors. Bank lending rates are increased by the government regulation known as the agri-agra financing requirement, wherein 25 percent of the bank's loanable funds are supposed to be channelled to the agricultural sector. The requirement is split into 15 percent for agricultural activities and 10 percent for agrarian reform.

Lack of Rural Infrastructure

Inadequate infrastructure in the rural areas continue to discourage investments outside Metro Manila, halting the development of the agricultural sector. Despite the government's efforts to raise capital spending in the rural sector, the 1988-92 Medium Term Public Investment Program still exhibits a strong bias in favor of the high income regions. The infrastructure outlay per capita in Metro Manila is 72 percent higher than for Cagayan Valley (region with the next highest income) and definitely much more than the infrastructure expenditure per capita in the poorer income regions.

B. Recent Growth Experience

In 1987, the debt-saddled Philippine economy bounced back from the 1983-85 crisis as it grew by 5.9 percent in real terms. Leading the recovery was a consumer sector whose purchasing power was rejuvenated by low inflation, by improved prices of cash crops and by government spending. It was sustained in 1988 and invigorated further by strong business capital spending, culminating in a 6.7 percent real growth. Last year's record, thus far, stands as the strongest performance of the economy in this decade.

Despite two years of impressive growth, footdragging in the implementation of most of the structural reforms creates doubts about the sustainability of the recovery. Note as well that in those two buoyant years, the Philippine economy had windfall gains from favorable exogenous shocks (e.g. price declines in oil and price rises in coconuts and copper) and from currency realignment among the country's competitors. Government spending as the growth catalyst was also very evident. Strong growth in 1987 and 1988 barely made an impact on poverty and on the maldistribution of income which was the case in the 70's when growth was narrowly based.

1. GNP by Expenditures

Strong investment spending, particularly on durable equipment, boosted real GNP in 1988 so that a growth of 6.7 percent was attained as against 5.9 percent in 1987 (see Table 1). Combined investments of the public and the private sectors grew by 19.2 percent, enabling the share of total investments to GNP to climb to 16 percent in 1988. The 1988 share, however, is still below the pre-crisis share of investments which was 25-30 percent. Expenditures on durable equipment posted a phenomenal 29 percent real growth. The continued expansion of the economy nudged most firms closer to their production capacity, ushering in factory expansion and plant modernization. There were also considerable capital expenditures on air and water transports. Besides the creation of income and jobs, last year's investments confirmed the return of investors' confidence on the economy. Statistics show that the net level of foreign investment (as indicated in the balance of payments) reached $986 million, up by 202 percent from its 1987 level. Other indicators of foreign investment published by different government agencies confirm similar upward trends. Roughly 83 percent of these foreign investments were conducted through the debt-to-equity arrangements. Currently, the GOP is rethinking its debt-to-equity program to accommodate more foreign investments while ensuring the minimum inflationary impact from the monetary effects of these investments.

Table 1. Gross Domestic Product and
Gross National Product by Expenditures
(Million Pesos, In Constant 1972 Prices)

	1986	1987	1988
1. Personal Consumption Expenditure	66,597	70,409	74,646
% Growth	0.9	5.7	6.0
2. Government Consumption Expenditure	8,187	8,774	9,769
% Growth	-0.4	7.2	11.3
3. Capital Formation	10,111	13,171	15,705
% Growth	-9.1	30.3	19.2
A. Fixed Capital	10,057	11,631	13,653
% Growth	-15.0	15.7	17.4
1. Construction	5,505	6,348	6,836
% Growth	-22.6	15.3	7.7
a. Government	2,161	2,290	2,299
% Growth	-7.7	6.0	0.4
b. Private	3,344	4,058	4,537
% Growth	-29.9	21.4	11.8
2. Durable Equipment	4,452	5,283	6,817
% Growth	-5.5	16.1	29.0
B. Increases in Stocks	54	1,540	2,052
% Growth	-107.7	2,751.9	33.2
4. Exports of Goods and Non-Factor Services	23,560	23,245	26,675
% Growth	21.8	-1.3	14.8
5. Imports of Goods and Non-Factor Services	15,802	19,987	27,378
% Growth	12.9	26.5	37.0
6. Statistical Discrepancy	-1,473	-149	2,117
GROSS DOMESTIC PRODUCT	91,180	95,463	101,534
% Growth	1.41	4.7	6.4
Net Factor Income from Abroad	-1,676	-666	-348
GROSS NATIONAL PRODUCT	89,504	94,797	101,186
% Growth	1.86	5.9	6.7

Source: The National Income Accounts of the Philippines: CY 1986 to CY 1988 as prepared by the Economic and Social Statistics Office of the National Statistical Coordination Board (as of April 1989)

Personal consumption expenditures grew by 6.0 percent in 1988. On a per capita basis, its growth was 3.6 percent. Food consumption, at 56.3 percent, represented the bulk of personal consumption expenditures. Next largest expenditure share in real terms were household operations at 9.3 percent, followed by clothing and footwear at 5.3 percent. Government consumption expenditures, on the other hand grew by 11.3 percent. This was primarily due to a 16 percent real growth of outlays for compensation. Exports of goods and nonfactor services had an equally impressive growth of 14.8 percent in 1988, fully recovered from the slump in 1987 when exports fell by 1.7 percent. Foreign demand for shrimps and prawns expanded by 57.6 percent. Real earnings of coffee exports (not roasted), on the other hand, grew by 63.3 percent. Export growth of semiconductors and electronic microcircuits and garments were 27 percent and 22 percent, respectively. As a consequence of robust domestic and foreign demands, the imports of goods and nonfactor services in 1988 were 37 percent higher than its year-ago level. The importations of transport equipment grew the fastest among the different import items consistent with the investment trends in 1988.

2. GNP By Industrial Origin

Despite being battered by three typhoons in the last quarter of 1988, output from the combined agriculture, fishery and forestry sector grew by 3.5 percent in 1988 (see Table 2). Moreover, this feat is a reversal of the sector's one percent decline in output a year-ago. Agricultural crops grew by 1.1 percent led by sugarcane at 12.8 percent growth, palay at 6.1 percent growth and corn at 2.8 percent growth. Livestock and poultry grew by 8.8 percent and 11.4 percent, respectively. Aquaculture output, induced by external demand grew by 4.2 percent. For the forestry sector's output, it was estimated to grow by 6 percent.

In 1988, the industrial sector's output grew by 8.3 percent, slightly better than its year-ago performance of 7.7 percent. Mining and quarrying had a good year in 1988 as output grew by 4.4 percent due to low interest rates, stable world demand and firm metal prices. Gross value-added in the manufacturing sector increased by 9 percent. Its performance was dictated by the strong consumer, investment and external demands in 1988. Availability of financing and the impetus from the government's public investment program explain the upswing of the construction sector by as much as 9.5 percent. Higher growth in the agricultural and the industrial sectors translated into higher demand for utilities services. Output of the utilities sector expanded by 4.6 percent in 1988. Forty percent of the country's Gross Domestic Product (GDP) was the contribution of the gross value-added from the service sectors. Overall, the service sector's output rose by 6.6 percent in 1988.

Table 2. Gross Domestic Product by Industrial Origin
(Million Pesos, In Constant 1972 Prices)

	1986	1987	1988
1. Agriculture, Fishery and Forestry	27,110	26,834	27,771
% Growth	3.3	-1.02	3.5
a. Agriculture and Fishery	26,456	26,186	27,082
% Growth	3.6	-1.02	3.4
b. Forestry	654	648	689
% Growth	-7.4	-0.9	6.3
2. Industry Sector	28,396	30,590	33,205
% Growth	-2.1	7.7	8.6
a. Mining and Quarrying	1,574	1,547	1,615
% Growth	-10.97	-1.7	4.4
b. Manufacturing	21,717	23,168	25,251
% Growth	0.8	6.7	9.0
c. Construction	3,382	3,967	4,344
% Growth	-20.6	17.3	9.5
d. Electricity, Gas and Water	1,723	1,908	1,995
% Growth	20.2	10.7	4.6
3. Service Sector	35,674	38,039	40,558
% Growth	2.9	6.6	6.6
a. Transport, Communication & Storage	5,105	5,251	5,487
% Growth	3.1	2.9	4.5
b. Trade	14,337	15,153	15,832
% Growth	1.9	5.7	4.5
c. Finance and Housing	4,831	5,832	6,200
% Growth	12.7	20.7	6.3
d. Private Services	6,039	6,106	6,437
% Growth	-0.9	1.1	5.4
e. Government Services	5,362	5,697	6,602
% Growth	2.1	6.3	15.9
GROSS DOMESTIC PRODUCT	91,180	95,463	101,534
% Growth	1.42	4.7	6.4

Source: The National Income Accounts of the Philippines: CY 1986 to CY 1988 as prepared by the Economic and Social Statistics Office of the National Statistical Coordination Board (as of April 1989)

GDP at 1972 prices is ₱101.5 billion in 1988, which corresponds to a growth of 6.4 percent over its year-ago level. Net factor payments to the rest of the world is estimated at ₱348 million in real terms. The resulting GNP, which is the sum of GDP and net factor payments, amounted to ₱101 billion pesos, slightly under the GDP estimate, to register a buoyant 6.7 percent growth. GNP per capita in real terms is ₱1,723, which translates into a growth of 4.3 percent. In current dollars, the per capita GNP is $657 (based on the end-year official exchange rate of ₱21.335/$).

Growth Prospects

In 1989 and over the medium-term, the government's GNP growth target is 6.5 percent. Attainment of the annual GNP growth targets would enable real per capita incomes prevailing in the early 1990s to be restored to the pre-crisis level. The medium-term growth targets are to be supported by a substantial increase in total investments as well as efficient resource use. The Memorandum on Economic Policy (MEP) submitted by the government to the IMF calls for an increase in the investment to GNP ratio from 18 percent in 1988 to 24.7 percent by 1992. Moreover, the ongoing structural reforms will be complemented by prudent financial policies to foster a business environment conducive to investment growth. The private sector is expected to take the lead in investments and thus, sustain the investment recovery that transpired in 1988. The MEP, however, does not neglect the need for more public investments. It lays the groundwork for an expanded public investment program that should complement the investment thrust of the private sector. As a ratio to GNP, the public sector investments will rise from 3 percent in 1988 to over 5.5 percent in 1991-92.

3. Employment and Wages

The labor force in 1988 was estimated at 23.5 million, an increase of 4.1 percent. Out of this aggregate, 9.6 percent were unemployed, which is a slight decline from the 10 percent unemployment rate in 1987. The unemployment rate in 1988 is also the lowest in recent years. The agricultural sector absorbed most of the labor force. Statistics show that the sector employed 45.8 percent of the labor force followed by the social/personal services sector at 18.1 percent, the trade sector at 13.8 percent, the manufacturing sector at 10.5 percent and the remaining 11.8 percent spread out in various industries. Workers deployed abroad in 1988 reached 471,000, which was 4.8 percent higher than the number in 1987. Improved relations between management and labor marked the 1988 period as evidenced by the decline in strike occurrences from 420 in 1987 to 253 in 1988 during the January-November period.

Real wage rates (1978 base year) of the agricultural and nonagricultural workers throughout the country were better in 1988 compared to the rates in 1987. In the agricultural sector, statistics show that the real legislated wage rates of plantation and nonplantation workers were ₱14.83 and ₱11.95 respectively, slightly higher than the ₱13.21 and ₱10.13 estimates of plantation and nonplantation real wage rates in 1987. The minimum wage adjustment of ₱10 in 1988, effective mid-December 1987, augmented real wage rates of the nonagricultural workers in the provincial areas and in the National Capital Region. In the manufacturing sector, the index of nominal compensation in key manufacturing industries rose by 34 percent in 1988. Higher sales of manufacturing output during the year were mainly responsible for the dramatic increase in the sector's index of compensation.

4. Price and Monetary Developments

The domestic inflation rate, as indicated by the end of year to end of year rate of change of the Consumer Price Index (CPI, base year 1978), in 1988, was 9.1 percent (1988 average inflation was 8.8 percent). Although last year's inflation was below what was regarded as the safe inflation threshold of 10 percent, it was substantially higher than the 1987 year-end rate of 7.5 percent (1987 average inflation was 3.8 percent). Inflationary pressures were generated by the sustained demand, the scarcity of construction materials and the ₱10 daily wage adjustment. Efforts of the government to relieve the system of inflation were reflected in oil price rollbacks in May, August and November 1988; the reduction of transport fares at the year-end; the importation of rice and corn to beef up the country's stocks to match the increases in demand; and the prudent management of broad money.

The depreciation of the foreign exchange rate hardly posed any inflationary threat in 1988. By year-end, the ₱/$ rate settled at ₱21.335/$, marking a slight depreciation of 2.6 percent from the end December figure in 1987. The authorities claim that the movement of the rate was market-determined which would enhance the country's competitive position in markets abroad. Any intervention by the Central Bank (CB) over and above its requirements is occasioned by the need to "smoothen out unnecessary fluctuations of the foreign exchange rate brought about by speculative factors." But market participants observed that the debt-financing of the government's budget deficit and the attractive yields offered by the debt instruments of the CB, cushioned the depreciation of the domestic currency.

The average yield on Treasury Bills for all maturities climbed to 15.5 percent in 1988 from 12.9 percent in 1987. The movement of the yields on treasury bills could have encouraged the substitution of government debt for either domestic asset holdings, including money, or foreign exchange asset holdings, if their yields did not match those offered by government debt. Moreover, the issuance of treasury bills was an important component of monetary control in 1988. Proceeds from the sales of the Treasury bills in excess of the national government's deficit financing requirements were deposited in the government's account with the Central Bank. This arrangement siphoned off liquidity when speculative incidents arose especially in periods when the reserves of the Central Bank were precariously low due to debt-servicing commitments. Furthermore, this arrangement reduced the need for the CB to issue its own debt instruments to attain its monetary targets. By year-end, the national government's deposits with the CB amounted to ₱58.5 billion in 1988 corresponding to a growth of 37.5 percent. Following the general rise in the returns from holding government securities, the average yield on the CB's bills jumped to 14.6 percent in 1988 picking up as much as 380 basis points (1 percentage point = 100 basis points). This discouraged foreign investors from converting their discounted Philippine debt papers into Philippine pesos until their selection of a viable investment option.

Fiscal expansion unaccommodated by monetary policy in 1988 led to high real rates of interest that ranged from 5-7 percent, most specially on government debt. The most undesirable effect of the government's policy mix was the undervaluation of foreign exchange. Having adjusted the nominal effective exchange rate (the trade-weighted basket of the currencies of the major industrial countries and the trade-weighted basket of currencies of the country's major competitors) for relative inflation, the peso was found to have appreciated by 3.3 percent vis-a-vis the currencies of major industrial countries and by 2.1 percent vis-a-vis the currencies of the competing countries.

Except for the savings deposit rate, the other costs of bank funds were higher in 1988, causing bank lending rates across maturities to rise as well. The average rate offered by time deposits across maturities was 13.4 percent, an increase of 360 basis points. Likewise, the interbank call loan rate picked up 230 basis points. Promissory notes of various maturities averaged 12.4 percent in 1988, higher by 290 basis points over its 1987 level. Finally, the average commercial bank lending rate across different loan maturities settled at 16.7 percent in 1988, garnering in the process 270 basis points.

In 1988, monetary policy was cautious. But neither was it restrictive nor accommodative. Reserve money (currency in circulation and bank reserves held by the CB) for the most part of the year declined. It was reversed in the last quarter mainly due to the CB's net purchases of foreign exchange, drawdown by the national government of its deposits with the CB, interest payments of the CB's domestic obligations, and the public's seasonal preference for cash. Year-end 1988 saw the reserve money at ₱66.5 billion, an amount higher by 17 percent than its year-ago level.

The growth of total liquidity or Money Supply 3 (M3) was in step with the credit requirements of an expanding economy. Its outstanding year-end level in 1988 was ₱195.4 billion, 22.7 percent higher than its year-ago figure (see Table 3). Preference for interest-bearing, domestic assets over cash (or the increase in the broad money multiplier) and expansion of reserve money by 17 percent were responsible for liquid state of the system. Quasi-money (savings and time deposits) stood at ₱133.3 billion, an amount 28.8 percent larger than its year-ago estimate. Because of the positive real yields offered by time deposits to depositors, the demand for time deposits grew by 31.2 percent in 1988. This eclipsed its previous year's decline of 0.4 percent. Meanwhile, money supply 1 (M1) grew by 14.4 percent. Its outstanding level of ₱59.6 billion at year's end comprised 30.5 percent of M3.

Net domestic credits (NDC) comprised 40.6 percent of the monetary system's portfolio of net domestic assets (NDA) in 1988. NDC in 1988 amounted to ₱122 billion or a 12.6 percent growth over its previous level. The primary beneficiary of credit was the private sector while the main conduit of the credit were the deposit money banks. On the other hand, the net credits to the public sector contracted such that at the year's end, a deficit position of ₱15.4 billion was recorded. This can be traced to the build-up in the deposits of the national government with the monetary system.

Treasury Bill Auctions in 1988 had a prominent impact on the economy in the short-term. Fiscal debt had a dual function: to fund the budget shortfall and to regulate monetary aggregates. The latter required the buildup of the national government's deposits with the Central Bank through the arrangement requiring the funds, raised through the flotation of the treasury bills, in excess of the government's deficit financing requirements be deposited with the CB. Inflation was kept at the single digit mark but at the expense of the peso's overvaluation. The CB's rediscount facility had an outstanding value of ₱5.1 billion. In 1988, the CB charged an interest rate of 10 percent for every peso lent through its rediscount window. The outstanding value of the CB's facility barely changed from the amount in 1987 implying reduced dependence of the commercial banks on the CB's rediscount window. Reverse repurchase agreements of the CB, on the other hand, were offered to the market only when unstable fluctuations of the exchange rate were expected. The CB-approved sale of the four government banks to the private sector was meant to reduce the government's presence in the banking system and thus, encourage greater efficiency. In 1988, CB's program to rehabilitate the financially distressed rural banks proceeded as of end-1988, 500 rural banks were approved for rehabilitation.

