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Final Report

Evaluation of the Philippines Support for Development Program II

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Contents

Executive Summary	1
1. Introduction	7
Report Objectives	7
Background	7
Description of SDP II	7
2. The Economy and its Problems in 1991	9
Background	9
Economic Situation in 1991	9
Structural Issues Closely Related to Export Competitiveness	11
Exchange Rate Realism, Productivity, and Labor Cost	11
Legal Framework Governing Foreign Investment	13
Trade Protectionism	14
Conclusions	16
3. Implementation of SDP II	17
Design	17
Foreign Exchange Liberalization	17
Accelerating Value-Added Tax and Duty Drawbacks to Exporters	19
Improving Small-Savers' Access to Government Debt Instruments	20
Implementation	21
Foreign Exchange Liberalization	21
More Efficient Processing of Tax and Duty Refunds by the One-Stop Shop	24
Reducing Debt Servicing Costs by Mobilizing Small Savers	26
Technical Assistance	27
Foreign Exchange Market Management	28
Streamlining of Tax and Duty Refunds	28
Establishment of Small Savers Instrument	28
Improvement of Management Information Systems	29
Related Projects	29
A.I.D. Private Enterprise Policy Support Program	29
World Bank Economic Integration Loan	30
IMF Extended Fund Agreement	31
4. Economic and Policy Impact	33
Impact of Policy Conditionality	33
Foreign Exchange Liberalization	33
Improving the Return to Exporters by Accelerating Refunds	37
Reducing Debt Servicing Costs and the Small Savers Instruments	38
Simulation of the Benefits of the SDP II Program	38

Contents (*continued*)

Accelerating Duty Drawback and VAT Refunds	39
Increased Capital Inflows	39
Appreciation of the Peso	40
Overall Impact	40
A Cost-Benefit Analysis	41
5. The Economy in 1995 versus 1991	43
State of the Economy	43
Structural Issues Related to Export Competitiveness	44
Realism of the Exchange Rate	44
The Trend in Labor Costs	45
Foreign and Private Investment Policy	46
Protectionism	47
Overall Behavior of Exports and Sectoral Trends	49
Electrical and Electronics Industry	50
Computer Software	52
Garments	52
Future of the Enclave Industries	53
Resource-Based Exports	54
Tourism: Invisible Earnings	55
Conclusion	56
6. Lessons Learned and Recommendations for Future Action	57
Lessons Learned	57
Recommendations	58
Rationale	58
Institutional Recommendation	59
Project Recommendations	59
Conclusion	61
Appendix A. Scope of Work	
Appendix B. Persons Interviewed	
Appendix C. Documents Consulted	
Appendix D. Philippine Investment Incentive System	
Appendix E. Statistical Tables and Other Supporting Materials	
Appendix F. Trade Policy Reforms	
Appendix G. The Shift from the Home Consumption Value	
Appendix H. Some Notes on the Export Development Act	

Illustrations

TABLES

Table 2-1.	Selected Economic Macroeconomic Indicators, 1987–1991	10
Table 2-2.	Indices of REER and Labor Productivity	12
Table 2-3.	Hourly Wages in the Textile Industry, 1991	12
Table 2-4.	Changes in Effective Rates of Protection, 1985–1990	15
Table 3-1.	Number and Value of TCCs Issued by the OSS, May 1992–December 1994	24
Table 3-2.	Age of TCC Issuances for Non-VAT Claims, May 1992–December 1994	25
Table 3-3.	Status of Applications for VAT Credit, October 1, 1993, to August 31, 1994	26
Table 4-1.	Current Account	34
Table 4-2.	Selected Invisible Receipts and Capital Inflows, 1991–1994	35
Table 4-3.	Transactions in the Interbank Foreign Exchange Market, 1991–1994	36
Table 4-4.	Projected Annual Benefits	41
Table 5-1.	Selected Economic Indicators	43
Table 5-2.	Real Effective Exchange Rate of the Philippine Peso	45
Table 5-3.	Indices of Productivity and Wages in Philippine Manufacturing	46
Table 5-4.	Changes in Effective Rates of Protection, 1991–1994	48
Table 5-5.	Export Growth, 1990–1994	50
Table 5-6.	Exports of Major Philippine Commodities, 1990–1993	51
Table D-1a.	Percentage Share in Total Project Cost of BOI-Approved Projects, by Type of Producer	D-2
Table D-1b.	Percentage Share in Number of Firms Approved for BOI Registration, by Type of Producer	D-2
Table D-1c.	Capital/Labor Ratio of BOI-Approved Projects, by Type of Producer	D-3
Table D-2.	Percentage Share in Total BOI-Approved Project Cost, by Sector	D-4
Table D-3.	Percentage Share in Total BOI-Approved Project Cost in Manufacturing	D-4
Table D-4.	Percentage Share in Total Foreign Equity Investments of BOI-Approved Projects, by Type of Producer	D-5
Table E-1.	Breakdown for Imported, Domestic, and Value-Added Components and Price Reduction Coefficient of Exports	E-2
Table E-2.	Impact of Streamlining of Duty Drawback and VAT Systems	E-3
Table E-3.	Impact of Capital Inflows	E-4
Table E-4.	Impact of Peso Appreciation	E-5
Table E-5.	Overall Impact of SDP II	E-6
Table F-1.	Quantitative Restrictions on Imports in the Philippines	F-2
Table F-2.	Frequency Distribution of Tariff Rates	F-2
Table F-3.	Frequency Distribution of Tariff Rates (Executive Order 8)	F-4
Table F-4.	Tariffication Under Executive Order 8	F-4

EXHIBIT

Exhibit D-1.	Excerpt from PIDS-DIA Study on the Social Profitability of IPP Activities	D-5
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Glossary

AAB	Authorized Agent Bank
ADB	Asian Development Bank
A.I.D.	U. S. Agency for International Development
AO	administrative order
ASEAN	Association of Southeast Asian Nations
BAP	Bankers Association of the Philippines
BIR	Bureau of Internal Revenue
BOC	Bureau of Customs
BOI	Board of Investments, of the Department of Trade and Industry
BOP	balance of payments
BSP	Bangko Sentral ng Pilipinas, the Central Bank
BOT	build-operate-transfer
Btr	Bureau of the Treasury, Department of Finance
CPI	Consumer Price Index
CY	calendar year
DBM	Department of Budget and Management
DFI	direct foreign investment
DIA	development incentive assessment
DO	Department Order (Government of the Philippines)
DOF	Department of Finance
DRC/SER	domestic resource cost as a ratio to shadow exchange rate
DTI	Department of Trade and Industry
EDA	Export Development Act of 1994
EDSA	Epifanio de los Santos Avenue (where the People's Revolution took place in 1986)
EIL	economic integration loan (World Bank)
EO	Executive Order (Government of the Philippines)
ERP	effective rate of protection
ESF	Economic Support Fund
FCCI	Foreign Chamber of Commerce and Industry
FCDU	Foreign Currency Deposit Unit
FIA	Foreign Investment Act of 1991
FY	fiscal year
GDP	gross domestic product
GNP	gross national product
GOP	Government of the Philippines
GTEB	Garment and Textile Export Board
HCV	home consumption value
IACSSI	Interagency Committee on the Small Savers Instrument
IBRD	International Bank for Reconstruction and Development (World Bank)