As stipulated in the MEP, the annual, average growth of broad money will be limited to the range of 13-16.5 percent over the medium-term (1989-1992) while the range for base money growth is 11-14 percent. The sales of treasury securities by the national government will be the principal instrument of open market operations. Changes in the amount of the

Table 3. Domestic Liquidity
(End-of-Period, Outstanding Value in Million Pesos)

	1987	1988p
Domestic Liquidity	159,232	195,443
Annual Growth (%)	12.8	22.7
Share in Total (%)	100.0	100.0
Percent of GNP	22.6	23.7
A. Money Supply 1	52,091	59,591
Annual Growth (%)	22.1	14.4
Share in Total (%)	32.7	30.5
Percent of GNP	7.4	7.2
1. Currency in Circulation	35,452	40,696
Annual Growth (%)	21.0	14.8
Share in Total (%)	22.3	20.8
Percent of GNP	5.0	4.9
2. Demand Deposits	16,639	18,895
Annual Growth (%)	24.7	13.6
Share in Total (%)	10.4	9.7
Percent of GNP	2.4	2.3
B. Quasi-Money	103,536	133,318
Annual Growth (%)	10.6	28.8
Share in Total (%)	65.0	68.2
Percent of GNP	14.7	16.2
1. Savings Deposits	70,632	90,159
Annual Growth (%)	16.6	27.6
Share in Total (%)	44.4	46.1
Percent of GNP	10.0	10.9
2. Time Deposits	32,904	43,159
Annual Growth (%)	-0.4	31.2
Share in Total (%)	20.7	22.1
Percent of GNP	4.7	5.2
C. Deposit Substitutes	3,605	2,534
Annual Growth (%)	-26.1	-29.7
Share in Total (%)	2.3	1.3
Percent of GNP	0.5	0.3

p - preliminary

Source: 1988 Annual Report of the Central Bank to the President of the Philippines (dated March 17, 1989) government's deposit balances with, the CB could signal shifts in monetary policy. On the debt-conversion scheme, the monetary authority prefers private sector debt, instead of CB debt, since private sector debt conversion is not inflationary. In 1989 and over the medium-term, real interest rates are expected to remain high but a decline in nominal rates can not be ruled out.

The average inflation rate is to be kept at 8 percent in 1989. Over the medium-term horizon, fiscal and monetary policies are expected to limit average inflation to 6-7 percent in 1990, 5-6 percent in 1991 and in 1992.

C. The Balance of Payments Situation

1. Recent Developments

A surplus of $516 million was recorded for the balance of payments (BOP) in 1988 (see Table 4). The amount was 95.4 percent higher than the BOP surplus of $264 million in 1987. Last year was the fifth consecutive year of a BOP surplus since the crisis in 1983. The improvement in the external payments position in 1988 is even more impressive because the surplus was incurred when the economy's performance was robust. Without exceptional financing (rescheduling), however, the BOP in 1988 would have incurred a deficit of $908 million.

The current account deficit shrank from $444 million in 1987 to $373 million in 1988. As a share to GNP, the deficit in 1987 of 1.3 percent declined to one percent in 1988. Total merchandise exports raked in $7,074 million in 1988, an amount 24 percent higher than the 1987 level. Improvement in the country's terms of trade and sustained world demand explain the increase in export earnings, especially of the nontraditional items. Led by the exports of semiconductors and electronics ($1,476 million) and garments ($1,317 million), the nontraditionals comprised 75 percent of merchandise exports in 1988. Removal of the priviléges under the U.S. generalized system of preferences, granted to the exports of the country's major competitors further enhanced the competitiveness of nontraditional exports. Better metal prices in the international markets accounted for the $216 million dollar earnings from the exports of copper concentrates as well as the $295 million from the exports of copper metals.

Merchandise imports grew by 21.1 percent in 1988, another indication of brisk economic activity in that year. Completion of phase I of the country's import liberalization program (removal of the import restrictions on 1,232 items) further accelerated importations. Raw materials and capital goods had the lion's share of merchandise imports as a consequence of higher output and more investments. Exports grew faster than imports but the absolute value of imports at $8,159 million still exceeded export earnings. The trade gap as a result was $1,085 billion in 1988, slightly higher than the deficit of $1,017 million in 1987.

Table 4. Balance of Payments
(In Million U.S. $)

	1987	1988p
A. Merchandise Trade	-1,017	-1,085
Exports	5,720	-7,074
Imports	6,737	8,159
Non-Merchandise Trade	0	-77
Inflows	3,454	3,606
Outflows	3,454	3,683
Transfers	573	789
Inflows	575	791
Outflows	2	2
CURRENT ACCOUNT BALANCE	-444	-373
D. Long-Term Loans	159	-329
Inflows	2,598	2,372
Outflows	2,439	2,701
E. Foreign Investments	326	986
Inflows	439	1,077
Outflows	113	91
F. Short-Term Capital, Net	80	-205
G. Errors and Omissions	-144	40
CAPITAL ACCOUNT BALANCE	421	492
H. Monetization of Gold	365	314
I. Allocation of SDR	0	0
J. Revaluation Adjustments	-78	83
Of Which: Debt Reduction	72	73
OVERALL SURPLUS (+)/DEFICIT (-)	264	516

p-Preliminary

Source: 1988 Annual Report of the Central Bank Governor to the President of the Philippines (Dated March 17, 1989)

From a zero balance in 1987, the nonmerchandise trade (factor and nonfactor services) account deteriorated into a deficit of $77 million in 1988. Receipts from services brought in $3,606 million while payments amounted to $3,683 million. Interest expenditures, tentatively held at $2,159 million, constituted 58.6 percent of total nonmerchandise outflows in 1988. Net inward transfers stood at $789 million in 1988 largely because of the hike in personal remittances as well as in official grants/aid.

There was a slight improvement in the balance on nonmonetary capital from $421 million in 1987 to $492 million in 1988. Foreign direct investments contributed substantially to the surplus. Net investment inflow was $986 million in 1988, approximately three times the amount ($326 million) in 1987. This mirrored the growing interest of foreign investors in the Philippines. The balance on the medium to long-term loans was in the red in 1988 to the tune of $329 million. This was a reversal of the surplus it had incurred in 1987. Availments in 1988 were $2,372 million, short of the repayments valued at $2,701 million in the same year. Bottlenecks in government projects delayed the availments of pipeline loans. There were less rescheduled loans in 1988 as well. Net short-term capital registered a deficit of $205 million. Proceeds from the gold sales by the authorities injected an additional $314 million in 1988.

The country's gross international reserves at the end-of-period was valued at $2,059 million as against $1,959 million in 1987. The reserve position at the end 1988 was equivalent to 2.1 months of imports of goods and services. For the most part of 1988, the CB's dollar stocks were on the wane. Late in the year, the tranches from previous loan commitments (e.g. $75 million from the World Bank's Government Corporate Reform Program) were released to augment the country's dollar stocks and to offset the maturing debt-service payments of the national government and the Central Bank.

As of December 1988, the outstanding value of the country's external debt was $27,915 million. This is $734 million lower than the debt level for 1987. Roughly eighty-eight percent of the reduction from the debt could be attributed to the debt-to-equity conversion program. Out of the total debt stock, 69 percent is owed by the nonbanking sector. Classified by maturity, medium and long-term debt accounted for 86.5 percent of the total. Classified by institution, 48.9 percent of the nation's total debt was owed to private financial institutions and 23.3 percent to bilateral sources.

A total of 405 applications were received under the debt-to-equity conversion program valued at $1,827 million as of end-December. Close to eighty-seven percent of the total number of applications were approved with an aggregate value of $1,243 million. Most of the applications approved were investment projects classified under the schedule of the preferred investment areas, namely: export-oriented enterprises, government assets for privatization and those projects listed under the Investment Priorities Plan. Thus far, the debt-to-equity conversion program has pared off $738 million from the nation's outstanding external debt.

2. Prospects for 1989-1990

From a deficit of $377 million in 1988, the current account gap is projected to be $959 million in 1989 and $1,219 million in 1990 (see Table 5). As a ratio to GNP, the deficit is expected to be 2.2 percent in 1989 and 2.5 percent in 1990. The trade gaps are expected to exceed the surplus in the combined accounts of the invisibles (or factor services) and transfers. While the growth in merchandise exports is expected to move in step with the growth of merchandise imports for both years, the latter in absolute terms will still exceed the former, creating a trade gap valued at $1.5 billion in 1989 and $1.8 billion in 1990. Export volume growth placed at 9.2 percent in 1989 and at 9.3 percent in 1990 is a slow growth scenario compared to the 1988 experience. Nontraditional export volume is estimated to grow slightly faster than total export volume. Projections of export volume growth are based on sustained real growth of roughly 7 percent in the nonoil import demand from the country's trading partners. Price of exports, on the average, is expected to incur a positive change but not by as much as 11 percent experienced in 1988. Import volume growth is likely to hold at 10.8 percent in 1989 and 8.5 percent in 1990. Sustained industrial expansion and the effects of the trade reforms are expected to cause continued real growth of imports. Import prices are also expected to increase slightly faster than export price growth during the 1989-90 period.

Invisible payments, mainly on account of a higher interest payment schedule, are expected to surpass invisible receipts, causing the deterioration of the balance on invisibles. Net nonmerchandise trade balance is expected to have a deficit of $304 million in 1989 and $428 million in 1990, up from $112 million in 1988. Interest due is $2.55 billion in 1989 and $2.66 billion in 1990. Net resources expected from personal remittances and official aid/grants is $865 million in 1989, which is a 9.6 percent growth from its year-ago level. In 1990, net transfers are placed at $979 million.

Without rescheduling and new loans, the magnitude of the deficit in the capital account is $1.6 billion in 1989 and $1.8 billion in 1990. Shortfalls in the net medium to long-term loans by as much as $2.4-$2.6 billion are expected. Repayments in 1989 and 1990 will average $2.7 billion, offsetting availments from agreements signed before 1989 which are projected at $150-$300 million.

Net direct foreign investments are assumed to yield a surplus of $850-$880 million in 1989-90. These are slightly lower than the surplus of $986 million registered in 1988. Over 67 percent of foreign investments are expected to be coursed through the debt conversion scheme. Improvements are expected in the net short term capital account. Its deficits are projected to be in the range of $26 to $89 million in 1989-90 as against a deficit of $205 million in 1988. Gold sales will contribute anywhere from $350-$380 million.

Table 5. Balance of Payments, 1989-92
(In Million U.S. $)

	1989	1990	1991	1992	1989-92
A. Merchandise Trade Balance	-1,520	-1,770	-1,670	-1,530	-6,490
Exports	8,040	9,005	10,350	11,895	39,290
Imports	9,560	10,775	12,020	13,425	45,780
B. Non-Merchandise Trade Balance	-304	-428	-620	-859	-2,211
Inflows	4,078	4,298	4,555	4,741	17,672
Of which ESF	172	172	186	84	614
Outflows	4,381	4,726	5,175	5,600	19,882
Interest Payments	2,553	2,657	2,843	2,964	11,017
C. Net Transfers	865	979	987	1,065	3,896
Inflows	869	984	992	1,070	3,915
Grants	192	234	159	139	724
Outflows	4	5	5	5	19
CURRENT ACCOUNT BALANCE	-959	-1,219	-1,303	-1,324	-4,805
As a % of GNP	-2.2	-2.5	-2.4	-2.2	
D. Balance of Medium and Long-Term Loans	-2,412	-2,623	-2,843	-2,471	-10,349
Inflows (Pipeline)	287	152	62	50	551
Outflows	2,699	2,775	2,905	2,521	10,900
E. Net Direct Foreign Investments	880	850	850	875	3,455
New Foreign Investments	122	236	407	484	1,249
F. Short-Term Capital, Net	-89	-26	-54	-47	-216
Trade Facility	127	149	173	0	449
CAPITAL ACCOUNT BALANCE	-1,621	-1,799	-2,047	-1,643	-7,110
H. Monetization of Gold	345	380	420	460	1,605
J. Revaluation Adjustments	50	45	35	25	155
OVERALL BOP POSITION BEFORE RESCHEDULING AND NEW MONEY	-2,185	-2,593	-2,895	-2,482	-10,155

Source: Phililppine Agenda for Sustained Growth and Development, 1989

Before rescheduling, the expected shortfall in the balance of payments is \$2.2 billion in 1989 and \$2.6 billion in 1990 (see Table 6). Additional financing requirements come in the form of a reserve buildup amounting to \$3.1 billion in the 1989-90 period. Approximately 78 percent of this additional financing is meant to shore up the reserves of the Central Bank. Thus, the cumulative gross financing requirements before rescheduling, in the 1989-90 period is \$7.9 billion, equivalent to an average of \$3.95 billion per annum.

To be rescheduled in the 1989-1990 period are repayments amounting to \$1.5 billion in 1989 and \$1.7 billion in 1990. Close to 90 percent of the amount to be rescheduled are repayments due on the debt of the non-monetary institutions. After the rescheduling and considering the IMF drawdowns, the financing gap to be closed by new money is expected to reach \$2.4 billion in 1989 and \$1.8 billion in 1990. Furthermore, the rescheduling on non-monetary debt will trim the BOP deficit to \$812 million in 1989 and to \$1.1 billion in 1990.

The government plans to source \$1.35 billion or over 55 percent of the financing gap in 1989 from either the official or commercial creditors. The rest will be official credit. In the succeeding year, the financing gap is expected to dip slightly under \$2 billion. Credit from official sources will be relied upon to bridge 79 percent of the financing gap, equivalent to \$1.44 billion, in 1990.

Modest improvements in the country's debt-servicing capacity are likely to result from the net external payments position in 1989-90. The debt-service ratio is expected to remain above 30 percent despite rescheduling. In 1989, the ratio before rescheduling is 45.1 percent dropping to 33.8 percent after rescheduling. The following year, the debt service ratio before rescheduling is computed to be slightly lower at 43.4 percent while the estimate after rescheduling is 32.3 percent. These estimates are slight improvements over 1988. Interest expenditures to GNP will be kept below 6 percent. Under this scenario, total external debt outstanding at the end of the period will be \$29.1 billion in 1989 or 66.7 percent of GNP. In 1990, the debt level will inch upward to \$29.5 billion, equivalent to 61.2 percent of GNP. Beefed up by foreign credit, the Central Bank's gross international reserve position will likely settle at \$3.5 billion in 1989 and remain slightly under \$4 billion in 1990. For both years, the reserve level targets are sufficient to cover 3 months of imports.

3. Assessment

Assumptions used in the export and import projections are consistent with the notion of sluggish world trade and rising world prices. Although positive changes were assumed for unit export price and world demand for local products, the figures reflect a slowdown in comparison to 1988. Imported

Table 6. External Financing Gap (*)
1989-92
(In Million U.S. $)

	1989	1990	1991	1992	1989-92
OVERALL BOP POSITION BEFORE RESCHEDULING AND NEW MONEY	-2,185	-2,593	-2,895	-2,482	-10,155
Add: Monetary Requirement	-1,970	-1,160	-1,532	-977	-5,639
Gross Financing Requirements	-4,154	-3,752	-4,428	-3,459	15,793
Debt Rescheduling (a)	1,499	1,664	1,596	902	5,661
Non-Monetary Debt	1,373	1,486	1,419	748	5,026
IMF Drawdown	260	263	267	135	925
Financing Gap to be Filled by New Money	-2,395	-1,825	-2,565	-2,422	-9,207
New Money:					
1. Identified (b)	732	666	491	319	2,208
2. Indicative (c)	309	773	1,285	1,302	3,669
3. Residual (d)	1,354	386	789	801	3,330
OVERALL BOP POSITION:					
1. After Rescheduling of Non-monetary Debt	-812	-1,107	-1,476	-1,734	-5,129
2. After Rescheduling of Non-monetary Debt and Infusion of New Money	1,583	718	1,089	688	4,078

(*) Totals may not add up due to rounding.
(a) Refers to the rescheduling under the Paris Club and with Foreign Commercial Banks.
(b) Refers to loans from Official sources for which agreements have been signed between January 1, 1986 and February 28, 1989.
(c) Refers to loans from official sources for which 1) negotiations have been concluded as of February 28, 1989 and formal signing of agreements are being awaited; (2) negotiations and signing are expected to be concluded within 1989; or (3) indications have been made by creditors.
(d) Refers to the financing gap which has to be filled by new loans or grants from either official or commercial sources but which have not yet been identified.

Source: Philippine Agenda for Sustained Growth and Development inflation in 1989 implies a higher world inflation, presumably on account of the higher energy prices. The expected decline in the terms of trade, the sustained investment recovery and, at least in the short run, the liberalized policy on imports are responsible for the deterioration in the trade gap.

The projections for the net nonmerchandise trade account are on the optimistic side. Receipts in 1989 are projected to increase by 13 percent. A slower growth of 5 percent in 1990 is expected. Lower exports mean less dollar earnings from nonfactor services. The prospect for manpower exports is not at all that buoyant. Having world inflation higher than expected is not remote based on present trends. If world inflationary pressures persist, foreign interest rates will likely follow in the latter part of 1989, creating debt-servicing problems. Although a larger deficit relative to 1988 is anticipated for the invisibles account in 1989, the effects of current global trade and financial trends forebode the likelihood of a wider gap.

The assumption on net transfers could be jeopardized by disbursement delays. Future flows of official development assistance in the form of aid and grants are threatened because of the country's inability to effectively utilize approved project funds.

The assumption of a surplus in the direct foreign investments is critical to the capital account balance. The prospect of having more foreign investors availing of the debt conversion scheme risk triggering either inflation or high real rates of interest in the future. Entry of foreign investments, therefore, might be deliberately restrained unless the authorities come up with innovative debt conversion schemes that constrain the immediate creation of additional currency. In the BOP projections, direct foreign investments are slated to be slightly under $900 million in 1989-90. But if the financial impact would compromise the monetary targets under the IMF agenda, the actual amount of net foreign investments could be substantially less than the projections.

It may be tough to obtain a new money facility from the foreign creditor banks because the bulk of it would simply finance the CB's accumulation of foreign exchange reserves. From the creditor banks' perspective, the magnitude of the amount requested by the government is irrelevant to the present external requirements of the economy. Providing money to raise the CB's reserves would only increase their exposure needlessly. In the past, there were borrowings that went straight to the buildup of the reserves but not by the amount for which the CB is currently aspiring. Lower reserves, however, could imply higher domestic interest rates to stave off speculative attacks against the CB's remaining dollar stocks.

D. National Budget Deficit

1. Recent Developments

The National Government incurred a budget deficit of ₱23.2 billion ($1.09 billion using the end-of-year exchange rate of ₱21.335/$) in 1988, higher by 39.0 percent than the deficit in 1987 (see Table 7). Reflected as a ratio to GNP, however, the deficit in 1988 of 2.8 percent was slightly ahead of the estimate for the ratio in 1987. Lower-than-expected revenues resulted in an actual deficit higher than what was originally programmed (₱22.1 billion).

Total revenues, estimated at ₱112.9 billion in 1988, grew by 9.3 percent. The level, however, was short of the government's tax target by ₱15.4 billion. Taxes constituted 80 percent of total government income. Their absolute value in 1988 stood at ₱90.4 billion, 5.2 percent more than the 1987 figure. Actual tax payments, however, failed to meet the government's goal by ₱11.2 billion. Low import duty collections on oil, deferred payments on imports and poor implementation of the value-added tax scheme were the major reasons cited by the government behind the revenue shortfall. The nontax revenue sources did comparatively better in generating revenues. Their combined collections were valued at ₱22.5 billion. The amount was 30.2 percent more than their contribution in 1987 but still the effort fared below the government's target for nontax sources by ₱7.3 billion. Income from the disposal of government-held assets, remittances of the Presidential Commission on Good Government (PCGG), interest income from bank deposits and profits from the asset-debt swaps were the main nontax sources of government income in 1988.

Table 7. Government Cash Budget Operations, 1986-88
(In Million Pesos)

	1986	1987	1988
REVENUES	79,245	103,214	112,861
1. Tax Revenues	65,491	85,923	90,352
Domestic Based	47,645	59,649	64,772
a. Net Income and Profits	19,148	21,799	27,409
b. Excise Taxes	16,383	22,641	19,597
c. Sales Taxes and Licenses	10,276	13,252	12,356
d. Other Domestic Taxes	1,838	1,957	5,410
International Trade and Transactions	17,846	26,274	25,580
a. Import Duties and Taxes	16,859	25,977	25,011
b. Export Taxes	637	15	3
c. Other Taxes	350	282	566
2. Non-Tax Revenues	13,754	17,291	22,509
EXPENDITURES	110,497	119,907	136,067
1. Current Operating Expenditures	66,921	96,264	113,595
a. Personal Services	24,991	32,527	40,795
b. Maintenance and Other Operating Outlays	15,024	19,644	19,546
c. Subsidy	1,279	1,835	2,032
d. Tax Expenditure	441	1,049	996
e. Allotment to Local Government Units	3,574	4,304	4,361
f. Interest Payments	21,612	36,905	45,865
2. Capital Outlays	16,092	12,152	15,234
a. Infrastructure	7,827	6,576	8,400
b. Other Capital Outlays	3,856	5,576	6,834
c. Capital Transfers to PNB/DBP	4,409	0	0
3. Equity and Net Lending	27,484	11,491	7,238
SURPLUS (+)/DEFICIT (-)	-31,252	-16,693	-23,206

FINANCING	31,252	16,693	23,206
1. External (Net)	3,580	6,781	4,242
Gross Borrowings	9,769	15,420	17,290
Less: Amortization	6,189	8,639	13,048
2. Domestic (Net)	27,672	9,912	18,964
Gross Borrowings	35,461	58,618	47,339
Less: Payments	4,420	25,549	10,316
a. Amortization	7,012	24,281	12,251
b. Non-budgetary Accounts	-2,592	1,268	-1,935
Less: Change in Cash	3,369	23,157	18,059

Source: Bureau of Internal Revenue, Customs & FMD, Bureau of Treasury (As of June, 1989)

Government expenditures grew by 13.5 percent in 1988 enabling outlays to reach ₱136.1 billion. Delays in the implementation of capital projects resulted in lower-than-targeted capital expenditures. The government raised the outlays on some of the elements under current spending (e.g. personal services) which made up for the slack in public investments. In the final tally, however, government expenditures were still short of the target by ₱17.2 billion. Current operating expenditures comprised 83.5 percent of the total, followed by the share of capital outlays measured at 11.2 percent.

Domestic borrowings, primarily through the sales of Treasury securities, financed the bulk of the national government's deficit in 1988. Net domestic borrowings (or domestic borrowings net of the government's debt repayments) amounted to ₱19 billion. External borrowings, on the other hand, were ₱4.2 billion. Meanwhile, the outstanding value of the public sector's internal debt at end-December 1988 was ₱207.7 billion ($9.73 billion based on the year-end exchange rate). The amount reflected an increase of 28.9 percent relative to its year-ago level. The national government's borrowings accounted for 94 percent of the increase while the rest was from monetary institutions. At the end of the year, the national government's outstanding value of internal debt reached ₱195.5 billion ($9.2 billion), a 29.7 percent increase against the 1987 figure. The CB's issuance of bills to regulate the monetary effects of the debt conversion program was mainly responsible for the ₱3 billion debt expansion of the monetary institutions.

2. Prospects for 1989 and 1990

The government projects a budget deficit of ₱15.3 billion in 1989 and ₱9.7 billion in 1990 (see Table 8). These are reductions compared to the actual fiscal gap of ₱23.2 billion in 1988. As a share to GNP, the budget shortfall is 1.6 percent in 1989 and 0.9 percent in 1990. In the subsequent years, the deficit will be limited to the range of 0.9-1.4 percent of GNP.

As a share to GNP, tax revenues are targetted to rise from 12.3 percent of GNP in 1989 to about 14 percent in 1992. To comply with the targets, measures will be adapted to strengthen the government's tax administration and collection efficiency. New tax measures in support of the targets in 1990 will be identified in 1989 and submitted for Congressional approval in time for their implementation in the beginning of 1990. Collections from domestic-based taxes are targetted at ₱81 billion in 1989 and ₱102.4 billion in 1990. Revenue from international trade taxes are posted at ₱35.2 billion in 1989 and ₱42.4 billion in 1990.

Total government expenditure (including net lending and equity) is planned at ₱165.2 billion in 1989 and ₱189.7 billion in 1990. As a ratio to GNP, the total outlay for expenditures will be maintained at slightly above 17 percent in 1989 and in 1990. The budget for personal services is

Table 8

Table 8. Government Cash Budget Operations, 1989-92
(In Billion Pesos)

	1989	1990	1991	1992
TOTAL REVENUES AND GRANTS	149.9	180.0	204.4	227.9
1. Tax Revenues	116.2	144.8	169.0	198.3
A. Domestic Based	81.0	102.4	120.1	140.6
B. International Trade and Transactions	35.2	42.4	48.9	57.7
New Tax Measures	6.6	8.3	8.7	10.7
2. Non-Tax Revenues (including ESF)	33.7	35.2	35.4	29.6
TOTAL EXPENDITURES AND NET LENDING	165.2	189.7	215.6	248
1. Current Operating Expenditures	137.1	146.9	159.3	169.6
A. Personal Services	47.4	52.0	57.2	62.9
B. Maintenance and Other Operating Outlays	25.9	29.5	34.0	39.3
C. Interest Payments	54.2	54.2	55.7	55.6
Domestic	34.7	34.1	33.9	33.6
External	19.5	20.2	21.8	22.1
D. Subsidies	6.2	7.2	7.8	7.6
2. Capital Expenditures and Net Lending	28.1	42.8	56.3	78.3
A. Capital Expenditure	20.6	27.1	35.4	49.5
B. Equity and Net Lending	7.5	15.7	20.9	28.9
SURPLUS (+)/deficit (-)	-15.3	-9.7	-11.2	-20.1
FINANCING	15.3	9.7		
1. External (Net)	-1.1	4.8		
2. Domestic (Net)	16.4	4.9		
AS A PERCENT OF GNP:				
Total Revenues and	15.8	16.7	16.6	16.2
Tax Revenues	12.3	13.4	13.7	14.1

Expenditures and Net Lending	17.5	17.6	17.5	17.7
Personal Services	5.0	4.8	4.6	4.4
Maintenance and Operating Outlays	2.7	2.7	2.8	2.7
Capital Expenditures	2.2	2.5	2.9	3.5
Surplus (+)/Deficit (-)	-1.6	-0.9	-0.9	-1.4
GNP Assumption (in Billion Pesos)	945.8	1,076.7	1,230.3	1,402.5

Source: Memorandum on Economic Policy Submitted by the Philippine Government to the IMF set at 5 percent of GNP in 1989 and slightly lower than 5 percent in the succeeding year. The target spending for maintenance and operations is ₱25.9 billion in 1989 and ₱29.5 billion in 1990. Both of them are equivalent to 2.7 percent of GNP. Interest payments due in 1989 and in 1990 are expected to amount to ₱54.2 billion. As a ratio to GNP, interest expenditures are 5.7 percent and 5 percent respectively. Servicing public internal debt would comprise 63-64 percent of total interest payments. Relative to the government's overall budget, interest expenditures will vary from 28-33 percent in 1989-90. Total current expenditures (including interest payments) are set at ₱137.1 billion in 1989 and ₱146.9 billion in 1990. Planned outlay for current spending relative to the total budget is 83 percent this year. The following year its budget share will be lower by 6 percentage points. Compared to GNP, the current expenditure target is 14.5 percent in 1989 and 13.6 percent in 1990. Over the medium term, current expenditures will be restrained from expanding so that by 1992, its share to GNP will be kept within 12 percent. The government plans to raise the share of the allowances for operations and maintenance and the outlay of social services for the poor.

Capital expenditures by the national government are set at ₱20.6 billion in 1989 and ₱27.1 billion in 1990. These are higher targets compared to the outlay of ₱ 17.9 billion in 1988. As a ratio to GNP, the investment target levels are 2.2 percent and 2.5 percent respectively. Rural and social infrastructure, including transportation, agricultural support facilities and the expansion of energy facilities are the government investment priorities. Reconciling the plan to hike capital expenditures with the objective to pare down the deficits will require the combination of revenue-enhancing measures and restrained current expenditures. Summing up the capital expenditures of the national government and the 14 major, nonfinancial government corporations yields a public sector investment program valued at ₱39.7 billion or 4.2 percent of GNP in 1989 and ₱50.3 billion or 4.6 percent of GNP in 1990.

Net lending and equity will rise from ₱7.5 billion in 1989 to ₱15.7 billion in 1990. Equity infusion by the national government to the 14 major, nonfinancial government corporations is targetted at ₱2.2 billion in 1989, a decline from the previous year's infusion of ₱4 billion. In 1990, the government's equity contribution is projected to be lower by ₱1.2 billion. Measures to improve the internal cash generation of the public corporate sector will complement the plan to reduce the national government's equity contributions.

The public sector borrowing requirement in 1989 is estimated at ₱20 billion, equivalent to 2.1 percent of GNP. The following year, the government intends to limit the overall gap to ₱17.2 billion or 1.6 percent of GNP. Close to 70 percent of the public sector deficit will be financed by domestic borrowings in 1989. In 1990, however, external sources will be tapped to fund 60 percent of the public sector deficit.

One of the performance criteria under the MEP is a ceiling on the public sector borrowing requirement (PSBR). The PSBR, by end-September, 1989, should not exceed the ceiling of ₱16.4 billion. Six months after, the new PSBR ceiling is ₱25.6 billion. Total tax collections of the national government are pegged at ₱85.2 billion by end-September, 1989. For the same period, the ceiling on capital expenditures of the monitored public sector is ₱28.5 billion.

Other structural targets under the fiscal sector that should be accomplished within 1989-90 are:

a. To hire and train 850 Value-Added Tax (VAT) agents by end-September 1989 eventually reaching the quota of 1,700 agents by end-March 1990;

b. To increase the number of paying VAT registrants from 65,000 by end-September 1989 to 75,000 by end-March 1990;

c. To increase the share of imports subjected to the 'fair market values' assessment as the basis for C.I.F. valuation of imports for duty and tax purposes from 30 percent in 1988 to 40 percent by end-September 1989 and 60 percent by end-March 1990;

d. To complete the cross-checking and registration of income-tax withholding agents by June 1989 and December 1989, respectively; and

e. To offer for sale 20 percent of the 1985 estimated book value of assets of the state enterprises to be privatized by December 1989 and 50 percent by December 1990.

Over the medium term, the plan calls for restraining the consolidated public sector deficit to the range of 2.3-2.5 percent of GNP. The national government's deficit as a proportion of GNP is set at 0.9-1.4 percent. Public investments as a ratio to GNP are to be held slightly under 6 percent.

3. Assessment

The government's actual budget deficit may exceed the target unless tax administration, which includes the enforcement of tax laws, is improved. Reaching a tax collection efficiency sufficient to generate resources that would pare down the deficit over the medium term could take time. The GOP, however, takes the optimistic position that the reforms on tax administration and enforcement can bear fruit in a short period of time. From a collection of ₱64.8 billion in 1988, domestic-based taxes are projected to increase by 25 percent to ₱81 billion in 1989. The expansion of the revenue base will also depend to a large extent on the growth of international trade taxes and official aid/grants to the national government. The former is assumed to grow by 37.5 percent in 1989 while the revenues from nontax sources (including the ESF) are projected to rise by nearly 50 percent. The optimistic scenario of foreign trade taxes is due to expectations of a higher demand for imports resulting from sustained economic activity, a faster depreciation of the currency, and higher import prices. Uncertainty, however, prevails in the assessment of the economy's performance in 1989. There is no broad consensus that economic growth in 1989 will be better than the previous year. The reaction of the monetary authorities to higher domestic inflation due to sustained demand, wage adjustments and currency depreciaton could translate into sluggish economic growth and thus, weaken the demand for imports. The government will have to resolve delays in project implementation to achieve a faster rate of utilization of the official development assistance. Measures to unclog bottlenecks in project implementation have been adapted by the Aquino administration but it still remains to be seen whether they will prove effective.

The tax implications of creating debt to finance the public sector deficit and to regulate liquidity in the system have yet to be assessed. Present government debt has future tax implications. Put in another way, interest expenditures imply a tax on savings or future wealth. What complicates matters is when public debt-creation serves the dual purpose of regulating liquidity. Future tax obligations are raised by more than what is required to support, not only government expenditures but monetary operations as well. It has been stipulated that the amount of borrowings in excess of the budgetary shortfall should be deposited with the CB. Increasing levels of government deposits with the CB may finance future deficits. In the future, the government may not feel obliged to restrain spending in view of its deposits with the CB.

The high level of public internal debt at ₱207.7 billion is cause for worry. Servicing the debt could be achieved through taxes or through the monetization of debt. But the strategy of debt-monetization requires taxation in the form of an inflation tax. This tax in most developing countries is often used since it does not require legislation and does not encounter much political opposition. Economic history also cites incidents where debt-monetization is resorted to by the government when the public debt reaches an unsustainable level, as may be indicated by the government debt-to-GNP ratio. The main consequence is inflation. However, the evidence in the past confirms a Philippine government exercising fiscal prudence by relying less on monetary creation to finance the deficit. But the public internal debt is fast approaching a level which could create financing problems. In 1988, the outstanding value of public domestic debt was 25 percent of GNP. Government domestic borrowings in the same year was 5.6 percent of GNP. The rapid expansion of public debt makes another strong case against using fiscal debt to regulate liquidity in the system. The CB still has a host of instruments at its disposal which it can use with similar effectiveness in its monetary operations, such as the reserve requirements and the discount rate.

V. POLICY REFORMS

A.I.D. and the Philippines' other major donors are in broad agreement with the GOP's growth objectives and its emphasis on poverty alleviation and rural development. In general, A.I.D. and the rest of the donor community supports the priorities laid out in the Medium Term Philippine Development Plan discussed above. A.I.D. also strongly supports the reform agenda that the GOP recently articulated in the Letter of Intent (LOI) with the International Monetary Fund (IMF). However, the program submitted to IMF focuses primarily on monetary and external indicators, and relies most heavily on financial and monetary instruments to effect targets which are achievable in the relatively short term (three year) horizon of the program. Other structural reforms to address the Philippines' longer term developmental needs and constraints, especially as they relate to the private sector, are also necessary. Under SDP, A.I.D. will pursue a subset of the overall A.I.D. Policy Dialogue agenda for the Philippines.

A. Policy Dialogue Agenda

A.I.D. concerns with the longer term policy issues in the Philippines led to the development of a policy dialogue framework, with emphasis on furthering the role of the private sector in development. (See Policy Dialogue Agenda which starts on the next page.) This framework, which forms the basis for formal and informal discussions with GOP counterparts, corresponds closely to the Mission's Interim Strategy Statement discussed above. In keeping with the Interim Strategy, the overall goal of the policy dialogue is self sustaining improvement in rural living standards. The accomplishment of this goal will necessitate both economic and administrative reforms. SDP will focus on the sections on supportive framework, conducive climate, project preparation and implementation. Hence, these sections are discussed in greater detail after the presentation of the overall agenda.

The key to achieving self sustaining improvement in rural living standards is the creation of conditions which foster broad based, employment generating, private sector led development. The private sector must be allowed to play its role as the engine of development. A number of components are critical to the creation of such conditions. One is a generally supportive economic environment, which includes a competitive foreign exchange rate, stable macroeconomic conditions which do not crowd out private investment, and tariff and quota policies which are not biased against agriculture or exports. Another critical component is a climate which is conducive for private investment. This entails minimum regulation of and public involvement in the economy; and, precludes investment incentives which discriminate against small- and medium- sized, labor intensive, and rural located enterprises. Also necessary are profitable agricultural and rural based sectors; this will require, among other things, a healthy rural financial sector; free input and output pricing for agricultural and export

POLICY DIALOGUE AGENDA

GOAL: Self sustaining improvement in rural living standards.

KEY: Creation of conditions which foster broad based, employment generating, private sector led development.