Glossary (*continued*)

IMF	International Monetary Fund
IPP	Investment Priority Plan
IRR	internal rate of return
ITV	invoice transaction value
MFA	Multi-Fiber Agreement, a quota system on textiles and garments trade
NEDA	National Economic and Development Authority
OIC	Omnibus Investment Code
OPSF	Oil Price Stabilization Fund
OSS	One-Stop Shop (Interagency Tax Credit and Drawback Center)
PDS	Philippine Dealer System (Bankers Association of the Philippines)
PEPS	Private Enterprise Policy Support Program (A.I.D.)
Philexport	Confederation of Philippine Exporters
PIDS	Philippine Institute of Development Studies
PITO	Private Investment and Trade Opportunities Project (A.I.D.)
QR	quantitative restriction (or quotas) on imports
RAMO	Revenue Administration Memorandum Order
REER	real effective exchange rate
SAL	structural adjustment loan
SDP	Support for Development Program (with Stages I and II)
SGS	Société Générale Suisse
SOW	scope of work
SRRS	Shipping Rate Rationalization Study
SSI	small savers instrument
TA	technical assistance
TCC	tax credit certificate (Bureau of Internal Revenue)
TSC	Technical Support Component of SDP II
TV	transactions value (as a basis for tariff assessment)
USAID	A.I.D. Mission
USG	U.S. Government
VAT	value-added tax
WTO	World Trade Organization (successor to the General Agreement on Tariffs and Trade)

Preface

This report was prepared for USAID/Manila under the Macroeconomics and International Trade IQC Contract No. AEP-5451-I-00-2058-00, Delivery Order 18. The project team consisted of Mr. Edgar Gordon, team leader; Mr. Edward Chesky, international trade specialist; Dr. David Redding, macroeconomist; Dr. Ponciano Intal, macroeconomist; Dr. Rosario Manasan, public finance specialist; Dr. Erlinda Medalla, international trade specialist; and Dr. Celia Reyes, econometrician. This is a second draft of the report submitted to USAID on March 21, 1995.

This is the final evaluation of the Support for Development Program II (SDP II). Two monitoring and assessment reports were made in September 1992 and August 1993 covering the implementation of policy conditions attached to Tranches 2 and 3 of the program.

The project team would like to thank Mr. Kenneth Schofield, the Mission Director; Dr. Jim Mudge, Chief of the Office of Program Economics; and especially the Mission's SDP II project managers, office deputy Mr. John Chang and Ms. Maria Luisa Panilio, for their help in providing advice and background material. Special thanks also to Ms. Corazon R. Reyes and Ms. Maria Cyril Felix, who ably assist Mr. Chang.

Among our many contacts with Philippine officials, we would like to single out Department of Finance Undersecretary Romco Bernardo, GOP coordinator of SDP II; Mr. Amando Tetangco, Managing Director of the Research Division of the BSP; his deputy, Ms. Wilhelmina Manalac, who with her staff was extremely helpful in providing data; and Ms. Ofelia Templo of the National Economic and Development Authority.

Executive Summary

This report is the final evaluation of the Support for Development Program II (SDP II), a policy-conditioned grant to the Government of the Philippines authorized in 1991. Although the government has fully complied with all program conditions, the overall goal of the program, which was to make Philippine exports more competitive, has not been met because of an unanticipated appreciation of the peso-dollar exchange rate. To a large extent the appreciation of the peso was one result of the foreign exchange liberalization component, which led to an increase in foreign exchange inflows from invisible receipts and capital inflows that substantially exceeded the increase of the trade deficit as growth resumed from 1992 to 1994. However, this appreciation and the loss of competitiveness can be considered short-term phenomena. Over time, if the economy maintains a growth rate of 5 to 6 percent or higher, the forces of supply and demand in the now well established flexible exchange rate market should cause the peso to depreciate because

- The overvalued exchange rate is artificially stimulating imports,
- Most of the recent increase of invisible and factor receipts is a one-time shift from the black market, and
- Overall capital inflow is already at very high levels.

By having an exchange rate mechanism that is more sensitive to market forces than in the past, the ultimate policy goal of loosening the balance-of-payments constraint on growth will be accomplished.

Traditionally, the Philippines was a commodity exporter that created an industrial sector through import substitution in the 1950s and 1960s. In the early 1970s, a second industrial sector emerged, consisting mainly of electronics and garments firms and operating largely from export enclaves. By the 1980s, the Philippines had suffered repeated balance-of-payments crises. By the time the Aquino administration took power in 1986, the country was technically bankrupt and the economy was severely distorted by structural and policy problems.

The Aquino administration undertook to reform and at the same time expand the economy well in excess of the rate of growth permitted by its domestic resources. Despite massive foreign aid, another wave of balance-of-payments problems occurred in 1989-1990. By 1991, the Philippines had made significant headway toward reducing macroeconomic imbalances but still had a formidable reform agenda to carry out.

Our conclusions on structural issues bearing on competitiveness at the end of 1991 are as follows:

- The Philippine peso, relative to most of its competitors in East Asia, had become more overvalued since 1975.
- Labor costs were so high that only in the more skilled occupations was the country competitive.
- The country was not attractive as a site for foreign investors in the late 1980s.
- The national investment incentive program did not favor exporting.

- Although the extreme protectionism of the early 1980s had been eliminated, most industrial and agricultural activity was still shielded by high barriers.

With respect to implementation of the conditions of SDP II, all conditions have been met. All conditions except one, value-added tax (VAT) refunds, were met on or ahead of schedule.

Our conclusions concerning the foreign exchange liberalization component are the following:

- The interbank market is much more open to market forces and is more competitive in 1995 than it was in 1991.
- The liberalization of foreign exchange controls has been more extensive than required under SDP II, verging on de facto convertibility for the peso.
- The Central Bank has entered into the spirit as well as the letter of the program, becoming a principal element in the President's economic policy of opening the Philippine economy to foreign investment.
- Although the decision to liberalize was made by the Central Bank and the Philippine authorities, A.I.D. played a strong supporting role in helping to carry out a more extensive foreign exchange liberalization than was initially envisaged by the government.

With respect to duty drawbacks, VAT refunds, and the establishment of the One-Stop Shop (OSS), we conclude that

- Of the duty drawback claims in 1992–1994, 99 percent were processed within the OSS's own target of 30 working days from the date completed applications were received rather than the SDP II's target of 60 working days.
- Only 90 percent of VAT refunds were processed within 60 days, a compliance rate that was not reached until mid-1994, a year behind schedule, and then only by transferring the process to the OSS.
- The OSS is now a permanent unit of the Department of Finance (DOF), the basis for expecting a continued good performance.

With respect to the small savers instrument (SSI), a cost-benefit analysis in 1993 found that the cost of issuing SSIs would have exceeded the interest savings from doing so, given the lower T-bill rates (12.5 percent) and the rate of inflation (8.3 percent) prevailing in 1993–1994. Therefore, the program was suspended and the remaining funds allocated to technical assistance for the Treasury division of the DOF.