CRITICAL COMPONENTS:

ECONOMIC POLICY REFORMS

Supportive Framework

- Competitive foreign exchange rate
- Stable macroeconomic conditions without crowding out of private investment
- Tariff and quota policies which do not discriminate against agriculture or exports

Climate Conducive for Private Investment

- Minimum regulation, e.g. deregulation of interisland shipping, ports, and cargo handling
- Investment incentives without biases against small- and medium-sized, labor intensive, and rural located enterprises
- Minimum public involvement in the economy, e.g. privatization of acquired assets, government corporations, and provision of public services

Profitable Agricultural and Rural Based Sectors

- Healthy rural financial sector
- Free input and output pricing for agricultural and export products
- Sufficient, cost effective transportation

Effective Management of Natural Resources

- Enforcement of existing legislation addressing conservation
- Regulatory framework emphasizing responsibility of the user of a public good to replenish it
- Privatization of user rights

ADMINISTRATIVE REFORMS

Effective and Efficient Project Preparation

- Completed technical feasibility studies
- Early stage coordination between potential donors and implementing entities
- Streamlined, coherent appraisal and approval process, including delegation to lower levels

Efficient Implementation of Approved Projects

- Delegation in budgeting, contracting and procuring
- Timely disbursement of funds through GOP channels or by direct mechanisms
- Faster disbursement of ODA project funds

Decentralization

- Greater autonomy to local government units (LGUs)
- Increased revenues for LGUs
- More direct foreign funded projects for LGUs

Efficient Delivery of Basic Social Services

- Effective government delivery of family planning, basic education and health services
- Use of NonGovernment Organizations (NGOs) and private sector
- Autonomy in setting user fees and raising revenues

products; and sufficient, cost effective transportation. Finally, effective management of natural resources is also crucial. Economic reforms must include better enforcement of existing legislation addressing conservation; a regulatory framework which emphasizes the responsibility of the user of a public good to replenish it; and, increased privatization of user rights.

Critical administrative reforms for achieving self sustaining improvement in rural living standards are effective preparation and implementation of public investment projects, delivery of basic services, and decentralization. Effective and efficient project preparation include technical feasibility studies; early stage coordination between donors and implementing agencies; and streamlined, coherent appraisal and approval processes. Efficient implementation of approved projects requires greater delegation in budgeting, contracting and procuring; timely flow of funds through the GOP system; and faster disbursement of ODA project funds. Decentralization involves greater autonomy to local government units (LGUs); increased revenues for LGUs, and more direct foreign funded projects for them. Finally, the effective delivery of basic social services entails greater attention and resources to family planning, basic education and health services; use of non-governmental organizations and the private sector; and devolved autonomy in setting user fees and raising revenues.

The Support for Development Program focuses on a subset of this general A.I.D. policy framework. SDP's policy agenda gives attention to administrative reforms needed to facilitate project preparation and implementation, and economic reforms needed to provide a supportive macroeconomic framework and a climate conducive for private investment. Other projects and programs in the Mission and of other donors concentrate on other elements. For example, under development are programs on Local Development Assistance which focuses on decentralization, Natural Resources and Child Survival. The PL 480 self help measures aim at obtaining the policies for a profitable agricultural and rural based sectors. See earlier Section III.D. for the role of other donors.

B. Supportive Framework: Exchange Rate, Monetary and Fiscal Policies

1. Background

Protectionism, complemented by external borrowings to fund the fiscal deficit, resulted in the overvaluation of the currency from the latter years of the seventies to the early eighties. The estimate of the peso's overvaluation ranged from 16 to 20 percent. Its most sinister effect was to undermine the competitiveness of exports. Since most of the country's exports are linked in one way or another to the agricultural sector, with the exception of the country's two most prominent manufactured exports (namely garments and semiconductors), currency over appreciation resulted in depressed rural incomes. Agricultural prices were depressed by as much as 26 percent in comparison to their world prices during 1976-86. Low returns from agricultural activities discouraged investments in the rural areas. This served to limit the development of the country's industrial base. One ramification is the narrow base of manufactured exports, forcing most of them to be dependent on imported inputs. Net value-added from manufactured exports was negligible at times. Chronic balance of payments difficulties, indicative of a severe investment-savings gap, were the result of an incentive system that offered protection to domestic industries and of an exchange rate policy that did not reflect the scarcity cost of foreign exchange.

Fear of inflation was one motive behind the monetary authority's decision to intervene in the foreign exchange market to maintain stability. Since protectionist policies led to the composition of imports biased towards raw materials and supplies, cost-push inflation would emerge after every major exchange rate adjustment. Devaluation of the currency would also result in the payment of more pesos for every dollar of debt. In a debt-ridden economy, increasing budgetary cost of servicing external financial obligations is another side-effect of depreciation. On the other hand, maintaining a competitive real exchange rate would serve to reallocate the economy's resources to export-oriented, labor intensive industries away from the protected domestic industries. In the final analysis, the vested interests of the protected industries, the budgetary consequences arising from the country's debt burden and the inflation emanating from high raw material costs are reasons why the monetary authority decided against enforcing a floating exchange rate system. As a result, intervention in the foreign exchange market has been guided by stability rather than by efficiency.

Massive public sector deficits that reached as high as 4 percent of the country's GNP in the early years of the eighties caused the country's external debt level to swell. Low responsiveness of the tax system to growth and inflation, low collection efficiency and a regressive tax structure explain the apparent weakness in the government's revenue performance. The average tax elasticity with respect to nominal income was estimated to be 0.5 percent for the period 1978-85, which is low by comparison to estimates for other developing countries. Inefficient tax collection is blamed on the tax leakages in the guises of: tax evasion and underreporting of income taxes; numerous tax exemptions to corporations; obsolete scheme for real property valuation which remains unadjusted for inflation; and low collection rates on assessed property. Because most of government projects were poorly planned and were ornamental in nature during the Marcos period, debt-service obligations required more borrowings. Compounding the problem was a public corporate sector that expanded beyond what was necessary. Guided by nonmarket criteria, the inefficient operations of most of these government firms were financed mostly by budgetary allocations plus external borrowings. As the crisis started to unfold, manufacturing concerns that thrived on the government's protectionist policies and banks hard hit by the regime of high interest rates, were absorbed by the government. Although the deficit was not monetized, monetary creation was largely conducted through the CB's rediscounting facilities that offered interest charges below market rates. Parliamentary elections in 1984 and presidential election in early 1986 brought about surges in the growth of money supply.

2. Accomplishments

A series of exchange rate adjustments during the crisis period of 1983-85 brought the official rate closer to market levels. There was a real depreciation of 8.2 percent in the 1984-85 period. In the years after the crisis, the gap between the official exchange rate and the black market rate (or the exchange rate quoted in the informal currency markets) was essentially eliminated. The current account gap was kept at manageable proportions despite two years of strong growth. Recently, however, domestic inflation reared its ugly head once again, moving at a pace faster than world inflation. Debt-financing of the budget deficit raised real interest rates, boosting the value of the peso. Trade reforms were immediately initiated by the Aquino government only to get stalled by the recovery of the economy and its buoyant prospects.

In 1986, the Aquino government initiated the reform of the tax system. The objectives were:

- To simplify the Philippine tax system;
- To address equity concerns;
- To address distortions in resource allocation in the previous tax code;
- To raise revenues;
- To increase the responsiveness of tax collections to economic growth;
- To improve the tax administration.

The tax reforms reduced the taxation of the poorest families. The shift towards the global method of taxation will raise the tax liability of the rich. Conversion of specific taxes to an ad valorem system , the reduction of the number and dispersion of sales and tariff rates, and the globalization of income taxes ought to increase the responsiveness of the tax system to growth and inflation. In 1987, tax collections rose significantly. The government in 1988 adopted the Value-Added Tax system (VAT) as part of its effort to shift to a global method of taxation and remove the distortions brought about by sales taxes and import duties. Revenue from the disposal of government-held assets and the privatization of state-owned firms provided additional revenue to the government. In 1987, the Asset Privatization Trust (APT) generated ₱1 billion worth of revenues from sales of private assets held by the government. In 1988, the APT handed in ₱4.5 billion.

Structural reform measures in the financial sector which were adopted by the Marcos government were continued by the Aquino government. Interest rate ceilings were lifted. Selective and priority credit allocation schemes were dismantled. Government's influence on credit allocation was substantially reduced. Meanwhile the six private commercial banks acquired by the Marcos government during the financial crisis are presently being privatized.

3. Remaining Tasks

Reducing the budget deficit would augur well for the exchange rate. Real interest rates would decline to a level that would discourage the substitution of government securities (or local currency) for foreign exchange. Moreover, the CB should desist from significant intervention in the foreign exchange market. Intervention is conducted through its open market operations directly in the form of the sales/purchases of dollars in the exchange trading floor and indirectly but more significantly through the issuance of high yielding debt instruments (e.g. reverse repurchase). Real interest rates remain high and domestic inflation, on the average, settled at 8 percent, higher than world inflation. Overvaluation of the peso is due more to the current trade and monetary policy framework rather than CB direct intervention in the foreign exchange market. Faster currency depreciation through trade and monetary policy reforms is necessary to regain the country's competitive edge. Any depreciation, however, must be permanent in real terms. The depreciations that occurred 5 years ago led only to temporary increases in competitiveness.

Lower budget shortfalls should reduce the chances of crowding out private investments and thus, prevent the emergence of high, positive real interest rates. Tax administration, which includes collection efficiency, are the main worries of the current regime. The 1986 tax reform adequately addressed the equity concerns and neutralized market distortions from the previous tax code but had limited impact on improving tax administration. The Bureau of Internal Revenue's (BIR) technical enforcement capacity (ability to obtain and retrieve information that would be useful for identifying tax violators) and institutional enforcement capacity (prosecute tax offenders) must be strengthened. Lack of commitment to the enforcement of tax laws seem to be the most pressing problem in Philippine tax system. Delaying the process of decentralization might have an adverse effect on revenue generation. Real property taxes collected by the local governments are woefully inadequate unless the latter are given more autonomy and a larger share of resources to improve their collection efficiency. Administration of the VAT should be improved. Under the MEP, the BIR is committed to hire and train additional persons in the administration of the VAT. Improvement of the government's tax administration would also alleviate the regressivity of the present tax structure. Seventy percent of tax revenues come from indirect taxes.

Financial intermediation in the Philippines is still low. Broad money measures as a share to GNP have fallen since 1983. Recent experience suggests that savers were attracted by the high yielding government securities. This suggests that under a stable financial environment, financial intermediation can be strengthened by offering positive real yields to savers. The agri-agra requirement has to be abolished soon. This policy requires the banks to set aside 25 percent of loanable funds to finance agricultural endeavors (split into 15 percent for agricultural production and another 10 percent for agrarian reform activities). This policy constitutes a tax on intermediation and a source of cheap funds for the government. Another tax on intermediation which the government must remove soon, if not lowered, is the gross receipts tax. Finally, the reserve requirement ratio should be reduced to narrow the gap further between loan rates and deposit rates. Closer supervision of the banks and the other financial institutions are required to assure financial stability. The restrictions on bank entry and bank branching, particularly in areas outside Metro Manila, should be relaxed. This would promote the banking habit as well as mobilize savings in the rural sector. Lastly, the rehabilitation of rural banks should be pursued to assure the flow of credit in the rural sector.

C. Trade Policy

1. Background

A crucial feature of any economic development strategy is trade policy which affects the structure of the economy, employment generation, and overall rate of economic growth. Strong circumstantial evidence, as well as theoretical support argues that a liberalized trade regime brings about the most rapid expansion in growth and incomes as well as a fairly equitable distribution of incomes. Such a regime fosters competition, provides a set of market prices closely reflecting social opportunity costs, and gives emphasis to external markets and increasing exports.

Import controls, often defended for balance of payments reasons, create serious market distortions, characterized by unjustified rewards and penalties, leading to grave inefficiencies. They attract resources into industries made profitable only by the protection of import restrictions. Tariffs represent the second line to current protectionist defense which, after lifting of import controls, becomes the main line. The bias in the tariff structure in favor of firms which depend heavily on imported inputs and nonessentials usually promotes the misallocation of resources. Also, the tariffs on imports penalizes exports since tariffs on imports translate into an implicit tax on exports.

Philippine experience has shown that a protective trade policy regime characterized by heavy quantitative restrictions on imports, high effective rates of protection, and an overvalued exchange rate resulted in the recurrence of a balance of payments (BOP) crisis about every ten years. The Philippines had this crisis in 1949 which led to postwar policy efforts being geared towards an import substitution strategy where controls in imports and foreign exchange were instituted to curb balance of payments problems but which were later on utilized as a protective device to encourage production of import substitutes. This had a favorable consequence only in the first half of the 1950s.

The second half of the fifties showed signs of the start of another balance of payments crisis in the early 1960s. Despite export promotion efforts in the early 1970s, the protective trade policies which remained entrenched in the system contributed, in addition to external shocks, to the balance of payments problems in the 1970s. The same protective features of the trade environment predominated the early eighties and coupled with the external debt problem contributed to the economic crisis starting in 1983. These protectionist practices have caused the country's scarce resources to be allocated inefficiently; have constrained the growth of output, employment and foreign trade; and have created price distortions which discriminated heavily against agriculture and exports.

One important key to making the economic recovery of the last two years, a "solid" one, is the creation of a competitive trade regime. This requires trade policy reforms geared towards greater trade liberalization and export orientation, e.g. reduction of tariffs protecting domestic industry, the elimination of quantitative restrictions on imports, and the reduction of explicit taxes against the traditional export sector.

2. Accomplishments

In 1980, as part of its initial structural reform effort, the Philippines undertook a trade liberalization program consisting of reduction in the level and dispersion in tariff rates; removal of quantitative import restrictions; realignment of indirect taxes to make them neutral; and curtailment of exemptions to import substituting industries. The program was envisioned to reduce the distortions of the trade regime and to establish a competitive climate appropriate to the country's factor endowments.

The tariff reform component of the program was completed in 1985. It consisted of: (1) reduction of average nominal tariffs from 43 percent to about 28 percent; (2) narrowing of the dispersion in rates from the range of 5-100 percent to 10-50 percent; and, (3) parallel reduction in the average effective rate of protection for all sectors from 24 percent in 1979 to about 12 percent in 1985.

Another round of tariff changes were proposed and some were adopted starting in 1987 in order to help cushion the impact of import liberalization. As of December 1988, a total of 196 tariff items were adjusted. Because of the predominance of upward adjustments (more than half), average nominal tariff rates would likely have increased from its 1985 rate of 28 percent to approximately 30-35 percent.

The most important and controversial area of trade reform has been the import liberalization program or the lifting of the import licensing and quantitative restrictions on imports. The import liberalization program proceeded as scheduled until it was halted by the 1983 economic crisis. When the Aquino administration came into power in 1986, the phased lifting of quantitative restrictions proceeded. Under Phase I of the program, which was completed over the period April 1986 to April 1988, a total of 1,232 items were liberalized. After review and consultations, the remaining 673 items still subject to import restrictions were classified as follows: (1) those for liberalization-104 items (List A); (2) those for review or further study-453 items (List B); and (3) those for continued regulation for reasons of health, safety and national security (List C). As of December 1988, ninety-four items out of a total of 104 items under List A have been liberalized as scheduled. The review of the items under List B is still ongoing.

3. Remaining Tasks

Trade liberalization has, on average, reduced tariff rates and nontariff barriers. However, it has failed to correct the anti-agriculture bias of Philippine trade policy. The agricultural sector continues to have lower trade protection than the industrial sector. A recent A.I.D.-funded study (1989) commissioned by the Secretary of the Department of Agriculture showed that the weighted tariff rates for agriculture are lower than in industry. The extent of coverage of the import liberalization program in agriculture has proceeded faster than in industry. This was measured by the NTM (nontariff measure) which refers to the ratio of the number of product items subject to import licensing regulations to the total number of product items in a given product group or sector. In the case of agriculture, its NTM coverage ratio declined faster than manufacturing which implies the greater extent of import liberalization in the former and subsequently, lower protection.

The study implies that the flow of resources into agriculture will likely not be any better than it was before the trade liberalization program. The anti-agriculture bias of the program had given more protection to industry which makes industry more profitable than otherwise, thereby attracting more resources than agriculture.

Under the second phase of the import liberalization program a balance of 463 items remains to be liberalized. This is broken down into 10 items out of a target of 104 items under List A and all of the 453 items proposed under List B (sectors under rationalization). The latter is dependent on the set of guidelines being formulated by the BOI. Considering the length of time spent already in its preparation, there should be no longer any delay in coming up with the guidelines affecting the liberalization of sectors under rationalization like cars, trucks, motorcycles, consumer durables, among others. For about 283 out of the 453 items whose quantitative restrictions will be replaced by tariff protection not later than 1994, efforts should be made to come up soon with the new tariff plan in order to guide private sector planning.

Although the temporary tariff protection accorded to liberalized commodities are time-bound, there should be a re-evaluation of the need for continued temporary protection at least every year to avoid the distorting effect on resource allocation of continued protection when no longer needed.

D. Investment Climate

1. Background

Climate conducive for private investment is needed to foster efficient investment required for a private sector fueled growth of the economy. Among appropriate conditions is the establishment of an investment incentives system which is neutral with respect to factor choice and to size of enterprises. If the investment incentives system must carry some biases, it should be towards labor-intensive, small and medium, and rural-located industries. In order to influence not only expansion in investments but more importantly the efficient allocation of investment, the incentives system must eliminate or offset market imperfections or failures in a direct manner, and not cause worse distortions.

Another important condition necessary to creating a conducive climate for private investment is the recognition and operationalization of the development role that of the private sector. This involves maximizing private sector involvement and likewise minimizing the involvement of the public sector. The latter requires the privatization of acquired assets and government corporations as well as limiting government participation in businesses. It is only in an atmosphere of a private sector-led growth that investments in productive sectors of the economy can flourish.

2. Accomplishments

Between 1983 and 1986, the volume of investments in real terms shrunk by 59 percent. With 1986 as a starting low base, investments expanded by 20 percent in 1987 to reach almost half of its 1983 volume. Investments continued to post expansions in 1988 to reach a little over 60 percent of its 1983 level. As a good indicator of domestic investment, durable equipment purchases posted increases in the last two years, although they are still only three-fifths of the 1982 pre-crisis level. Foreign investments also grew impressively starting in 1988.

In July 1987 the Aquino government established an investment policy through the issuance of an Omnibus Investments Code. The Code compiled into one document all Philippine laws on investments and changed the incentives to prospective investors by making them similar to those being offered by other ASEAN countries. Administrative measures have also been undertaken to streamline the process of investment incentive application by simplifying the procedures and reducing the forms and documentation required. Efforts have been made to establish a One-Stop Investment Action Center where all government agencies having to do with investment proposals would be housed under one roof to facilitate action on an investor application. A debt-equity conversion scheme under Central Bank Circular 1111 was set up and has encouraged many foreign investors. However, the program was suspended because of inflationary fears.

The Aquino government, shortly after obtaining power, moved to reduce the extremely regulated environment left behind by Marcos. In agriculture, reform measures included: (1) dismantling of the coconut monopoly and the lifting of the copra export ban; (2) abolition of the sugar monopoly and the creation of the Sugar Regulatory Administration; (3) disbanding of the meat importation monopoly; (4) opening up of wheat and soybean meal importation to the private sector with the withdrawal of National Food Authority's (NFA) exclusive role in this endeavor; and, (5) lifting of direct price controls on poultry and pork.

Among other areas needing deregulation, one of the most critical is interisland transportation. President Aquino has approved just recently a number of measures recommended by the Presidential Task Force on Interisland Shipping aimed at improving the efficiency of interisland transport. These measures include: (1) abolition of the 10 percent share of the Philippine Ports Authority on stevedoring and arrastre fees at privately owned ports; (2) establishment of at least two operators in every commercial port to avoid monopoly; (3) deregulation of fares (for first and second class only) and routes for the country's interisland shipping (MARINA protection for shipping routes shall be available only for five years); (4) reduction of tariffs on spare parts and auxiliary equipment for vessels not produced locally; (5) reduction of tax on common carriers from 3 percent to 2 percent; (6) revision of tax components of blended fuel being used by shipping companies; (7) abolition of current policy requiring the hiring of "harbor pilots" who will assist people entering the harbor premises; and (8) protection for passengers and vessel operators through strict enforcement of updated ship standards for seaworthiness, communications and passenger amenities.

The Aquino government adopted a privatization policy. The privatization of government acquired assets is progressing well, while the privatization of government-owned corporations is moving much slower. Of the 296 existing government-owned or controlled corporations in 1985, 130 have been earmarked for privatization, 48 are proposed to be retained in the public sector, while the rest are to be merged, absorbed as line agencies, converted to private nonprofit organizations, or simply abolished. The corporations which are targetted for privatization account for 15 percent of the total book value of assets of the government corporate sector and one third of the sector's labor force. As of the end of 1988, 121 government-owned corporations have been approved for privatization, of which four were already privatized prior to December 1986 when the privatization program was promulgated. Of the remaining 117 government corporations approved for privatization, 19 have been fully or partially sold, generating total sales of ₱4.35 billion while 3 are currently in the process of dissolution.

The privatization program for nonperforming assets (NPAs) acquired by the government is being handled by the Asset Privatization Trust (APT). Out of a total of 399 accounts by the end of 1988, APT had disposed of 104 accounts fully and 48 accounts partially for a cumulative total of 152 accounts. The program had set a sales target of ₱24 billion over a five-year period. During the first 17 months of selling operations, APT sold about ₱10 billion worth of these assets. Thus, ₱14 billion worth of assets remain to be sold in 3.5 years.

3. Remaining Tasks

The present investment incentives system remains very much like the past one and poses serious threat to achieving rural development. Several critical elements of the current system are seriously biased against a successful private sector led, rural development strategy. First, the policy-induced distortion in the exchange rate results in an overvaluation of the peso by about 16 to 20 percent. This hurts agriculture and Philippine export goods by depressing their prices and subsequently farmers' and exporters' incomes. Second, the incentives system favors the use of capital over labor, which, coupled with the small domestic market and the inability of the industrial sector to compete in the world market, results in low rate of labor absorption. Third, the investment incentives system has found it hard to accommodate small and medium businesses. Fourth, the system has placed greater emphasis on the manufacturing sector. Lastly, the administration of incentives has focused on the regulatory rather than the promotional side of investment generation.

The government's privatization program should be accelerated, especially with respect to the government-owned corporations (GOCCs). The will to privatize GOCCs should be strengthened to counter the resistance posed by GOCC executives. Administrative barriers to faster implementation should be minimized if not completely avoided, such as requirement of nearly unanimous vote of the Committee on Privatization (COP) in the sale of government assets. The large number of agencies engaged in individual privatization activities which result in poor coordination and delays in implementation should be reduced. Methods must be developed to overcome legal impediments like settlement of creditors' claims. The privatization efforts of the government need to be accompanied by the development of the capital market as a source of equity and a means to share ownership widely.

With the deregulation of the shipping industry approved by the President, what remains to be done is the difficult step of implementation of the policy. The appropriate policy prescription is gradual economic deregulation and a refocusing of the government's limited regulatory powers on safety considerations. Prices should be set free and new entrants should be welcomed. Aside from this, continuous review of the reforms approved and implemented should be done since some of the proposed reforms are not complete as to full coverage or have implications for other development-related areas. For instance, the deregulation of shipping fares apply only to first and second class passengers, excluding the third/low-class fare. There is not yet complete deregulation as to entry into specific shipping routes. This is partly an issue of cross subsidy among different sectors and passengers, which needs further study. If the need exists for subsidy, a direct subsidy from the Treasury rather than an implicit one (hidden taxes) should be preferred. With respect to fleet modernization, government intervention is needed only in promoting safety.

E. Pipeline

The Aquino government has implemented a number of administrative measures to facilitate project preparation and implementation. In 1987, the newly formed Project Facilitation Committee (PFC) was created to study implementation bottlenecks, particularly for foreign assisted projects, and to recommend salutary measures. Since their initial report was released in 1988, a number of measures have been put into place. The Commission on Audit's (COA) prior review of project contracts and pre-audit of expenditures have been eliminated for all but the final 15 percent of expenditures (although many implementing agencies' accountants still hesitate to proceed due to uncertainty on the consequences of doing so). The Department of Budget and Management (DBM) has instituted and is in the process of implementing a New Disbursement System, which authorizes release of 60 days' worth of projected expenditures whenever implementing agencies' bank balances fall below one month's needs and which allows certain funds released in one fiscal year to carry over into the next. DBM also established "common funds" for implementing agencies, to enable resources to be shifted from slow to fast moving projects. For foreign assisted projects, DBM will now release the total amount of the donor agency to the implementing agency, whereas before the agency was only eligible for 60 days' worth of projected expenditures. The Regional Directors of the Department of Public Works and Highways (DPWH) can now approve projects costing up to ₱5 million, up from a previous ceiling of ₱1 million.

Other necessary reforms still need to be done. More resources must be made available for feasibility studies. Authority for budgeting, contracting and procuring must be delegated. Appropriations and advices of allotment for foreign assisted projects should be made on a multiyear basis. The funding warrants system should be further streamlined to shorten the processing time between donors' deposits into the Treasury and DBM's release of funding warrants to implementing agencies. Donors must be allowed to deal directly with provincial governments and other decentralized groups after consultation with the central GOP offices.

F. SDP Matrix

SDP will assist the GOP's efforts to further reforms in the above areas by releasing tranches based upon GOP performance in meeting specified targets indicating progress in implementing meaningful reforms. A.I.D. will pursue policy dialogue in accordance with the following policy matrix. The actual matrix or policy package will depend upon negotiations with the GOP.

SUPPORT FOR DEVELOPMENT PROGRAM
POLICY IMPLEMENTATION MATRIX

POLICY OBJECTIVE	IMPLEMENTATION ACTION	PERFORMANCE INDICATORS	TIMETABLE 2nd Tranche	TIMETABLE 3rd Tranche
I. STRATEGY: Creation of conditions which promote broad-based, employment-oriented, sustainable private sector-led development, with broader distribution of economic opportunity.				
			Cumulative	
A. Privatization	Privatization of selected government owned and/or controlled corporations (GOCCs).	- Completion of steps to get in vendible form and offer for sale in the period beginning January 1, 1989	5 GOCCs 9 percent of asset values based on 1985 book values	20 GOCCs 13 percent of asset values based on 1985 book values
B. Liberalization of Regulations	Phased liberalization of regulations on interisland shipping.	- Adoption of a policy to liberalize entry to shipping routes.		X
		- Upgrading of liner freight rates on basic commodities.	X	
		- Shipping companies to set their respective rates for second class passengers.	X	
		- Completion of terms of reference and initiation of a comprehensive A.I.D.-financed study of interisland freight rates.		X

POLICY OBJECTIVE	IMPLEMENTATION ACTION	PERFORMANCE INDICATORS	TIMETABLE 2nd Tranche	TIMETABLE 3rd Tranche
C. Increased Efficiency and Competitiveness in Industry	Trade Reforms	- Selection of a minimum of 90 items (1) for which quantitative restrictions will be removed if the recommended tariff is less than or equal to current tariff or (2) for which quantitative restrictions will be removed upon Congressional approval of tariff rates if the recommended tariff is higher than the current tariff.	X	
		- Selection of an additional 45 items from the remaining items on List B for which quantitative restrictions will be replaced by tariffs by mid-1992.		X
D. Improved Fiscal Responsibility	Improved tax collection efficiency.	- Adoption of measures to improve VAT collections.		
		- Raise the number of paying VAT registrants.	68,000 (cumulative)	78,000
		- Increase VAT collections (full-year 1989 over full-year 1988)		25%
		- More effective anti-smuggling enforcement procedures.		
		- Increase the share of imports covered by published "fair market values", as a basis for the C.I.F. valuation of imports for duty and tax purposes, from the present coverage of 30 percent.	50% of imports	65% of imports

POLICY OBJECTIVE	IMPLEMENTATION ACTION	PERFORMANCE INDICATORS	TIMETABLE 2nd Tranche	TIMETABLE 3rd Tranche
	Provision for an adequate level of operations and maintenance expenditures.	- Increased level of actual disbursements for maintenance and non-personnel operations of the National Government for the full year 1989 in current terms.		At least 15 percent over 1988 level
II. STRATEGY: Pipeline Drawdown - Effective preparation and implementation of public sector programs and projects				
A. Improved Planning of Public Investment Projects	Strengthened capability for project identification and preparation.	- Increase budgetary releases for the PFC (Project Facilitation Committee) Feasibility Studies Fund for 1989.		650 percent over 1988 level
		- Studies in progress/completed since January 1, 1989.		20
B. Improved Monitoring and Implementation of Public Investment Projects	Improved monitoring of project progress through decentralization of monitoring system.	- Issuance of a Memorandum Order by the Office of the President to establish the Regional Project Monitoring and Evaluation System (RPMES).	X	
		- Creation of Regional Project Monitoring Committees in all regions, except National Capital Region, to adopt the RPMES.		13 committees

POLICY OBJECTIVE	IMPLEMENTATION ACTION	PERFORMANCE INDICATORS	TIMETABLE 2nd Tranche	3rd Tranche
	Greater delegation of authority in implementation of projects	- Issuance of order for the decentralization of the supervision and implementation of Integrated Area Development (IAD) projects, including Philippine Assistance Program (PAP) demonstration projects.	X	
		- Transfer of overall direction, coordination and supervision of IAD projects to respective levels (Office of the Provincial Governor for single-province projects, Regional Development Council for multi-province projects), and inclusion of appropriate private sector participation.	4 on-going projects	At least 3 new projects
• Increased Non-Government Organization (NGO) Participation in Delivery of Basic Services	Implementation of NEDA Board guidelines on collaboration between government organizations and NGOs.	- Preparation and dissemination of the Primer on the Procedures and Guidelines for Availment of Tax and Duty Exemptions by NGOs.	X	
		- Establishment of NGO desk or designation of liaison officers in the remaining 4 out of the 11 line departments at the national level that offer frontline services and were previously involved in NGO consultations.	X	
		- Preparation and dissemination to NGOs of a list of government agencies and their respective NGO units/desks.		
		- Preparation of a list of national and region-based NGOS, for use by government agencies.		

POLICY OBJECTIVE	IMPLEMENTATION ACTION	PERFORMANCE INDICATORS	TIMETABLE 2nd Tranche	TIMETABLE 3rd Tranche
D. Improved Implementation of ODA-Funded Projects	Faster drawdown of ODA project funds.	- Increase/growth in the annual drawdowns of foreign-assisted project funds implemented exclusively by major infrastructure agencies (drawdowns for full year 1989 over 1988 drawdowns). - DPWH (Department of Public Works and Highways) progress report on the effectiveness of delegated authorities for bidding and approval of contracts in improving the implementation of foreign-assisted projects.		50 percent

VI. USES OF THE PESOS

A. Education, Health and Population

1. Education

Nearly 9 million are enrolled in elementary education in the Philippines, over 3 million in secondary education, and over 1.5 million in tertiary education, representing gross enrollment ratios of about 100 percent, 65 percent and 30 percent respectively. These levels of coverage are high by international standards. These achievements are particularly striking when differences in per capita GNP are considered. International data show that countries with a per capita GNP similar to that of the Philippines have an enrollment ratio only about half as high in both secondary and tertiary education. The coverage of the Philippine education system is wider even than that of countries of East Asia and Latin America - countries that on average have higher levels of per capita GNP and relatively well-developed systems of education.

The quantitative achievements in education, however, mask qualitative problems. Several years of economic crisis preceding the 1986 revolution led to reduction of resources for government operations. The consequences on service sectors, such as education, which require proportionately larger amounts of recurrent expenditures, were serious. Not only were cuts made in the compensation of teachers and other nonteaching staff, expenditures for text books and other learning materials were also frozen. The quality of education declined as a result of these resource deficiencies.

The literacy rate in the Philippines (about 75 percent) disguises the magnitude of illiteracy and low skill level among Filipino youth. The average elementary school completion rate for the nation is approximately 60 percent and only slightly higher for students enrolling in secondary schools. Poor quality of schools and instruction is further evidenced by consistently poor achievement scores by students from all regions on primary and secondary school standard exams. Internal efficiency, as measured by repetition and dropout rates and test performances, are markedly poorest in areas most distant from the national capital. Although the economy has recovered and it has been possible to restore the investment program, the Philippines continues to face severe financial constraints.

At the same time, the demand for education services continues to rise. The population is growing at around 2.5 percent annually which will double the number of school-age children in about thirty years. This population increase plus increasing enrollment rates especially in secondary education implies demand for more classrooms, teachers and other operating support. A national goal to raise literacy standards also requires programs addressed to those adults and out-of-school youth who need assistance.

Similarly, the national economic development strategy which calls for increased productivity in agriculture and accelerated industrialization with diversification into manufactured goods requires appropriately trained manpower. The education sector continues to face the twin challenges of serious budgetary constraints and societal pressures for education.

The fiscal inadequacy of the GOP has caused problems of system growth, access to schools and poor quality. The Aquino Administration has redressed a number of these problems. The education budget has been increased substantially to ₱23.6 billion in 1988 and teacher salaries have been upgraded and nationalized (i.e., paid by the national rather than local government). However, the new Constitution enshrines free public secondary education and this is placing further strains on the education budget. Hence, despite the GOP's commitment to redress problems in education, sector investments will depend heavily on donor assistance in the near future.

The government's Six Year Development Plan for Education (1987-92) focuses on improving the quality of the system and meeting the provision of the new Constitution for free universal secondary education. Teacher salary increases, upgrading teacher quality, new construction, and increased textbook production are the major vehicles identified by the GOP for realizing increased educational opportunity and greater internal efficiency and quality of instruction. Implementation of these ambitious plans will rely largely on foreign loans/assistance. The World Bank is finalizing its assessment of the sector.

2. Health

In the past two decades, life expectancy at birth among Filipinos rose from 51.2 years in 1960 to 62.2 in 1988 for males and from 55.0 years to 66.4 years for females. The rate of increase was highest in the period from 1970 to 1980 but has slowed down in the 1980s as a result of general economic decline and reduced per capita health expenditure.

The major causes of death and morbidity are still respiratory infections, tuberculosis and gastro-enteric diseases while endemic diseases like malaria and schistosomiasis remain unchecked. Malaria has made a dramatic comeback in recent years to become the sixth leading cause of morbidity. Acute respiratory infection on the other hand continues to be the major cause of death among infants and remains a major public health challenge.

Children of ages 0-6 comprise approximately 20 percent of the total Philippine population or about 11.7 million of the estimated 59 million Filipinos in 1988. Infants alone numbered nearly 1.8 million. By 1992, the number of children 0-6 years of age would reach around 13 million. Existing socio-economic conditions do not ensure survival for many of these children. Deaths under 5 years of age accounted for over 30 percent of all reported deaths in 1985, with infant mortality claiming over one-fifth of total deaths.

Acute respiratory infections (ARI) and diarrhea continue to be the major causes of deaths among infants and pre-schoolers. Pneumonia persists as the single most important cause of infant deaths. The 1981-85 average incidence rate of ARI-related diseases in the 0-6 age group was 59/1000 while the mortality rate was 5/1000. Over 10 of every 100 children stricken with severe ARI died during the same period. The regions with the highest ARI incidence rates are in Mindanao. Mortality rates due to pneumonia tended to be highest in the less developed regions (Bicol and Eastern Visayas) as well as in Metro Manila.

The malnutrition problem for children in the Philippines appears to have been unchanged since the 1950s, and is characterized by protein-energy malnutrition, iron deficiency anemia and Vitamin A deficiency. The proportion of low birth weight newborn infants could be as high as 12 percent and the proportion of severely and moderately underweight pre-school children remains high and may even have increased from 17.2 percent in 1982 to 21.9 percent in 1985. Malnutrition incidence and ARI child mortality rates appear to be correlated.

Meanwhile, the health sector continues to be beset by institutional, financial and manpower constraints. Problems of high health personnel turnover and shortages, severe restrictions in medical supplies, and hampered implementation of outreach programs remain. Communicable and infectious diseases continue to be prevalent, requiring the expansion of vaccination and disease prevention programs.

In the past two years, the Department of Health (DOH) has made strategic moves towards improving the general health conditions of the Filipino people. The DOH implemented a reorganization and identified and addressed obstacles to effective program administration. The DOH also identified weaknesses in existing programs and administrative support systems. The DOH is continuing its efforts to improve effectiveness of major public health programs and to upgrade institutional capabilities at all levels. It is mobilizing GOP as well as donor resources. The World Health Organization (WHO) and A.I.D. have provided support for developing and testing a health information system. A.I.D. also initiated significant efforts to improve child survival through Oral Rehydration Therapy (ORT), immunization, and child feeding programs. The U.N. Children's Emergency Fund (UNICEF) is providing support for universal child immunization against the six major childhood diseases and for improved growth monitoring of young children. In addition, the DOH is seeking funding from the World Bank, A.I.D. and ADB for its Philippine Health Development Project III to provide the necessary additional investments for upgrading the public health system. A.I.D. support for this activity is envisioned through a planned Child Survival Program.

The magnitude of the financial, manpower and institutional constraints on resolving the country's health and medical problems, however, require a high level of resources. Further, the policy and operational decisions already taken by the GOP leadership in the sector indicate positive steps toward reducing the constraints noted above and should be encouraged.