The economic impact of the SDP II program arises mainly from the effects of foreign exchange liberalization. They may be summed up as follows:

- The unification of the official and parallel markets and the redirection of almost all receipts that had been in the parallel market into official channels;
- A major inflow of foreign private and, to some extent, Philippine capital;
- A rebuilding of foreign exchange reserves to comfortable levels; and
- A loss of competitiveness compared with 1990 as a result of exchange rate appreciation.

With regard to duty and VAT refunds, their acceleration represented about 0.7 percent of the value of all exports in the 1992–1994 period. The net benefit to society from the streamlining of the system was equal to P1.25 billion.

To estimate quantitatively the economic impact of the program, simulations of each of the three aspects of SDP II—accelerated tax refunds, higher capital inflow, and the appreciation of the peso—as well as of the overall impact, were made for the 7-year period from 1992, when the first measures were taken, through 1998.

When measured by the impact on growth, exports, and employment, the results indicate that SDP II had a small negative impact on the economy over the period 1992–1994. But even then, prices were lower, manufacturing capacity greater, and consumption higher than in the baseline case without SDP II. From 1995 onward, the net impact for almost all indicators, especially growth and exports, is positive. There is no doubt that the net impact effect for 1992–1998 period will be an improvement in the performance of the Philippine economy and that the favorable impact would be larger if the projection were extended further into the future.

To take into account the time value of economic costs and benefits, a simple cost–benefit analysis was used to compare the costs of the SDP II program with projected benefits (defined as GNP increases facilitated by the program). Annual costs included the program's direct implementation costs and also its negative impacts on GNP growth during the period from 1991 to 1994, because for each year, "net benefits" were measured by comparing GNP projections "with" and "without" the SDP II program. When the program acted as a brake on GNP growth, from 1991 to 1994, actual GNP growth lagged growth projections based on assumptions that SDP II was not in place and that estimated shortfalls in GNP growth were shown as negatives or costs. For the period 1995–1998, projections of GNP with the SDP II project exceed projections of GNP under scenarios assuming no project. The annual additional increments to GNP were measured by subtracting the "with" project forecasts of GNP from the forecasts made assuming no project. Undiscounted net annual benefits for the period were estimated to be P 14.6 billion at constant 1985 prices. Then, using a 15 percent discount rate [the same rate used by as the National Economic and Development Authority (NEDA) for economic analysis of projects], a discounted net present value of projected annual net benefits for each year from 1991 to 1998 was calculated. The overall discounted net present worth of the SDP II project (1991–1998) was estimated to be P3.4 billion at 1985 prices. That equates to a net gain (after deducting for SDP II's direct cost of \$60 million) of approximately US\$248 million using a 1985 exchange rate of 13.9 pesos/dollar, or approximately \$140 million at a 1995 exchange rate of 24.5 pesos/dollar. The ratio of gross benefits to program costs was \$308/\$60, or about 5/1 at constant 1985 prices. The same 8-year annual stream of net benefits in constant 1985 pesos represents an estimated internal rate of return of 31 percent.

It is clear that the economy in 1995, compared with that of 1991, has improved in a number of significant ways. It has grown at a more than 5 percent annual rate, while the rate of inflation has fallen to more manageable levels. The budget deficit had been eliminated, at least temporarily, and interest rates have declined by about one-third. Through the combined forces of higher invisible earnings and capital inflow, the effect of the SDP II program has been to finance the much larger trade deficit that growth required while increasing exchange reserves.

A review of recent history and structural issues as they stood at the beginning of 1995 suggests the following major findings on export competitiveness and the behavior of exports:

- Realistically measured, the exchange rate had appreciated significantly by the end of 1994.
- Labor costs in real terms, on the other hand, had fallen somewhat because annual nominal wage increases were smaller than in the late 1980s.
- Although the new freedom for foreign investors to do business should increase competition and improve technology, the incentives offered by Board of Investments (BOI) of the Department of Trade and Industry (DTI) still favor investments aimed at the domestic market. What favorable impact there has been on exporting is still probably not very significant.
- Since 1991 there has been a continued but slow reduction in effective rates of protection, that is, the protection against imports provided to "value added" domestically. However, current

4

effective rates of protection are still quite high for imported goods (50 to 70 percent), a situation that channels domestic as well as foreign investment away from exporting.

- Further tariff reductions are promised in the next few years, and a more radical reduction is promised by 2005. However, even if implemented as promised, the anti-export bias will be strong at least until the end of the century.
- The share of Philippine exports in the markets of its trading partners has not declined. However, that result has depended heavily on electronics, an industry that has only a 10–15 percent domestic value-added component and is not, therefore, strongly affected by exchange rate changes.
- Export competitiveness of Philippine products—particularly when compared with that of the Philippines' neighbors, Indonesia, Thailand, and Malaysia—has not improved since 1991. In fact, competitiveness has probably fallen. However, the institutional and policy changes cited earlier should lead to a gradual improvement in the situation.

CONCLUSIONS

On the basis of the preceding findings, we have drawn five principal conclusions about the effectiveness of this element of the Philippines' reform efforts and USAID's contribution to those efforts. First, USAID/Manila, by choosing export promotion and emphasizing, within that goal, foreign exchange liberalization, has, independently of other donors, made an important contribution to the Ramos administration's reform program. Although other donors have expressed some interest in this subject, none has made it a major condition for the disbursement of assistance.

Second, by concentrating on a few selected objectives united under the common theme of export competitiveness, the Mission has created a program that is clearly defined and, in concept at least, straightforwardly simple to implement and monitor.

Third, because new institutions have been created as the tool for reaching program objectives, the results are likely to be more permanent than if the Mission had required only adherence to quantitative targets or legislation as a condition for aid release. The creation of a market for foreign exchange (in the context of exchange control liberalization) that is responsive to supply and demand is shaping the behavior of the banks, the Central Bank, and exporters and importers. It has established a set of interests that reinforces the market's continued operation. On a smaller scale, the new One-Stop Shop refund center has made duty drawbacks and VAT refunds effective aids to exporting by shortening the length of time required for claims to be processed. Previously delays in payment had been long enough to effectively nullify the incentive value of the program.

Fourth, although the reorganization of the foreign exchange market did have some negative consequences for export competitiveness in 1992–1994 (as the peso rose in value in response to significant increases in the supply of foreign exchange), the policy achieved the ultimate goal: allowing rapid growth of output and employment to occur without balance-of-payments problems.

Finally, the new market will produce a more realistic exchange rate and greater export competitiveness over time as the import needs that flow from economic growth temporarily draw down the accumulated supply of foreign exchange.

RECOMMENDATIONS

These recommendations are based on the idea that further improvements in export competitiveness are essential to sustaining growth and increased employment, and that USAID/Manila can help by supporting the analysis that would be the basis for measures to reduce the anti-export bias that is still built into Philippine laws and practices.

Export competitiveness has three policy legs: a stable macroeconomic situation, a realistic exchange rate, and a neutral international trade and investment policy. The first leg is the responsibility of the Philippine authorities working with the International Monetary Fund (IMF), if the IMF chooses to do so. With regard to the second leg, the results of SDP II, which reflect a basic shift in Central Bank exchange rate policy, have established an institution that will produce a realistic exchange rate over time.

But even with inflation under control and a more realistic exchange rate, the disincentives to exporting created by the trade protection apparatus (tariffs, quantitative restrictions, and home consumption value), the BOI industrial investment incentive structure, and the numerous institutional and legal obstacles to more efficient investment in agriculture are holding back the entry of new exporters and the expansion of existing ones. The export policy of the Philippines, where it pertains to these policy areas, still lacks coherence.

It is also by no means certain that development of exports enjoys a very high priority among economic policymakers. There is a tendency to trust that the projected schedule of tariff reduction will solve the problem despite evidence (such as the "temporary" increase of protection for agriculture in 1992) that as soon as political pressure from vested interests is exerted there is a protectionist reaction. Yet if President Ramos's new policy of openness can continue with the success it has enjoyed so far and can be strengthened, nothing is more important than tackling the problems of anti-export, pro-import biases as soon as possible.

The objectives would be to

- To establish a set of analytical standards by which to judge what is happening in the export sector, and
- To explore the current policy environment, sector by sector, to determine the incentives and disincentives it provides to exporters.

Therefore, the following five-part program is recommended, by which USAID Manila, with a modest investment, could change the approach to the problem:

1. Help NEDA develop an export strategy that would broaden the focus of the DTI secretariat of the Export Development Council created by the Export Development Act, in particular, by identifying the parts of existing laws and regulations that need to be modified to reduce the anti-export bias.
2. Help NEDA and the Central Bank create an export monitoring system that accurately measures the competitive situation.
3. Determine why the electronics and garment industries, after two decades and much support in their export enclaves, have such a small domestic value-added component. In other words, identify those elements of the trade and investment laws and regulations prevent industries physically located in the Philippines from deepening their local production processes.
4. Study sectors that have been successful in exporting to determine which factors have been favorable. For example, the automobile parts sector has been successful, often with the help of foreign investment.
5. Examine the effect of investment restrictions and trade protection on the export prospects of agriculture. With its mixture of uncompetitive export commodities, low productivity in basic foodstuffs, and insufficient concentration in products for which demand is growing in foreign markets, agriculture is a drag on export growth rather than a contributor to it.

All these projects could be carried out with a mix of foreign and local consultants, building on the work of the Philippine Development Institute's economists and the Central Bank's insights into

exchange market trends and behavior. Collectively, the projects could provide the analytical framework and information necessary to justify remaking the trade and investment regime so that a level playing field is created, markets are able to send and received unbiased signals about the value of goods and services, and neither production for sale locally nor production for sale abroad is favored.

ORGANIZATION OF REPORT

This report is divided into six chapters. Chapter 2 describes the economy and its problems in 1991 as a background for explaining choices made in the design of SDP II. Chapter 3 is divided into four parts that describe the design of SDP II, its implementation, related technical assistance, and the experience of similar projects sponsored by A.I.D. and other organizations. Chapter 4 examines the project's impact on the behavior of the economy and the private sector using both descriptive and modeling techniques. Chapter 5 gives an overview of the economic situation in 1995 in order to identify remaining structural issues related to competitiveness and analyses export behavior since SDP II was instituted. Finally, Chapter 6 summarizes the lessons of SDP II and makes recommendations about the information and technical assistance programs that would be necessary to continue the type of policy reform begun by SDP II.

1. Introduction

This report evaluates the second phase of the Support for Development Program (SDP II) grant to the Philippines, a program that began in 1991 and terminates in 1996. It also reviews current economic policy issues and proposes options for technical assistance and studies that A.I.D. might want to undertake in the future.

REPORT OBJECTIVES

The objectives of this report are

- To determine whether the SDP II has met its goals and objectives;
- To assess the economic benefits and impact of the program; and
- On the basis of the lessons learned, and taking into account the problems that need to be tackled to further the overall objective of SDP II, to recommend appropriate technical assistance and studies.

BACKGROUND

Since 1986, the United States, as part of its aid program, has made grants from development assistance funds, the Multilateral Initiative, food aid, and the Economic Support Fund (ESF) to the Government of the Philippines (GOP). The ESF grants served the dual purpose of providing resources to the budget and the balance of payments on the one hand and furthering the process of policy reform on the other, by conditioning their release on the achievement of specific measures. The immediate ancestor of SDP II, the first Support for Development Program, disbursed \$209 million in 1989 and 1990 and had a substantial effect on the balance of payments. There were numerous conditions and a complex monitoring system to enforce them.

In 1991, when SDP II was being designed, the Philippine authorities and USAID/Manila reached a consensus that the program would be more effective if it were focused on one goal. Therefore, the authorities accepted the goal of assisting the GOP with improving the competitiveness of Philippine exports. Repeatedly, in the past, growth has been cut off because the growth of exports had been insufficient to pay for the necessary imports. More competitive products would not only help solve this problem but improve efficiency in the economy as a whole, widen opportunities for private enterprise, and increase employment.

DESCRIPTION OF SDP II

The initial design of SDF II called for \$120 million. However, after the Mission's overall funding levels were reduced, the amount was reduced to \$60 million to be disbursed in three tranches, the first two of which would be \$18.5 million, and the third, \$19 million. The remaining funds were for technical assistance and evaluation. This final evaluation is now being undertaken because the

conditions have been met and all but a small part of the technical assistance allocation has been disbursed.

The broad purpose of the different measures agreed to by the authorities was either to increase the return to or reduce the cost of production of the exporter. The first and most important measure was to create an interbank market that reflected the supply and demand for foreign exchange and to liberalize the exchange control system so that businesses and individuals would be freer to make their own decisions. It was expected that by making the exchange rate more market responsive it would become more realistic, increasing the price incentive to sell abroad.

The second measure was to accelerate the refund of duty drawbacks and value-added tax (VAT) refunds from 1 to 2 years to 60 days so that it became an effective incentive to exporters rather than being eroded by the interest paid on borrowed funds while waiting and by processing costs.

The third measure was to develop a small savers instrument that, by tapping a new source of funds to finance the budget, would tend to lower the overall level of interest rates. This measure was never put into effect for reasons described in Chapter 3. The funds not used in the initial study were reallocated to improve the functioning of the Treasury Bureau of the Department of Finance.

The fourth measure was to induce more competition in interisland shipping rates to reduce the cost of bringing goods to the export port of embarkation. This last objective will be evaluated in a separate report.

2. The Economy and its Problems in 1991

This chapter describes the macroeconomic situation in 1991 when SDP II was being formulated, and indicates the structural problems relevant, at that time, to the broad issue of export competitiveness that was chosen as the theme of the new program.

BACKGROUND

The background of Philippine postwar economic history and economic policy was examined at some length in a report prepared by Nathan Associates Inc.¹ The main points may be summarized as follows:

1. The Philippines, like much of Southeast Asia in the early postwar period, was a well-endowed exporter of such commodities as coconuts, sugar, fruit, logs, and minerals.
2. Balance-of-payments crises in the 1950s and 1960s, and the prevailing development ideology of the time, led to an import substitution program, mainly for consumer goods, protected by quotas or high tariffs, or both.
3. In the early 1970s the success of Hong Kong, Taiwan, and Korea inspired the Philippine government to establish export processing zones and attractive conditions for foreign investors to build factories to process electronics and garments for export.
4. In the late 1970s, the Marcos government, taking advantage of the availability of medium-term private foreign credit, undertook a massive infrastructure investment program. Much of this effort was ill conceived and wasted through corruption.
5. Caught up in the world recession of 1980–1982 and the international debt crisis, the economy made little or no progress in the following years.
6. Political unrest leading to the Epifanio de los Santos Avenue (EDSA) uprising in 1986 led to a further decline.