3. Population

The Philippine population grew from 19 million in 1948 to 48 million in 1980, an increase of 2.5 times in three decades. The rapid population growth rates in the 1950s and 1960s, averaging 3.0 percent per year, only slightly decelerated in the 1970s to an average annual rate of 2.7 percent. The University of the Philippines Population Institute (UPPI) estimated that the Philippine population reached 57 million in 1987. UPPI estimated population growth rate at 2.38 percent per year between 1984 and 1987. At this rate, the Philippine population will double in 30 years. The Philippines is the 17th most populous country in the world and ranks 12th in absolute annual increments. Population density is projected to be 203 per square kilometer in 1990, more than twice the Southeast Asian average.

The crude birth rate in the Philippines generally declined over the past few decades. However, the crude birth rate decline has been minimal in recent years (31 births per 1000 in 1984 from 35 births per 1000 in 1975). A 1986 survey indicated the contraceptive prevalence rate had reached almost 44 percent, but contraceptive effectiveness had not improved. Actual use of clinical effective methods was about 20 percent.

The combined effect of poor economic performance, slow structural transformation and declining capacity of the public sector to provide for basic services has been to slow progress towards the alleviation of poverty, to limit occupational mobility, and to reduce geographical mobility. All of these phenomena have had demographic consequences. The slow shift of the population away from the agricultural sector, where the social and economic environment favors large family size, has not lowered fertility. Although declining real incomes, coupled with expectation of an unfavorable future economic situation, may have changed the fertility plans of poor households, their limited independent means for obtaining family planning information and services, coupled with the declining capacity of the family planning program to provide such information and services, meant that these revised fertility plans could not have been be effectively realized. The net effect of all these developments has been to slow gains in mortality and fertility reduction, and to maintain a highly uneven spatial distribution of the population.

The family program in the Philippines faces considerable challenges, after almost two decades in existence. Abundant resources have not produced the results expected. This is partly due to inappropriate or unreasonable goals, partly due to a weakening of political and bureaucratic resolve and partly due to diminished program output efficiency. Although the program has created a sizeable and well dispersed structure and has involved NGOs in the dissemination of services, achievements have been modest.

From 1970 to 1987, the family planning program focused exclusively on family planning service delivery. In 1987, the GOP expanded its scope to become a family planning and welfare program. Today, under a new population policy, the program is to integrate itself with other social actions of the GOP towards a comprehensive approach to the improvements of the conditions of the family. In spite of present uncertainties in the implementation of the population policy, there is ample room for A.I.D to provide population assistance, in keeping with the responsible parenthood and family welfare tenets of the Philippine Population Policy, through the public sector represented by the Commission on Population (POPCOM) and the Department of Health (DOH), and the private sector through a network of nongovernment organizations (NGOs). While the debate on appropriate implementation policies continues, POPCOM remains the organization with central responsibility for the coordination of the National Population Program . The DOH has embarked on a new integrated primary health care program which features family planning as a major service. The NGO family planning sector continues its operations with dedication and enthusiasm. The POPCOM is the chief coordinating, monitoring and policy-making body of the Philippine Population Program. Its role as a coordinating body is to consolidate efforts of all agencies which are involved or wish to become involved in population related activities. Funds managed by the POPCOM have come from the GOP, A.I.D., U.N. Family Planning Association (UNFPA), Japan International Cooperation Agency (JICA), and the World Bank.

4. Budget Requirements

In 1989, the budget of the Department of Education, Culture and Sports is ₱23.6 billion of which 86 percent is for current operating expenditures. By major category, regional operations accounts for 76 percent of the total budget. The 1989 Department of Health budget amounts to a smaller ₱6.8 billion, with current operating expenditures accounting for 88 percent. Major budget categories include regional operations, general administration and special projects. The POPCOM is administratively under the Department of Social Welfare and Development. Its 1989 budget is ₱53.7 million of which 98 percent is for current operating expenditures.

The intent of SDP is to sustain, or at least minimize any cuts in, programmed levels of selected budget items under the pressures of continuing financial constraints. In particular, SDP will support such categories as elementary education operations for relatively depressed regions; public health services and tuberculosis control; and general administration and coordination functions of the POPCOM.

B. Local Currency Costs

As stated in the Memorandum of Understanding (MOU) of May 15, 1989 between the Republic of the Philippines and the United States of America:

> "The peso equivalent of not less than $4 million deposited in the peso special account in connection with the initial disbursement of dollars by A.I.D. and the peso equivalent of not less than $10 million deposited in the peso special account in connection with the third disbursement of dollars by A.I.D., will be used to help the Government of the Philippines implement, for calendar years 1989, 1990 and 1991, the provisions of paragraph 3 of Section of the Annex to the Agreement on Economic and Technical Cooperation, which entered into force on May 21, 1951."

C. Monitoring and Evaluation

The peso equivalent of up to $3 million will be used for separate contractor services for monitoring and evaluation, if at the time of signing of the SDP Grant Agreement, the GOP has not yet satisfied the reporting requirements of six previous cash transfer agreements between the United States and the Republic of the Philippines. These agreements are: (i) the Grant Agreement for the Budget Support Program dated June 25, 1986; (ii) the Grant Agreement for Budget Support Program II dated May 28, 1987; (iii) the 1986 P.L. 480 Title I Sales Proceeds Agreement dated October 26, 1986; (iv) the Agricultural Commodity Grant Agreement dated June 16, 1987; (v) the 1986 Section 416 Sales Proceeds Agreement dated May 8, 1987; and (vi) the 1987 Section 416 Sales Proceeds Agreement dated May 11, 1988.

The requested services are intended to:

1. Provide an independent professional opinion on whether or not an amount of pesos equivalent to 125 percent of the annual total of transfers from the SDP Peso Special Account to the GOP General Fund has been disbursed on eligible budget categories within that year;

2. Provide similar opinions for the minimum peso amounts required to be disbursed under other past and present budget support programs funded either under ESF or through food commodities;

3. Provide assistance to A.I.D. in monitoring SDP implementation, including monitoring GOP reform implementation accomplishments and the services of an FSN PSC for contract management and other SDP implementation monitoring requirements; and

4. Conduct SDP evaluation.

Separate contractors will be used for monitoring and evaluation services to ensure the independence of the evaluation.

VII. PROGRAM

A. Objective

The objective of SDP is to help the GOP ameliorate its BOP and fiscal problems so that it can continue to provide essential services and to pursue its medium term structural adjustment program.

B. Program Funding

The amount and source of SDP funding is in accordance with a Memorandum of Understanding (MOU) between the United States and the Philippines dated May 15, 1989, entered into pursuant to a Memorandum of Agreement (MOA) between the two countries dated October 17, 1988. Under the MOU, the two countries agreed to allocate $169 million for SDP in 1989 from FY 1988 and 1989 ESF appropriations. The USG will obligate the balance of $49 million, subject to availability of funds, from requested ESF appropriations for FY 1990.

C. Description

SDP is a cash transfer with formal policy conditions. The cash transfer assistance will be provided in three tranches as balance of payments support and general budget support. The U.S. dollar assistance will be used to service official debt to multilateral lending institutions or for such other uses as may be agreed to. The peso proceeds of the grant will be used to support the GOP budget for the 1989 and 1990 Budget Years for essential services in selected areas, to help the GOP meet its commitment to provide the A.I.D. Mission with local currency for operating expenses, and to finance SDP monitoring and evaluation services, or such other uses as may be agreed to. See chapters on Implementation Procedures and Conditions and Covenants for details on regulating activities and steps to fill out the general description presented in this chapter.

1. Rationale

The cash transfer will help the GOP in meeting its international reserves and fiscal targets for calendar years 1989 and 1990. The SDP dollars will be used to service official debt to multilateral lending institutions or for other agreed to uses. The pesos that will be made available for budget support will help the GOP meet the National Government budget deficit target and continue to finance essential services in selected sectors. The use of pesos for Mission operations provides a mechanism to help the GOP meet for calendar years 1989, 1990 and 1991, its commitments under the Agreement on Economic and Technical Cooperation of May 21, 1951 between the GOP and the USG. The use of pesos for separate monitoring and evaluation services will assist the GOP in complying with SDP reporting requirements, and enable the GOP and A.I.D. to monitor and verify disbursement reports, assist the GOP in completing reporting requirements of previous budget support program agreements, provide program monitoring assistance, including monitoring reform implementation performance, and conducting SDP evaluation. The main rationale for reform conditionality is the USG and A.I.D. commitment to ensure effectiveness of development assistance through sound host country policies. A more specific rationale is the 1988 Memorandum of Agreement providing for the utilization of a substantial portion of FYs 1988-1990 ESF assistance to the Philippines "to assure continued progress in implementation of agreed on Philippine economic and administrative reforms".

2. Dollar Uses

The dollars will be used to pay GOP official debt (other than obligations incurred for public corporations) to multilateral lending institutions such as the IMF, IBRD, the Asian Development Bank (ADB), and International Development Association (IDA). Other uses of the dollars may be agreed to. The dollars will be used prospectively to make payments to the lending institutions. A.I.D. approval of a schedule of payments is a condition precedent to each tranche. This approval requirement will enable A.I.D. to ensure that the dollars will be used as quickly as possible to make eligible loan payments. To comply with the statutory provisions and regulations on tracking dollar uses, special arrangements will be undertaken to this effect. These arrangements will ensure that each dollar disbursement by the Central Bank of the Philippines is made directly to the payee and trackable to the payee.

In case of the payment of official debt for which the Central Bank is the payor on its own account, the Central Bank will simply debit the SDP Dollar Special Account. In the case of official debt of the Republic of the Philippines payable by the national government for which Central Bank only acts as an agent, the national government will have to provide pesos to the Central Bank to compensate for the Central Bank using dollars out of the SDP Dollar Special Account to make the debt payment. This is because in order to deposit an amount of pesos equivalent to the dollar deposit into the SDP Peso Special Account, the national government will sell the dollars to the Central Bank for pesos. In order for the national government to avail of the dollars sold to the Central Bank to make a debt service payment on national government debt, it must repurchase the dollars from the Central Bank.

3. Peso Uses

A.I.D. dollar disbursements of $218 million will generate an equivalent amount of peso proceeds for deposit in a Peso Special Account of which at least $201 million in pesos will be programmed for budget support for the GOP Budget Years 1989 and 1990 for GOP disbursements for costs incurred in mutually agreed upon budget categories in such priority sectors as education, health, and population. The GOP will provide peso proceeds equivalent to $4 million and $10 million from the first and third tranche, respectively, to help meet Mission operating expense requirements for calendar years 1989, 1990 and 1991. The GOP also will provide peso proceeds from the first tranche equivalent to $3 million to A.I.D. for financing services for monitoring peso disbursements for costs incurred under the eligible budget categories, for completing reporting requirements under previous budget support program agreements, funding management monitoring requirements, including monitoring reform performance and contract management assistance, and evaluation of the program.

Any amount of pesos mutually determined by the GOP and A.I.D. to be in excess of the requirements for separate monitoring and evaluation services will be returned to the Peso Special Account and reprogrammed for budget support. Similarly, any amount of pesos mutually determined by A.I.D. and the GOP to be in excess of Mission local currency needs for calendar years 1989, 1990 and 1991 also will be returned to the Peso Special Account and reprogrammed for budget support. Carrying out this provision, or the refund provision, may mean that budget support will be provided to the GOP for eligible items in GOP budget years beyond 1990.

The GOP may use for budget support the entire amount of pesos planned for monitoring services if at the time of SDP grant agreement signing, the GOP has satisfied its reporting requirements under the previous two cash transfer agreements with A.I.D. (the Budget Support Program Agreement dated June 25, 1986, as amended; and the Budget Support Program II Agreement dated May 28, 1987) and four food aid agreements with A.I.D. (the 1986 P.L. 480 Title I Sales Proceeds Agreement dated October 26, 1986; the Agricultural Commodity Grant Agreement dated June 16, 1987; the 1986 Section 416 Sales Proceeds Agreement dated May 8, 1987; and the 1987 Section 416 Sales Proceeds Agreement dated May 11, 1988). However, A.I.D. will attempt to achieve funding for SDP evaluation.

Additionality is not required for use of SDP pesos made available for budget support. The GOP will either retroactively or prospectively attribute these pesos to disbursements for costs incurred in eligible budget categories for the GOP's Budget Years 1989 and 1990 (or other future years as required by return or refund provisions). A.I.D. will use pesos provided for Mission operating expense requirements and program monitoring and evaluation services in accordance with USG and A.I.D. financial management regulations and procedures. A.I.D. may make arrangements to convert pesos made available for program monitoring and evaluation services into foreign exchange to pay for expatriate services, but pesos made available for Mission operating expenses will only be used to pay peso costs.

Upon receipt of each tranche of dollars, the GOP will within one business day deposit into a special account the equivalent pesos. SDP budget support pesos transferred from the SDP Peso Special Account to the GOP's General Fund will be reported against disbursements in the identified priority budget categories. The amounts of these transfers are initially estimated at ₱2.1 billion for the GOP's 1989 Budget Year and ₱2.3 billion for the 1990 Budget Year. To ensure sufficient developmentally sound disbursements, the GOP will disburse at least 125 percent of the total transfers for each year, in that year (including any future years) for the eligible budget items. Mutual agreement on eligible budget support categories is expected to ensure the selection of items with desirable development impact.

4. Tranching of Dollars Disbursements

A.I.D. will disburse the first tranche of $104 million immediately upon grant signing and GOP satisfaction of initial conditions precedent. The second tranche of $65 million will be disbursed not earlier than January 1, 1990 and the third tranche of $49 million not earlier than July 1, 1990. However, actual timing of A.I.D. disbursements for the second and third tranches will depend on GOP reform performance and compliance with other conditions precedent. Use of three tranches will divide SDP resources between the two GOP budget years and encourage continued momentum in implementing reforms over the two year period.

5. Mechanics of Policy Conditionality

Assessment of GOP reform performance will be based on GOP attainment of all performance indicators for each tranche such as those described in the SDP Policy Implementation Matrix, presented in Section V.F. (Actual policy matrix will be determined through negotiations.). Compliance with the indicators will be required for a tranche release, except as a waiver, at A.I.D. discretion, may be appropriate. The GOP and A.I.D. will engage in consultations to assess jointly reform performance. Prior to each review, the GOP will provide to A.I.D. a report on the status of accomplishment of the performance indicators.

If justified because of uncontrollable or unforeseen developments, or sufficiently significant progress on other indicators, A.I.D. may waive or renegotiate indicators which the GOP is unable to meet. A.I.D. may negotiate additional indicators in such a case.

Unless A.I.D. agrees otherwise in writing, the GOP has until March 31, 1990 and September 30, 1990 to complete the agreed upon performance indicators for the second and the third tranche, respectively. If the GOP is unable to meet the performance indicators by the specified dates, A.I.D. may unilaterally terminate the grant.

D. Restrictions

SDP dollars will be used exclusively for official debt service payments, other than obligations incurred for government corporations, to the IMF, IBRD, IDA and ADB, unless otherwise agreed to. Funds provided or made available as a result of SDP will not be used for disbursements for (i) military, paramilitary or police purposes, (ii) equity transfers or subsidies to government owned or controlled corporations, or (iii) consumer subsidies budget expenditures.

Section 531(e) of the Foreign Assistance Act of 1961, as amended, prohibits the use of ESF for military or paramilitary purposes. The exclusion of dollar uses for servicing debt obligation incurred for government corporations and budget support to finance government corporation equity or subsidy, including government owned financial institutions, is in keeping with the A.I.D. dialogue with the previous and present GOP administrations on the need to reduce financial transfers to these entities. Consumer subsidies have caused distortions in the economy and have contributed to the current economic crisis. The IMF, the IBRD and the U.S. Government have conducted intense policy discussions with the previous regime on this subject and that dialogue continues with the present administration.

E. Expected Impact

The GOP targets a 6.5 percent real GNP growth per year and moderate inflation not exceeding 8 percent per year during 1989-1992. Growth financing involves targets for fiscal and external positions. Gross financing requirement after debt rescheduling will increase to $2,655 million in 1989 from $780 million in 1988 but will decrease to $2,088 million in 1990. The GOP targets international reserves sufficient for 3.0 months of imports both for 1989 and 1990, up from the 1988 level of 2.1 months. This target increases the financing gap to be filled by new money to $2,395 million in 1989 and $1,825 million in 1990. The GOP also targets an increase in national government revenues in terms of percent of GNP from 13.7 percent in 1988 to 15.8 percent in 1989 and 16.7 percent in 1990. The National Government budget deficit, on the other hand, is targeted to decrease from 2.8 percent of GNP in 1988 to 1.6 percent in 1989 and 0.9 percent in 1990.

To illustrate SDP's effects on GOP financial stability, GOP projections of its external and fiscal positions for 1989 and 1990 are recomputed without SDP inflows of $104 million in 1989 and $114 million in 1990. To maintain 3.0 months' worth of imports of goods and services of gross official reserves, the financing gap will be $104 million higher in 1989 and $114 million higher in 1990. If residual exceptional financing is not obtained to substitute for SDP, gross official reserves will be reduced from 3.0 month's worth of goods and services imports to 2.9 months in both 1989 and 1990. Without SDP flows, the National Government budget deficit as a percent of GNP will be 1.9 percent instead of 1.6 percent with SDP in 1989, and 1.1 percent instead of 0.9 percent in 1990. In addition, GOP failure to meet IMF requirements related to these indicators will result in reduced access to commercial bank credit and the withholding of releases of both IMF funds and $900 million in Japanese bilateral assistance expected to be tied to GOP performance under the IMF Agreement.

SDP reform conditionality increases the likelihood of effective implementation of announced GOP reforms. These reforms, in turn, pave the way for structural adjustment of the economy towards a more competitive production structure and more equitable growth.

The conducive climate for private investment which SDP hopes to help bring about will have a profound effect on the economy. A factor- and size-neutral investment incentives system will not only produce more investment capital for the country but will also influence the flow of these investments into more efficient sectors of the economy. More investments in the proper sectors will help ensure sustained growth in the long term.

Returning business to the hands of the private sector will help create an investment climate that will encourage private sector initiative and entrepreneurship. In the process, disposition of asset and stock ownership can also be broadened and the capital market strengthened. Privatization efforts should also reduce the strains on national budgets and on foreign debts of the country. It may serve as a vehicle to facilitate the adoption of free markets in which private enterprises effectively compete with each other and thus result in increased employment, higher income and improved standard of living.