The consequence of this history is that although the economy grew by about 5 percent per year before 1980, it has fallen behind its Asian neighbors and accumulated serious structural problems that have made the balance-of-payments deficit the principal obstacle to sustained economic growth. This was the legacy of the Aquino administration, which took office in 1986. This administration decided to promote growth and reform, at the same time, with massive foreign assistance. The results were mixed.

ECONOMIC SITUATION IN 1991

By 1989–1990, the Philippines was in the midst of another dual-edged inflation and balance-of-payments crisis (see Table 2-1). The merchandise trade deficit, which had averaged 2.2 percent of GDP during 1986–1988, rose sharply to 6.1 percent in 1989 and to 9.1 percent in 1990, peaking at

¹ *Evaluation of the Support for Development Program*, Nathan Associates/USAID, 1991.

Table 2-1. Selected Economic Macroeconomic Indicators, 1987–1991 (percent)

	1987	1988	1989	1990	1991
1. GNP rate of growth	4.6	7.7	5.9	4.5	0.1
2. Savings/GDP	19	20	19	19	18
3. C/A deficit/GDP ^a	1.3	1.0	3.4	6.1	2.3
4. CPSD/GNP ^b	2.3	3.7	4.3	5.4	1.6
5. M3 rate of growth	12	23	28	18	15
6. Price increase	3	9	12	14	19
7. 91-day Treasury bills	11	14	19	23	21

^aCurrent account of the balance of payments.

^bConsolidated public sector deficit (ouduget + government corporations + Central Bank..

Source: National Statistics Office, Central Bank.

more than \$4 billion. Similarly, the current-account deficit, which had averaged 1.2 percent of GDP during 1987–1988, worsened to 3.4 percent in 1989 and 6.1 percent in 1990. This deterioration was attributable primarily to (1) external shocks, especially the sharp rise in oil prices, which worsened the country's terms of trade by 10.4 percent in 1989 and by another 4.5 percent in 1990; and (2) excessive stimulation of domestic demand arising from the public sector deficit, which reached 5.4 percent of GNP in 1990.

Although money supply growth reached a peak annual rate of 28 percent in 1989, the full impact on prices was delayed until 1991 (19 percent) for several reasons—cumulative excess liquidity, a minimum wage increase, and a 9 percent import levy. An attempted coup and an earthquake delayed the start of the stabilization program. Only in January 1991 did the Philippine government establish a mechanism for coordinating fiscal disbursements and monetary management among concerned government agencies, especially the Department of Finance, the Central Bank, and the Department of Budget and Management. The macroeconomic managers were able to reduce the consolidated public sector deficit to 1.6 percent of GNP in 1991. This achievement reflected declines in the deficits of both the national government (from P37 billion in 1990 to P26 billion in 1991) and government corporations (from P20 billion in 1990 to P2 billion in 1991), as well as a turnaround in the Oil Price Stabilization Fund (OPSF) from a deficit of P3 billion in 1990 to a surplus of P12 billion in 1991.

The decline in the budget deficit in 1991 is attributable to both increased tax effort and a moderation of the increase in expenditures. Tax revenues increased from 14.5 percent of GNP in 1990 to 15.0 percent in 1991, mainly because of a sharp increase in import duty collections (from special import levies in addition to regular tariffs) and increased business income taxes. Expenditures increased by 14 percent in 1991, well below both the inflation rate of 19 percent and the 17 percent increase of GNP at current prices.

The decrease in the combined deficit of government corporations reflects primarily the cutback in their planned capital expenditures, whereas the turnaround in the OPSF balance resulted from the government's decision to raise domestic oil prices.

The country's external balances also improved in 1991. The merchandise trade deficit declined from 9.1 percent of GNP in 1990 to 7.0 percent in 1991. The improvement arose from the effect on imports of the special import surcharge, the depreciation of the peso, and the slowdown of the Philippine economy. Exports continued to rise. The current-account deficit also declined, to 2.6 percent. And the overall balance of payments turned in a surplus in 1991 equivalent to 3.1 percent of GNP, in sharp contrast to the balance-of-payments deficit of 0.4 percent in 1990. Interest rates declined slightly.

The macroeconomic stabilization program, the worsening power outages, and the explosion of Mt. Pinatubo combined to send the Philippine economy into a recession in 1991. GDP, in real terms, declined by 0.8 percent, and even with large-scale inflows from overseas workers, GNP was virtually stagnant. Reflecting a population increase of nearly 2.4 percent, real per-capita GNP declined by 2 percent in 1991, so that it was nearly 10 percent below the average level of 1980-1984. Gross domestic capital formation, in real terms, declined by 16 percent, and imports of goods and services (also in real terms) decreased by 2 percent.

Unemployment rose from 8.4 percent in 1990 to 10.6 percent in 1991. The number of unemployed in 1991 (2.7 million) was one-third greater than in 1990. The only sector in which employment increased significantly was overseas contract work, placements of which reached about 620,000 in 1991, a 38 percent increase over 1990.

By end of 1991, the Philippines had made significant headway toward reducing macroeconomic imbalances, but at the cost of an economic recession. Continuing the reform of major policies and consolidating macroeconomic stability as a foundation for sustainable economic growth, as is discussed in the following sections, was the primary policy challenge facing the Philippine government in 1991, as it had been 5 years before.

STRUCTURAL ISSUES CLOSELY RELATED TO EXPORT COMPETITIVENESS

The theme of SDP II is export competitiveness. In principle, most aspects of the economy have some bearing on the subject. To make the subject manageable we will concentrate on the following topics:

- The realism of the exchange rate and related issues of productivity and labor cost,
- The legal framework governing foreign investment as a source of resource mobilization and technology, and
- Trade protectionism.

We omit discussion of the prospects for stabilization, which are implicit in the analysis of the exchange rate, and of the rates of national investment and savings, which are important for sustained export growth but go well beyond it.

Exchange Rate Realism, Productivity, and Labor Cost

The decline in the international competitiveness of the Philippines in the years leading up to 1991 can be illustrated by (1) the appreciation of the peso in real terms compared with currencies of competitor countries and (2) the sluggishness in the growth of productivity during the 1980s compared with significant increases in productivity in key competitor countries. Poor allocation of resources, technological obsolescence, market demand shocks, and infrastructural bottlenecks (e.g., power outages) contributed to the sluggishness in the growth of productivity.

Estimates of real effective exchange rate (REER) indices in 1991 relative to 1975 for several Asian countries are presented in Table 2-2. The estimates show that although the peso did not lose ground against Thailand and Singapore, Malaysia made significant gains and China and Indonesia transformed their situation. They succeeded in carrying out major real depreciations of their currencies during the 1980s and thereby improving the price competitiveness of their exports, as well as their import substitutes, during the decade.

An important explanatory factor, also illustrated in Table 2-2, is the differential trends of the indices of labor productivity. The table shows that in every case except Malaysia, the behavior of productivity and the REER is parallel. The cases of China and Indonesia are particularly striking. The Philippines has the worst REER and labor productivity performance.

**Table 2-2. Indices of REER and Labor Productivity
(1975 = 100)**

	REER		Productivity, 1990	
	1986	1991	All Sectors	Manufacturing
Philippines	113	109	104	119
Indonesia	242	256	140 ^a	227 ^a
Malaysia	112	136	163	161
Singapore	109	90	187	189
Thailand	116	114	167 ^b	165
China	221	275	205 ^b	NA

^a1989/1976.

^b1989.

Source: Intal and Jovellanos.

Although Table 2-2 indicates the decline in the relative international competitive position of the Philippines over time, it does not show the level of costs in the Philippines relative to other countries at a given point in time. An indication of the differences in the labor costs in the textile industry among selected countries in Asia is presented in Table 2-3.

**Table 2-3. Hourly Wages
in the Textile Industry,
1991 (US\$)**

Country	Wage
Japan	6.4
Taiwan	5.0
South Korea	3.6
Malaysia	1.0
Thailand	0.9
Philippines	0.7
Indonesia	0.3
China	0.3
India	0.6
Pakistan	0.4

Source: Intal and Jovellanos.

The figures in Table 2-3 indicate that wage costs in the Philippines were lower than those in Malaysia and Thailand but significantly higher than those in Indonesia, China, and Pakistan. They imply that in 1991, assuming that higher Philippine productivity did not offset the wage differences, the economy was not competitive as compared with these last three countries in commodities and product lines that rely heavily on cheap, unskilled labor.

Given this situation, the Philippines is likely to do better in industries where Thailand and Malaysia are the logical competitors, that is, in skilled-labor intensive industries like electronics, midrange garments, metal products, and jewelry. As Table 2-2 indicates, however, labor productivity in Thailand and Malaysia grew faster than in the Philippines during the 1980s. In addition, both Malaysia and Thailand had better infrastructure facilities, resulting in lower internal transport costs and a more reliable power supply. In short, taking into consideration labor costs, labor productivity, quality of infrastructure, the exchange rate, and other factors affecting international competitiveness, both Malaysia and Thailand were clearly the more competitive investment sites and export bases than the Philippines in 1991.

In summary, the picture is of an economy that has partly priced itself out the low-wage, low-skilled segment of manufacturing while only partially qualifying for the semi- and high-skilled

sectors, mainly because of an overvalued exchange rate and a tendency to push up wages for political reasons.

Legal Framework Governing Foreign Investment

In this section, we will discuss the investment incentive system as it affects the profitability of export-oriented activities, comparing the system with incentives directed at the domestic market and restrictions on foreign direct investment.

In view of the low domestic saving rate and the large investment needs of economic growth, the Philippines needed a large infusion of foreign investments. However, it missed out on the movement of capital from Northeast to Southeast Asia during the late 1980s. When the foreign chambers of commerce and industry in the Philippines compared the country's relative attractiveness as an investment site with that of other ASEAN countries (FCCI 1990), they concluded that a sluggish economy, policy uncertainty, poor infrastructure, peace and safety problems, and restrictions on foreign investments were major obstacles to investing in the country.

Investment Incentives

The Philippines has long had a system of investment incentives. It was formally institutionalized in 1967 with the enactment of the Investment Incentives Act of 1967. Priority areas were selected and "measured capacity" established for these areas. Incentives were geared mainly toward the production for the domestic market. Priority areas were given further incentives in the form of tariff and/or import control protection (an import licensing requirement or an outright import ban).

In 1970, incentives were extended to nontraditional exports with the passage of the Export Incentives Act (RA 6135). Since then, the act has been amended and codified three times, culminating in Executive Order 226 (EO 226) or the 1987 Omnibus Investment Code (OIC). EO 226 superseded Batas Pambansa 391 (BP 391), which was passed in 1983. BP 391 introduced an innovative form of incentives—a tax credit equivalent to a certain percentage of net value added earned (for domestic producers) and local content (for export producers). This was replaced by the income tax holiday for a duration ranging from 3 to 8 years under EO 226.

The effect was to substantially reduce the advantages to firms investing to export compared with those serving the domestic market. The effect was to reduce the percentage of exporter investments benefiting from the incentives from 72 percent in 1986 to 14 percent in 1994. Because export firms are less capital-intensive, the number of firms receiving incentives declined to about 50 percent. Finally, the BOI's Investment Priority Plan (IPP), which determines which sectors are aided, seems increasingly oriented to domestic market enterprises, another factor that works against exporters.

The conclusion of the experts who have studied this issue is that by making the incentive system more neutral and directing it to production sold locally, exporters are at a disadvantage because they already suffer from the import-substitution bias of trade protectionism (see Appendix D).

Foreign Investment Restrictions

Until passage of the Foreign Investment Act of 1991, the Philippines had one of the most restrictive foreign investment regimes in Southeast Asia. Foreigners were prohibited or were limited to a minority share in banking, natural resource development, utilities, and in almost every area of activity that the government believed was being adequately served by Filipino investors. The one general exception consisted in those enterprises that exported most of their output. That provision contributed to the growth of the electronics and garment industries. It may have also been a factor in

their "enclave" style of operation in which few of the inputs, other than labor, are produced locally. In the past, the investment regime was certainly a factor in the country's lack of competitiveness.

The 1991 Act fundamentally changed the legal framework and opened up an entire series of sectors to foreign investment. This should contribute to a more efficient and competitive economy in the future. (See Chapter 5.)

Trade Protectionism

The best measure of trade protection is the effective protection rate (EPR). Unlike the tariff, which measures the additional markup a domestic producer might charge while remaining competitive with a foreign manufacturer, the EPR takes into account the effect on local selling prices of domestically produced products in competition with imports, of quantitative restrictions (QR), and of other marketing barriers. It calculates the degree to which domestic value-added is protected by comparing domestic and foreign prices of inputs with those of final products. Therefore, a 20 percent tariff might be equal to an EPR of 30, 50, or even 75 percent depending on the circumstances.

Domestically produced exports may suffer negative protection because some of its inputs have to be bought on the local market at higher than world prices. A combination of a high EPR on "importables" and negative protection on "exportables" obviously inclines firms, whether locally or foreign owned, to sell domestically rather than abroad.

The object of the Philippine trade regime begun in the early 1950s was to promote import-substitution industries. Through the extensive use of quotas and high tariffs, the trade regime caused the manufacturing sector to provide very high effective protection for imports and negative or zero protection for exports. The policy created serious distortions. Artificially making certain import-substitution industries relatively more profitable through tariffs and quantitative restrictions has made potentially profitable exports relatively less attractive. As a consequence, manufactured exports have been highly concentrated in garments and semiconductors, which have enjoyed privileged access to foreign inputs at world prices, whereas other products that have to depend on high-cost domestic inputs have had a more difficult time competing.

Agriculture enjoyed lower but still high rates of protection except for the old traditional staples such as sugar and coconuts and coconut by-products. Partly for the same reasons, exports from this sector have largely stagnated and only a few new product lines have expanded significantly.