Deregulation of entry into shipping services as well as competitive pricing of shipping services will reduce exhorbitant transportation costs. This will improve the prices of domestic inputs, enhance the export competitiveness of Philippine products, and increase output. In turn, this will help bring about higher incomes, employment and overall improvements in the standard of living.

A more liberalized trade regime, which SDP hopes to encourage, will foster greater competition, provide a set of market prices more closely reflecting social opportunity costs, and give greater emphasis to external markets and hence exports. Minimum import controls will minimize market distortions, misallocation of resources, and inefficiencies among favored sectors. Less variability in tariff rates and probably a uniform tariff rate in the long term would minimize the implicit tax on exports arising from tariffs on imports. Minimum import controls and a rationalized tariff structure will encourage rapid expansion in growth and incomes as well as more equitable distribution of incomes.

The SDP's push for a sector-neutral implementation of trade liberalization by reducing the level of protection being enjoyed by industry relative to that of agriculture would remove the misallocation of resources in favor of industry and would attract resources to flow into agriculture instead of only into industry. This is expected to lead to more balanced growth, and push expansion in agricultural output and farmers' incomes.

Improved fiscal management would help ensure budgetary balance and financial stability of the country. Responsible fiscal management calls for less dependence on debt financing of government expenditures and maintaining an adequate level of public sector services to foster and complement private sector growth. Increased revenue financing will have profound long term beneficial impacts on the GOP's financial position.

The successful completion of administrative reforms included in SDP's policy dialogue agenda will assist in bringing forth better public sector programs and projects. More resources devoted to feasibility studies will improve project identification and preparation. Informed selection of public sector projects for their investment merits will better safeguard the local taxpayers' interests and foster greater confidence in government. Delegation and decentralization of project monitoring and implementation activities will improve efficiency of and expedite project implementation.

Development efforts may be enhanced through greater involvement of nongovernmental organizations (NGOs). NGOs are particularly effective in reaching geographical areas not normally reached by government basic services delivery systems, in linking beneficiaries to existing sources of basic services and resources, in helping beneficiaries better identify and articulate their needs and thereby plan development activities that emphasize self reliance, and in devising faster and more cost effective development interventions.

Improved implementation of ODA-funded projects will further the early realization of benefits from such projects. Equally significant is the generation of goodwill among and greater willingness of donors to continue assistance, perhaps at levels higher than before.

VIII. IMPLEMENTATION PROCEDURES

Presented below are the planned implementation procedures. Details will be finalized upon consultation and agreement between the GOP and A.I.D.

A. Process

1. Dollars

a. Disbursement of Tranches

Upon satisfaction of the legal, administrative and other non-reform performance Conditions Precedent to initial disbursement of dollars to the GOP (see Chapter IX for details on Conditions Precedent and Covenants), A.I.D. will disburse on behalf of the GOP the first tranche of $104 million for deposit in the separate account or accounts with the bank or banks specified by the GOP. Disbursement will be effected through the electronic funds transfer system.

Upon satisfaction of the conditions precedent to disbursement of of the second tranche but not earlier than January 1, 1990, A.I.D. will disburse on behalf of the GOP $65 million for deposit in the SDP Dollar Special Account.

Upon satisfaction of the conditions precedent to disbursement of of the third tranche but not earlier than July 1, 1990, A.I.D. will disburse on behalf of the GOP $49 million for deposit in the SDP Dollar Special Account.

b. The SDP Dollar Special Account

The separate bank accounts into which dollars disbursed are deposited will be referred to collectively as the "SDP Dollar Special Account". Funds deposited in this Account will not be commingled with funds from any other source. The Account will include and will be credited for any interest earned from funds held in this Account and any GOP refunds for unacceptable disbursements from the Account, The Account will be used for the payment of official debt obligations in accordance with mutually agreed upon implementation plans for SDP or for such other purposes as A.I.D. may agree to in writing. The GOP will disburse dollars in the SDP Dollar Special Account in accordance with the Dollar Implementation Plan. All dollar disbursements will be drawn directly from the Account and paid directly to the payees specified in the implementation plan for the amounts specified on the due dates specified.

2. Pesos

a. The SDP Peso Special Account

Immediately upon A.I.D. disbursement of the first tranche dollars, the GOP will establish a separate account with the Central Bank of the Philippines, the "SDP Peso Special Account", and will deposit therein within one business day of the time any dollar deposit is made by A.I.D. for the GOP an amount of pesos equivalent to each such dollar disbursement.

The total amount of pesos required to be deposited in the SDP Peso Special Account in connection with each dollar disbursement will be determined on the basis of the then prevailing rate of the Central Bank for the purchase of dollars on the date of conversion of each dollar deposit. However, if at the time of such conversion there is more than one lawful rate of exchange in the Philippines, the GOP will make arrangements such that the SDP dollars may be converted at the highest rate.

For purposes of the first tranche, the highest exchange rate which is not unlawful in the Philippines will be the prevailing Central Bank buying rate for the purchase of U.S. dollars from commercial banks if it is no more than one-half of one percent below the reference rate of the Bankers' Association of the Philippines for the purchase of U.S. dollars on the business day preceding the date of conversion. In making this determination, A.I.D. takes into consideration current applicable laws and regulations and prevailing practices in the Philippines. These include the fact that the BAP reference rate is currently based on a weighted average of unrestricted foreign exchange transactions on the BAP trading floor and the fact that spot rates offered by commercial banks do not generally reflect the market clearing rate for foreign exchange transactions of the magnitude of any of the planned SDP dollar disbursements. This determination will be reviewed in connection with subsequent dollar tranches in the light of applicable laws and regulations and prevailing practices then in effect.

Funds deposited in the SDP Peso Special Account will not be commingled with funds from any other source. The SDP Peso Special Account will include and will be credited with any interest in respect of funds held in this Account, any GOP refunds for unacceptable peso transactions and any refunds made by A.I.D. of amounts determined to be excess of Mission local currency operating expense requirements and SDP monitoring and evaluation services funding requirements. The Account will be used in accordance with the implementation plan for SDP or for such other purposes as A.I.D. may agree to in writing.

b. Disbursements to A.I.D.

Within six business days of the transfer of pesos into the SDP Peso Special Account corresponding to the first and third tranche dollar disbursements by A.I.D., the GOP will deposit the peso equivalent of $4 million and $10 million respectively into a designated bank account of the U.S. Disbursing Office for the Mission operations. In determining the amount of pesos that will be disbursed to A.I.D., the GOP will use the exchange rate used in connection with the deposit of pesos to the SDP Peso Special Account corresponding to the A.I.D. disbursed dollars. Unless otherwise agreed to, A.I.D. will refund to the SDP Peso Special Account on any day on or before March 31, 1992 funds in excess of those reported by A.I.D. to have been expended for Mission local currency requirements for calendar years 1989-1991.

Within six business days of the transfer of pesos into the SDP Peso Special Account corresponding to the first tranche dollar disbursement, the GOP will deposit the peso equivalent of $3 million into the designated U.S. Disbursing Office bank account. A.I.D. will use these pesos for acquiring SDP monitoring and evaluation services. If any costs require non-local currency payment, A.I.D. will make arrangements to obtain such currency and charge an equivalent amount to the pesos disbursed to A.I.D. using an exchange rate obtained under those arrangements. A.I.D. will refund to the Peso Special Account any amount including any interest earned agreed upon at any time to be in excess of funds required for acquisition and payment of the monitoring and evaluation services.

c. Transfers to the GOP General Fund

The GOP will be required to furnish A.I.D. quarterly reports of disbursements for costs incurred in the agreed upon budget categories. The report of disbursements in the quarter ended March 31, 1989 will be submitted to A.I.D. in connection with the disbursement of the first tranche of dollars by A.I.D. Subsequent reports will be due by the end of the following quarter. Disbursement reports may be amended from time to time at any time prior to the end of the quarter.

Any amount of pesos that will be transferred from the Special Account to the General Fund will be equal to the amount for the same GOP Budget Year by which the sum of the amount of pesos that the GOP and A.I.D. mutually agree is reasonably anticipated to be disbursed during the two fiscal quarters following the reported period and the amount of cumulative reported budget disbursements, exceeds the amount of previous cumulative transfers from the SDP Peso Special Account.

The GOP will make the initial transfer of pesos within two business days but not earlier than the later of the dates of GOP disbursements of pesos to A.I.D. for Mission local currency operating expense requirements and for monitoring and evaluation services corresponding to the first tranche dollar disbursement. For succeeding transfers, the GOP will transfer to the extent available the amount calculated from the above procedure from the SDP Peso Special Account to the General Fund within five business days of receipt of A.I.D. notification that the GOP disbursement report is in form and substance satisfactory to A.I.D.

The transfer of pesos from the SDP Peso Special Account to the General Fund Account will continue in the foregoing manner until all pesos in the SDP Peso Special Account have been transferred. However, the initial transfer of pesos corresponding to the third tranche disbursement will be made not earlier than the date of GOP disbursement to A.I.D. for Mission local currency operating expense requirements. In the case of any refund or deposit in connection with disbursements to A.I.D. or due to unacceptable transactions after December 31, 1990, the GOP will transfer to the General Fund any funds held in the SDP Peso Special Account within 90 days of any deposit. The GOP may make the transfers in accordance with agreements with A.I.D. on the eligible budget categories based on the GOP's current budget year against which costs incurred or to be incurred will be reported.

If at the time of any transfer of pesos from the Peso Special Account, the required transfer equals or exceeds the amount then held in the Account, including accrued interest, the GOP will credit the Peso Special Account with accrued interest at that time.

3. Monitoring, Reporting, and Evaluation

a. GOP Quarterly Disbursement Reports

The implementation of SDP will be monitored through GOP quarterly reports, which may be amended and which will be due by the end of the following quarter, and will contain at least the following information:

(1) SDP Dollar Special Account - Each disbursement from the SDP Dollar Special Account with a specification for each disbursement of the payee and the amount and date of payment, together with a certification that the GOP has obtained and is maintaining documentation for each disbursement.

(2) SDP Peso Special Account (Budget Support) - Cumulative actual disbursements by specific budget category through the end of the period reported upon for costs incurred in the GOP's budget year for the period on or after January 1, 1989 in the case of the 1989 Budget Year and on or after January 1, 1990 in the case of the 1990 Budget Year in the agreed upon budget categories.

b. Audited Disbursement Reports

The GOP will provide first semester (for each year) and annual reports of disbursements audited by the Commission on Audit (COA) beginning with the period commencing January 1, 1989 on (i) the use of dollars disbursed from the SDP Dollar Special Account and (ii) use of the pesos for budget support disbursements for costs incurred in the GOP's 1989 Budget Year in the

1989 eligible budget categories and in the 1990 Budget Year in the 1990 eligible budget categories. The report for the first semester of each year will be due by year end and the annual report for each year will be due by September 30 of the following year. The GOP will also furnish accompanying certifications (i) for all reports that all funds disbursed from the SDP Dollar Special Account and from the SDP Peso Special Account for budget support have been used in accordance with the terms of the SDP Grant Agreement; (ii) for all reports, the appropriate COA representative's certification required under the COA Memorandum that will be provided for purposes of preparing the SDP audited disbursement reports; and (iii) for each of the annual audited peso disbursement reports, that an amount at least equal to the amount of pesos transferred from the SDP Peso Special Account to the General Fund has not been reported against other external assistance available to the GOP for disbursements for such costs during the Budget Year reported upon.

c. Other Financial Reports

In the event of any transfer of funds from the SDP Peso Special Account to the General Fund due to refunds for unacceptable transactions or refunds by A.I.D., the GOP will submit the appropriate audited disbursement reports and certifications on disbursements for costs incurred in the agreed upon budget categories not later than the end of the semester following the semester in which the transfer is made. The GOP will prepare the reports in accordance with the COA Memorandum for SDP.

d. Reform Performance Reports

The GOP will submit a report on the performance indicators for the second tranche and a report on the performance indicators for the third tranche when it considers the performance indicators to have been satisfied and at least a month in advance of the desired disbursement dates. The reports will form the basis for joint consultations on performance. If necessary, the GOP and A.I.D. will exchange additional information regarding the satisfaction of the performance indicators.

e. Third Party Financial and Reform Performance Monitoring

A.I.D. will arrange for third party financial and reform performance monitoring of SDP. Financial monitoring will provide a professional opinion regarding disbursements in the eligible budget categories. Financial monitoring services will also include provision of professional opinions for nine previous budget support program agreements on whether or not the minimum amount of pesos required by each separate agreement were disbursed on eligible budget categories within the appropriate time period. Expatriate and local contractor services will be obtained with expertise in accounting, statistical surveys, and financial systems management. Preferably, any expatriate contractor should have relevant Asian country experience.

Reform performance monitoring will obtain detailed periodic information on GOP reform actions, relevant economic causative and impact variables, and developments in the environment that could directly or indirectly affect GOP reform performance. A team of expatriate and local contractors will be used with expertise in economic stabilization and structural adjustment, economics, operations research, statistics, and computer programming.

f. Evaluation Arrangements

Expatriate and local services, different from those used for financial or reform monitoring, will be used for SDP evaluation. The evaluation will cover appropriateness of program design, review of implementation and attainment of SDP objectives, quantitative and qualitative assessment of their impacts on the economy, implementation process and financial reporting evaluation. Expatriate and local services will be utilized with expertise in economic stabilization and structural adjustment, economics, statistics, operations research, accounting, financial management, and computer programming. Evaluation activities will carried out in the first half of 1991.

B. <u>Implementing Entities</u>

1. Department of Finance

The Department of Finance (DOF) will be the lead implementing agency for SDP. It will be responsible for timely and satisfactory implementation of SDP activities including monitoring and reporting requirements. DOF will also be responsible, in coordination with the Central Bank of the Philippines (CB), Bureau of Treasury (BTr), Commission on Audit (COA), and other involved entities for the preparation and submission to A.I.D. of implementation plans for the disbursement of dollars from the SDP Dollar Special Account, prior to such disbursement. In addition to the DOF, at least eight other GOP entities will be involved directly in implementing SDP.

2. National Economic and Development Authority

Together with DOF, the National Economic and Development Authority (NEDA), through its Public Investment and National Planning and Policy Staffs, will represent the GOP in dealing with A.I.D. in regard to SDP. It will also coordinate with DOF, BTr, CB, the Department of Budget and Management (DBM), and other entities, as necessary, in preparing the reform performance reports and conducting joint reviews with A.I.D. on the satisfaction of performance indicators described or similar to those described in Section V.F. NEDA will also have primary responsibility for meeting and monitoring the GOP's commitments to provide local currency for Mission operations.

3. Central Bank of the Philippines

The Central Bank (CB), through its Treasury, the Management of External Debt Department and the Department of Economic Research, will:

a. With the agreement of A.I.D. and in coordination with the BTr, establish a separate account or accounts with the designated bank or banks into which dollars disbursed by A.I.D. will be deposited (i.e. the SDP Dollar Special Account).

b. In coordination with BTr, prepare and submit to A.I.D., prior to dollar disbursements, statements of names, branches and U.S. Federal Reserve Bank branch numbers of the bank or banks with which the dollars disbursed will be deposited, together with statements of amounts of dollars to be deposited in separate accounts with those banks.

c. Upon the advice of BTr, establish a separate account or accounts to be called the SDP Peso Special Account, into which the peso equivalent of the dollars disbursed by A.I.D. will be deposited.

d. Deposit the peso proceeds of the A.I.D. dollar disbursement equivalent to the SDP dollar disbursements in the Peso Special Account.

e. Disburse dollars from the SDP Dollar Special Account to be paid directly to the specified creditors.

f. Prepare and submit to A.I.D., evidence that the agreed upon payments have been made from the Dollar Special Account, prior to disbursement by A.I.D. of the second and third tranche of dollars.

g. Prepare or obtain and submit to A.I.D. the required quarterly dollar disbursement reports and the final COA-audited cumulative dollar disbursement reports , together with the required certifications related to those reports.

h. Coordinate with NEDA and DOF, in obtaining and providing inputs to the reform performance reports.

4. Department of Budget and Management

The Department of Budget and Management (DBM), through its Budget Planning Bureau and National Government Accounting and Finance Bureau will:

a. With the agreement of A.I.D. and in conjunction with BTr, DOF and COA, determine the budget categories eligible for the budget support component of SDP and the total amount to be disbursed.

b. Prepare and submit to A.I.D., in conjunction with BTr, DOF, CB and COA, an implementation plan specifying the responsibilities and interrelationships of the entities involved in the implementation of the budget support component.

c. In coordination with BTr, prepare and submit to A.I.D. statements of estimated costs incurred and estimated costs to be incurred for the GOP's 1989 and 1990 Budget Years for the budget categories for which disbursements will be reported against.

d. Prepare or obtain and submit to A.I.D. quarterly reports and the final audited reports on peso disbursements against the priority budget categories, together with the required certifications related to those reports.

5. Bureau of Treasury

The Bureau of Treasury (BTr) will:

a. Provide to DOF and CB required information on official debt obligations to be paid.

b. Disburse pesos from the Special Account in accordance with the SDP Agreement.

c. Provide information, as necessary, to DBM and CB for the required financial reports.

d. Provide instructions to the Central Bank to credit the SDP Peso Special Account with any interest earned therein at the appropriate time.

6. Commission on Audit

a. The Commission on Audit (COA) will audit regularly all the books and records relating to SDP.

b. Ensure DBM submission of the audited financial reports to A.I.D. on their due dates and availability and maintenance of supporting disbursing unit report files.

c. Cooperate with the financial monitoring contractors in providing information necessary to carry out the scopes of work for monitoring and evaluation services.

7. Other GOP Departments

The Department of Education, Culture and Sports (DECS), the Department of Health (DOH), and the Commission on Population (POPCOM) will provide DBM the necessary information for the timely submission of acceptable peso disbursements reports for costs incurred in eligible budget categories in their respective budgets for the GOP Budget Years 1989 and 1990 and any other Budget Year with transfers from the SDP Peso Special Account to the General Fund for agreed upon budget categories included in their respective department budgets. These departments and the Department of Agriculture also will be expected to cooperate with the financial monitoring contractors in providing information necessary for the scopes of work for monitoring and evaluation services.