Trade reform has been on the policy agenda since the early 1980s but only made significant progress after the change in government in 1986. The most urgent issue was the reduction of quota restrictions because they were so extensive that tariffs became redundant in most commodity categories. The elimination of tariffs would lead to more reliance on the market, foster competition, and encourage the development of industries with a real comparative advantage to the extent that tariff protection permitted. From 1986 to 1989, import restrictions on some 1,471 PSCC lines (commodity categories) were lifted. This reduced the number of regulated items as a percentage of the total number of PSCC lines from 34 percent in 1985 to 5.2 percent in 1991.

There are two ways to measure the effects of these measures. The first is the EPR described previously. In Table 2-4, exportables are products that are mainly exported and importables almost exclusively imported. The results of this table can be summed up as follows:

- There was a sharp reduction in import protection as a result of the elimination of QRs between 1985 and 1988, but little progress between 1988 and 1991 except for machinery.
- Domestic production competing with imports still enjoyed very high protection in 1991, an average of 50 percent for agriculture and 74 percent for manufacturing.

Table 2-4. Changes in Effective Rates of Protection, 1985–1990 (percent)

	1985	1988	1991
All sectors			
Exportables	-9	-6	-5
Importables	97	75	70
Agriculture			
Exportables	-7	-1	-1
Importables	80	49	51
Manufacturing			
Exportables	-8	-5	-4
Importables	102	75	74
Food			
Exportables	-17	-11	-11
Importables	53	44	43
Textiles, Garments and FW			
Exportables	0	0	0
Importables	338	121	88
Paper, rubber, etc.			
Exportables	-15	-22	-24
Importables	353	135	150
Basic metals			
Exportables	-12	-21	-15
Importables	180	74	80
Machinery			
Exportables	0	0	0
Importables	97	64	59

Note: Based on price comparisons without taking into account the duty drawback except textiles, garments and semi-conductors (exportables).

Source: Tan 1994.

- A number of manufacturing subsectors continued to benefit from protection so high that most imports in these categories (e.g., paper, base metals) were essentially excluded.
- Exports throughout suffered from negative protection, i.e., value-added is lower than it would be if some inputs were available at world prices.

For the period 1985–1988 another measurement of change is available from the Philippine Institute of Development Studies Development Incentives Assessment (DIA). It shows that for the whole manufacturing sector, the domestic resource cost (DRC) as a ratio to the shadow exchange rate (SER)² declined from about 1.7 in 1983 to about 1.5 in 1988, clearly an indication of an increase in the overall level of competitiveness of the manufacturing sector. To illustrate further, the share of establishments whose DRC/SER ratios fall between the range of zero and one (i.e., those with allocative efficiency) rose substantially between 1983 and 1988, in terms of both value of output and number of firms. In terms of value of output, the share of efficient firms increased significantly from 18.8 percent in 1983 to 39.5 percent in 1988. Furthermore, there was significant correlation between the change in EPR and the change in DRC/SER between the 2 years.

²The measure of efficiency used in this project is the ratio of the domestic resource cost (DRC) to the shadow exchange rate (SER). The former indicates the value of domestic resources used to produce a unit of net foreign exchange, whereas the latter indicates how society truly values foreign exchange. Thus, a ratio of one, or less than one, indicates efficiency because the activity is using domestic resources, whose cost is lower than the value of the net foreign exchange it earned or saved. The lower the DRC/SER ratio, the higher the allocative efficiency.

CONCLUSIONS

Our conclusions on structural issues bearing on competitiveness at the end of 1991 are as follows:

- The Philippine peso, in relation to most of its competitors in East Asia, became more overvalued during 1975–1991.
- Labor costs were high enough to make low-skilled manufacturing relatively unprofitable and therefore uncompetitive compared with some Southeast Asian economies.
- The Philippines was not attractive in general as a site for foreign investors in the late 1980s, and its investment incentive program made domestic market-oriented investments more interesting than export projects.
- Although the extreme protectionism of the early 1980s, based on QRs, had been eliminated, most industrial and agricultural activity remained shielded by high barriers.

3. Implementation of SDP II

The object of the SDP II program was to develop a series of measures that the Philippines government could put in place to improve the competitiveness of the country's exports. Essentially, the approach was to eliminate barriers to the operation of market forces—barriers that the government itself had put into place specifically or inadvertently. The tactic was to either improve the return to sales or reduce the cost of production by eliminating or modulating legal or regulatory mechanisms that stood between the producer or trader and selling prices or the cost of inputs. All the measures proposed in this project affected one or the other for those directly involved in exporting.

The project did not address the problem of the structure of protection and its effect on the level of costs. It has been argued that the high levels of effective protection (i.e., tariffs, quantitative restrictions, and barriers to entry) are a major reason why Philippine exports are not more competitive. This issue was part of the conditionality of another USAID program as well as of a World Bank loan.

The emphasis has been on the export of commodities rather than services. The rationale was that long-run growth potential is greater for goods than for services (e.g., tourism), but that in the medium term this may not be the case. We believe this rationale was correct.

The remainder of this chapter is divided into four sections.

- The first section, "Design," summarizes the rationale and the mechanism chosen for each area: liberalization of foreign exchange, improving the refund process for VAT and duty drawbacks, and the influence of the SSI on the return to small bank deposits. It also describes what technical assistance was proposed to help each of the implementing agencies carry out its tasks.
- The second section, "Implementation," describes what was done and how it compared with the program proposals for both the policies and the technical assistance.
- The third section, "Technical Assistance," describes the operation of the technical assistance contracts helping participants carry out the projects.
- The fourth section, "Related Projects," summarizes both aspects in other projects and indicates their relationship to SDP II.

DESIGN

Foreign Exchange Liberalization

In 1991, before the SDP II program was initiated, the foreign exchange market consisted of three loosely related submarkets:

- The official interbank market, which produced a daily "reference rate";
- A bank-customer market in which transactions took place at different prices loosely related to the "reference rate"; and
- The parallel, or "black," market.

18

Because the commercial banks were instructed by the Central Bank to balance their customers' demand for and supply of foreign exchange with as little recourse to the interbank market as possible, its volume was tiny and totally dominated by Central Bank intervention. For the same reason, their customer transactions, through rationing or special commissions, created a range of more depreciated effective exchange rates compared with the reference rate. The banks could not influence the market by going long or short on dollars because they were required to keep their foreign exchange assets and liabilities approximately in balance.

The most depreciated rate was in the parallel market, where residual supply and demand met. The supply arose from overseas worker earnings, remittances, tourist exchanges, and unrecorded or understated commodity and service exports. Demand came from the need to spend more on travel, send more remittances, and pay for smuggled imports, as well as from capital flight.

The foreign exchange controls consist of two basic components: requirements to surrender foreign exchange receipts, whether from earnings, remittances, or capital inflow; and restrictions on payments, remittances, and capital outflow.

The rules were strict, comprehensive, intricate, and changeable. Just as the organization of the exchange market was designed for Central Bank dominance, the administration of exchange controls place it at the center of the system. In a regulatory framework requiring all receipts to be declared and converted through the official market and all payments and transfers to be authorized, the commercial banks were delegated relatively little discretion. They approved most import transactions and the small allowances for business and tourist travel but had to refer the transfer of profits, dividends, interest, royalties, and insurance to the Central Bank. Short-term investments were difficult because both their receipt and repatriation had to be approved by the bank, meaning that the exchange rate could change significantly while waiting. In short, participation in international trade and finance was neither user-friendly nor inexpensive.