IX. CONDITIONS AND COVENANTS

The following are the conditions and covenants proposed for SDP:

A. Conditions Precedent to Dollar Disbursement

1. First Tranche Disbursement

Prior to A.I.D. disbursement of the first tranche of dollars, the GOP will, except as A.I.D. may otherwise agree in writing, furnish to A.I.D., in form and substance satisfactory to A.I.D.:

(a) the Department of Justice opinion that the Grant Agreement has been authorized in behalf of the GOP and constitutes a valid and binding GOP obligation;

(b) signature certification of authorized GOP representatives and designation of additional representatives;

(c) the name(s), branch(es) and U.S. Federal Reserve Bank branch number(s) of depository banks for the first dollar disbursement and the amount of dollars to be deposited therein;

(d) the Dollar implementation plan;

(e) the Peso implementation plan; and

(f) A copy of the Commission on Audit (COA) Memorandum setting forth guidelines for the preparation and submission of the audited reports for A.I.D. budget support activities.

In addition, prior to A.I.D. disbursement of the first tranche:

(a) the GOP and A.I.D. should have completed consultations on the use of SDP pesos for Mission operations; and

(b) the GOP and A.I.D. should have agreed on the scopes of work for SDP monitoring and evaluation services.

2. Second Tranche Disbursement

Except as A.I.D. may otherwise agree in writing, prior to A.I.D. disbursement of the second tranche of dollars, the GOP should not be in default with respect to the appropriate terms and conditions of the SDP Agreement, including reporting requirements. In addition, the GOP will furnish to A.I.D., in form and substance satisfactory to A.I.D.:

(a) a report on completion of all reform performance indicators required for the second tranche disbursement;

(b) evidence that the SDP Dollar Special Account payments have been made in accordance with the submitted Dollar Implementation Plan or amendments thereto;

(c) the name(s), branch(es) and U.S. Federal Reserve Bank branch number(s) of depository banks for the second dollar disbursement and the amount of dollars to be deposited therein;

(d) a supplement to the previously submitted dollar implementation plan specifying a schedule of 1990 payments; and

(e) a supplement to the previously submitted peso implementation plan specifying the eligible budget categories and programs based on the GOP's 1990 General Appropriations Act.

3. Third Tranche Disbursement

Except as A.I.D. may otherwise agree in writing, prior to A.I.D. disbursement of the third tranche of dollars, the GOP should not be in default with respect to the appropriate terms and conditions of the SDP Agreement, including reporting requirements. In addition, the GOP will furnish to A.I.D., in form and substance satisfactory to A.I.D.:

(a) a report on completion of all reform performance indicators required for the third tranche disbursement;

(b) evidence that the SDP Dollar Special Account payments have been made in accordance with the submitted Dollar Implementation Plan or amendments thereto;

(c) the name(s), branch(es) and U.S. Federal Reserve Bank branch number(s) of depository banks for the third dollar disbursement and the amount of dollars to be deposited therein; and

(d) a supplement to the previously submitted dollar implementation plan specifying a schedule of 1990 payments identifying payees, amounts and due dates, including dollars to be deposited with the SDP Dollar Special Account.

In addition:

(a) the GOP and A.I.D. should have completed consultations on the use of SDP pesos for Mission operations; and

(b) the GOP should have satisfied the reform performance requirements of the second tranche.

B. Terminal Dates for Conditions Precedent to A.I.D. Dollar Disbursements

The terminal dates for the above conditions precedent are August 3, 1989 for the first tranche; March 31, 1990 for the second tranche; and September 30, 1990 for the third tranche. A.I.D. may agree in writing to later dates in each case or terminate the agreement by written notice to the GOP.

C. Other Special Covenants

Except as A.I.D. may otherwise agree in writing, the GOP should agree that:

(a) eligible budget disbursements during 1989 should be at least 125 percent of transfers from the SDP Peso Special Account for budget support for the same year;

(b) eligible budget disbursements during 1990 should be at least 125 percent of transfers from the SDP Peso Special Account for budget support for the same year;

(c) Disbursements in eligible budget categories for the GOP's current budget year should be at least 125 percent of transfers from the SDP Peso Special Account for budget support for that year, in the case of any such transfers made after 1990.

ANNEX A

REQUEST FOR ASSISTANCE

The Memorandum of Understanding on ESF Allocation between the United States and the Philippines dated May 15, 1989 serves as the request of the Government of the Philippines for the Support for Development Program.

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ANNEX B

ACTION: AID-6 INFO: AMB DCM AA ECON/10 SF

S DSGOYS NVVZCZCML0025
OO RUEHML
DE RUEHC #9150 1240001
ZNR UUUUU ZZH
O 040000Z MAY 89
FM SECSTATE WASHDC
TO AMEMBASSY MANILA IMMEDIATE 2973
BT
UNCLAS STATE 139150

04-MAY-89 TOR: 00:00
CN: 45271
CHRG: AID
DIST: AID
ADD: SF

IMMEDIATE TELEGRAM
ACTION TAKEN
5-4-89 9:00 a.m.
DATE | HOURS | MIN.

AIDAC

E.O. 12356: N/A
TAGS:
SUBJECT: SUPPORT FOR DEVELOPMENT PROGRAM (492-0430) - PAAD DEVELOPMENT AND AUTHORIZATION

REF: MANILA 11390

1. BASED ON PRC REVIEW OF REFTEL CHAIRED BY ANE/PD DIRECTOR VENEZIA ON 4/14/89, AA/ANE ADELMAN APPROVES MISSION'S REQUEST TO DEVELOP SUBJECT PAAD AND AUTHORIZES THE DIRECTOR, USAID MANILA, TO APPROVE THE PAAD FOR DOLS 218 MILLION. HOWEVER, REQUEST MISSION KEEP US CLOSELY INFORMED OF POLICY AND ADMINISTRATIVE REFORM AGENDA AND BENCHMARKS UNDER CURRENT NEGOTIATION AS WE WISH TO REVIEW AGENDA AND BENCHMARKS PRIOR TO AGREEMENT AUTHORIZATION. ALSO, PRIOR TO RELEASE OF SECOND AND THIRD TRANCHES, WE WOULD LIKE TO HAVE JOINT USAID/GOP REVIEWS OF PERFORMANCE BASED ON THE BENCHMARKS ESTABLISHED PRIOR TO THE SIGNING.

ONE SIGNIFICANT ISSUE AROSE DURING THE PRC -- THAT OF HIGHLIGHTING AND EMPHASIZING THOSE ELEMENTS OF THE GOP POLICY AGENDA RELEVANT TO INCREASED PRIVATE SECTOR PARTICIPATION IN THE ECONOMIC DEVELOPMENT OF THE PHILIPPINES AS WELL AS IDENTIFYING AND INCORPORATING OTHER POLICY REFORMS CRITICAL TO AN ENHANCED ROLE FOR THE PRIVATE SECTOR WHICH MIGHT NOT BE PART OF THE CURRENT GOP AGENDA. THE MISSION IS REQUESTED TO ADDRESS THIS ISSUE AS WELL AS OTHER BUREAU CONCERNS OUTLINED BELOW AS YOU DEVELOP THE PAAD.

DIV	ACT	INF
OD	✓	✓
PE	✓	
RLA		✓
PRO		
TD		
EO		
PER		
CSD		
LOG		
DMD		
GSO		
TRV		
CS/R		✓
CO		✓
OCD		✓
ORAD		
OPHN		
OFFPVC		
RIG/A		
RIG/II		
AR		
DUE DATE		

2. CONDITIONALITY LINKED TO IMPROVED ENVIRONMENT FOR PRIVATE SECTOR. PRC RECOGNIZED THAT MISSION'S POLICY DIALOGUE AGENDA (INCLUDING CONDITIONALITY) IS UNDER NEGOTIATION ALTHOUGH FOCUS WILL REMAIN ON MEETING STRUCTURAL AND ADMINISTRATIVE REFORM BENCHMARKS. BUREAU BELIEVES TIME IS RIPE TO EMPHASIZE THOSE POLICY/ADMINISTRATIVE REFORMS THAT ARE MOST RELEVANT TO A STRENGTHENED AND MORE EFFECTIVE PRIVATE SECTOR CONTRIBUTION TO GROWTH. WE LEAVE TO YOUR JUDGEMENT THOSE ELEMENTS THAT WOULD BE MOST IMPORTANT IN THIS REGARD AND THAT CAN BE ADDRESSED WITHIN CONTEXT OF THIS PROGRAM.

qv

ANNEX C

Th. .teria listed in Part A are applicable ge: ily to FAA funds, and should be used ir: ective of the program's funding source. In : t B a distinction is made between the crit ria applicable to Economic Support Fund assistance and the criteria applicable to Development Assistance. Selection of the criteria will depend on the funding source for the program.

CROSS REFERENCES:	IS COUNTRY CHECKLIST UP TO DATE?	Yes.
	HAS STANDARD ITEM CHECKLIST BEEN REVIEWED?	Yes.

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. FY 1989 Appropriations Act Sec. 523; FAA Sec. 634A. Describe how authorization and appropriations committees of Senate and House have been or will be notified concerning the project.	A Congressional Notification was submitted to Congress on 5/23/89 which fully descrit the nature and scope of SDP.
2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?	Further legislative action is not required.
3. FAA Sec. 209. Is assistance more efficiently and effectively provided thro..n regional or multilateral orga..zations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs.	No. The primary purpose of SDP is to provide direct bilateral balance of payments and budget support and to encourage implementation of selected policy reforms consistent with the Mission's strategy statement.

4. FAA Sec. 601(a). Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.	SDP will provide financial stability to and encourage the GOP to continue its identified policy actions for creating conditions which promote broad based, employment oriented and private sector led development and effective public projects. This in turn will encourage (a), (b), (d) and (e).
5. FAA Sec. 601(b). Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).	The dollar support and encouragement of policy actions will encourage financial and economic stability and more favorable private sector climate. The improved business environment will encourage U.S. trade with and investment in the Philippines.
6. FAA Secs. 612(b), 636(h); FY 1989 Appropriations Act Secs. 507, 509. Describe steps taken to assure that, to the maximum extent possible, foreign currencies owned by the U.S. are utilized in lieu of dollars to meet the cost of contractual and other services.	N/A.
7. FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?	No.
8. FAA Sec. 601(e). Will the assistance utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?	Yes. Up to $3 million of the local currency proceeds will be used for accounting and monitoring services. Procurement of these services will be in accordance with applicable USG and A.I.D. financial management regulations and procedures.
9. FAA Sec. 121(d). If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds?	N/A.
10. FY 1989 Appropriations Act. Will assistance be designed so that the percentage of women participants will be demonstrably increased?	No. However, local currency proceeds will be used for budget support for delivery of basic services, for which generally a greater percentage of the beneficiaries are women

Gul

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Fund

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA?

Yes.

b. FAA Sec. 531(e). Will assistance under this chapter be used for military or paramilitary activities?

No.

c. FAA Sec. 531(d). Will ESF funds made available for commodity import programs or other program assistance be used to generate local currencies? If so, will at least 50 percent of such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106?

Yes.

Yes.

d. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made?

N/A.

e. FY 1989 Appropriations Act. If assistance is in the form of a cash transfer: (a) are all such cash payments to be maintained by the country in a separate account and not to be commingled with any other funds? (b) will all local currences that may be generated with funds provided as a cash transfer to such a country also be deposited in a special account to be used in accordance with FAA Section 609 (which requires such local currencies to be made available to the U.S. government as the U.S. determines necessary for the requirements of the U.S. Government, and which requires the remainder to be used for programs agreed to by the U.S. Government to carry out the purposes for which new funds authorized by the FAA

(a) Yes.

(b) Yes. First priority use o the local currency proceeds of up to $14 million in local currency will be for A.I.D. Missio operations. Second priority use of up to $3 million in local currency equivalent will be for program accounting and monitoring requirements. Third priority of at leas $201 million will be used to provide budget support in mutually agreed upon budget categories.

would themselves be available)? (c) Has Congress received prior notification providing in detail how the funds will be used, including the U.S. interests that will be served by the assistance, and, as appropriate, the economic policy reforms that will be promoted by the cash transfer assistance?

(c) Yes.

2. <u>Nonproject Criteria for Development Assistance</u>

N/A.

a. <u>FAA Secs. 102(a), 111, 113, 281(a)</u>. Extent to which activity will (a) effectively involve the poor in development, by expanding access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (b) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries?

Gb

5C(3) - STANDARD ITEM CHECKLIST

Listed below are the statutory items which normally will be covered routinely in those provisions of an assistance agreement dealing with its implementation, or covered in the agreement by imposing limits on certain uses of funds.

These items are arranged under the general headings of (A) Procurement, (B) Construction, and (C) Other Restrictions.

A. PROCUREMENT

1. FAA Sec. 602(a). Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed?

   If it is determined that expatriate services are needed for program accounting and monitoring services, such arrangements will be considered

2. FAA Sec. 604(a). Will all procurement be from the U.S. except as otherwise determined by the President or determined under delegation from him?

   Procurement of accounting and monitoring services using local currency proceeds will be from U.S. and the host country

3. FAA Sec. 604(d). If the cooperating country discriminates against marine insurance companies authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company?

   N/A.

4. FAA Sec. 604(e); ISDCA of 1980 Sec. 705(a). If non-U.S. procurement of agricultural commodity or product thereof is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity? (Exception where commodity financed could not reasonably be procured in U.S.)

   N/A.

91

5. FAA Sec. 604(g). Will construction or engineering services be procured from firms of advanced developing countries which are otherwise eligible under Code 941 and which have attained a competitive capability in international markets in one of these areas? (Exception for those countries which receive direct economic assistance under the FAA and permit United States firms to compete for construction or engineering services financed from assistance programs of these countries.) N/A.

6. FAA Sec. 603. Is the shipping excluded from compliance with the requirement in section 901(b) of the Merchant Marine Act of 1936, as amended, that at least 50 percent of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent such vessels are available at fair and reasonable rates? N/A.

7. FAA Sec. 621(a). If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? Yes. Will the facilities and resources of other Federal agencies be utilized, when they are particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs? Yes.

8. International Air Transportation Fair Competitive Practices Act, 1974. If air transportation of persons or property is financed on grant basis, will U.S. carriers be used to the extent such service is available? Yes.

9. FY 1989 Appropriations Act Sec. 504. If the U.S. Government is a party to a contract for procurement, does the contract contain a provision authorizing termination of such contract for the convenience of the United States? Yes.

10. FY 1989 Appropriations Act Sec. 524. If assistance is for consulting service through procurement contract pursuant to 5 U.S.C. 3109, are contract expenditures a matter of public record and available for public inspection (unless otherwise provided by law or Executive order)? — Yes.

B. CONSTRUCTION

1. FAA Sec. 601(d). If capital (e.g., construction) project, will U.S. engineering and professional services be used? — N/A.

2. FAA Sec. 611(c). If contracts for construction are to be financed, will they be let on a competitive basis to maximum extent practicable? — N/A.

3. FAA Sec. 620(k). If for construction of productive enterprise, will aggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprises in Egypt that were described in the CP), or does assistance have the express approval of Congress? — N/A.

C. OTHER RESTRICTIONS

1. FAA Sec. 122(b). If development loan repayable in dollars, is interest rate at least 2 percent per annum during a grace period which is not to exceed ten years, and at least 3 percent per annum thereafter? — N/A.

2. FAA Sec. 301(d). If fund is established solely by U.S. contributions and administered by an international organization, does Comptroller General have audit rights? — N/A.

3. FAA Sec. 620(h). Do arrangements exist to insure that United States foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the Communist-bloc countries? — Yes.

4. Will arrangements preclude use of financing:

   a. FAA Sec. 104(f); FY 1989 Appropriations Act Secs. 525, 536. (1) To pay for performance of abortions as a method of family planning or to motivate or coerce persons to practice abortions; (2) to pay for performance of involuntary sterilization as method of family planning, or to coerce or provide financial incentive to any person to undergo sterilization; (3) to pay for any biomedical research which relates, in whole or part, to methods or the performance of abortions or involuntary sterilizations as a means of family planning; or (4) to lobby for abortion? — Yes.

   b. FAA Sec. 483. To make reimbursements, in the form of cash payments, to persons whose illicit drug crops are eradicated? — Yes.

   c. FAA Sec. 620(g). To compensate owners for expropriated or nationalized property, except to compensate foreign nationals in accordance with a land reform program certified by the President? — Yes.

   d. FAA Sec. 660. To provide training, advice, or any financial support for police, prisons, or other law enforcement forces, except for narcotics programs? — Yes.

   e. FAA Sec. 662. For CIA activities? — Yes.

f. FAA Sec. 636(i). For purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicles manufactured outside U.S., unless a waiver is obtained? — Yes.

g. FY 1989 Appropriations Act Sec. 503. To pay pensions, annuities, retirement pay, or adjusted service compensation for prior or current military personnel? — Yes.

h. FY 1989 Appropriations Act Sec. 505. To pay U.N. assessments, arrearages or dues? — Yes.

i. FY 1989 Appropriations Act Sec. 506. To carry out provisions of FAA section 209(d) (transfer of FAA funds to multilateral organizations for lending)? — Yes.

j. FY 1989 Appropriations Act Sec. 510. To finance the export of nuclear equipment, fuel, or technology? — Yes.

k. FY 1989 Appropriations Act Sec. 511. For the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights? — Yes.

l. FY 1989 Appropriations Act Sec. 516; State Authorization Sec. 109. To be used for publicity or propaganda purposes designed to support or defeat legislation pending before Congress, to influence in any way the outcome of a political election in the United States, or for any publicity or propaganda purposes not authorized by Congress? — Yes.

5. FY 1989 Appropriations Act Sec. 584. Will any A.I.D. contract and solicitation, and subcontract entered into under such contract, include a clause requiring that U.S. marine insurance companies have a fair opportunity to bid for marine insurance when such insurance is necessary or appropriate? — N/A.

101

ANNEX D

CERTIFICATION PURSUANT TO UTILIZATION OR GRAY AMENDMENT ORGANIZATION

I, Malcolm Butler, principal officer of the Agency for International Development in the Philippines, have fully considered the potential involvement of small and/or economically and socially disadvantaged enterprises, and do hereby certify that U.S. technical assistance required for program monitoring and evaluation will be provided through open competition, with special consideration given to firms submitting proposals which utilize the resources of small and/or disadvantaged firms. My judgment is based on the recommendations of the Program and Mission Review Committees.

Malcolm Butler

MALCOLM BUTLER
Director
USAID/Philippines

7/31/89
Date