The Philippine peso was not fixed to an external standard and thus could be changed without a formal devaluation. But it also was not governed by a crawling peg where periodic, expected small adjustments are made to compensate for a national rate of inflation superior to that of trading partners. Technically, it was a floating rate but barely responsive to market forces because supply and demand was heavily filtered by an artificial market and comprehensive exchange control regulations. It moved essentially when the Central Bank thought it appropriate.

An exchange rate affects the export and import of goods and services, the domestic price level, and the cost of servicing, in national money, of foreign liabilities. Judging from its behavior since 1972, the Central Bank, when it has had the choice, has chosen to keep the peso as unchanging as possible against the U.S. dollar. In other words, the Central Bank tended to be more concerned with the rate's impact on inflation through the cost of imports and the consequences for public and private finances of foreign debt than with any disincentive effect on exports.

In a world in which the dollar and other principal trading currencies are floating, and Philippine inflation has usually been faster than almost all its trading partners, the tendency to cling to the dollar has usually led, over time, to an effective appreciation of the peso and a loss of trading position compared with its competitors in East Asia, and therefore, a balance of payments crisis. The peso then has to be abruptly and steeply devalued against the dollar to restore the position and the process begun again.

The proposed policies, put forward as conditions under the second and third tranches of SDP II, were designed to persuade the Central Bank to dismantle its protective system so that market forces were reflected more promptly in the formation of the exchange rate and the traumatic crisis avoided. It was hoped that in this situation the exchange rate would be more realistic and contribute to a better equilibrium in the balance of payments by promoting exports and discouraging imports.

The conditions were as follows:

- Tranche 2
 - Completing a comprehensive review of foreign exchange regulations,
 - Substantially expanding exporters' foreign exchange earnings retention limits, and
 - Initiating off-floor trading among commercial banks.
- Tranche 3
 - Broadening participation in the foreign exchange market and
 - Eliminating licensing of foreign exchange brokers and dealers.

The objectives of these five conditions can be summarized as follows: (1) broadening the official interbank market so that commercially motivated transactions played a larger role and Central Bank interventions a smaller one; and (2) liberalizing the exchange control system so that business could react more quickly, more efficiently, and less expensively to economic signals.

To put this objective into perspective, two points are critical:

1. A thoroughgoing foreign exchange liberalization would mean abandoning one of the Philippines' most pervasive control measures. Although there have been episodes in the postwar history of the Philippines during which the form and administration of foreign exchange controls were more liberal than the general situation described earlier, setting an objective of eliminating most of the controls had never been envisaged. Although the Ramos administration and the new head of the Central Bank appointed in 1992 supported the goal in general terms, many permanent Bank staff were skeptical. As a result, the most the Bank was prepared to commit itself to, initially, was a "comprehensive review."
2. Unlike many elements of the reform program, this goal was not one that USAID/Manila shared with other major donors. USAID was practically alone in emphasizing the importance of the new policy. Although the IMF has traditionally sought to eliminate restrictions on current payments such as imports and repatriation requirements, its focus in its agreement with the Philippines has been to (1) stabilize the economy through controls on the budget deficit, credit creation, and appropriate interest rate policy and (2) manage and finance the balance-of-payments deficit. The World Bank stressed structural reforms, including tariff and quota reductions and privatization.

Accelerating Value-Added Tax and Duty Drawbacks to Exporters

SDP II supported the establishment of an Interagency Tax Credit and Duty Drawback Center, or One-Stop Shop. The objective of the OSS was to reduce to 60 days or fewer the processing time required for at least 80 percent of completed duty drawback applications and 80 percent of completed VAT credit claims.

The rationale for streamlining the duty drawback and VAT credit systems is to provide exporters access to inputs at world market prices. These systems are meant to enhance the overall competitiveness of Philippine exports by reducing the interest and transaction charges associated with the unduly long period of time it takes to process applications for drawback/credit of tariffs and taxes paid on their raw material and other inputs in the past.

Before the establishment of the OSS on May 8, 1992, four government agencies separately processed exporters' applications for duty drawback and VAT credit. The Board of Investments (BOI) processed the use of tax credit and duty drawback of

- Direct and indirect exporters registered under the Omnibus Investments Code (Executive Order 226),

- "Internal exporters" under the Order Regalo Program (Letter of Instruction 1355), and
- Local suppliers under the RP-US Military Bases Agreement.

The Bureau of Customs (BOC) attended to exporters' applications for duty drawback under Section 106 of the Tariff and Customs Code. The Bureau of Internal Revenue (BIR), pursuant to Section 106 of the National Internal Revenue Code, handled rebate claims of exporters for VAT paid on their locally sourced inputs (including raw materials, supplies, and intangibles). Finally, as provided under Executive Order 765, the Department of Finance administered the processing of duty drawback and VAT credit claims of domestic manufacturers selling goods to foreign-funded government projects.

Although both the Tariff and Customs Code and the National Internal Revenue Code mandate that the processing of rebate claims for duty and VAT be completed within 60 days, many exporters reported that actual processing time in these agencies was on average 1 to 2 years. As a result, the input costs faced by exporters rose relative to their price in the world market because of

- The transactions cost associated with their compliance with the administrative and documentary requirements and
- The cost of working capital used to pay the duty and tax on their inputs (for the period between the time they paid said duties or taxes and the time they received their rebates).

It has been estimated that these costs resulted in implicit tariffs on imported inputs that are 9 to 20 percent higher than that implied by the nominal tariff rate. In turn, this high implicit tariff on inputs gave rise to negative effective protection rates on exportables.

The specific commitments made by the government were the following:

- Tranche 2: effective operation of the OSS and the implementation of the procedures for the prompt processing of 40 percent of the VAT credit claims of exporters, and
- Tranche 3: reduction of the length of the processing time of 80 percent of completed duty drawback and VAT credit applications to 60 days or less for at least 3 months.

Improving Small-Savers' Access to Government Debt Instruments

The SDP II grant agreement called for the adoption of an action program and the design of mechanisms that would improve the access of small savers to government securities. This provision directly supports the SDP II policy objective of improving efficiency in mobilizing financial resources. It was envisioned that the mobilization of additional savings by giving small savers access to government securities, particularly in secondary cities and rural areas, would foster improved management of public debt financing, including lower domestic interest rates on public debt.

Many studies have pointed out that small savers are largely limited to savings accounts that pay low nominal interest rates (about 5 percent) and, at times, negative real interest rates. They are effectively excluded from the government securities market because it is open only to large, mostly institutional investors who buy Treasury, or T-, bills, the smallest denomination of which is P50,000, through a limited number of authorized dealers. Thus, an earlier study suggested that the feasibility of tapping the large potential pool of resources from small savers through the issuance of correctly structured and marketed small denomination T-bills should be studied.

An additional benefit of such an initiative would be the increased competition generated by small savers among government securities dealers and the concomitant reduction in the yields on government securities. Interest payments on domestic public sector debt are the largest single expenditure item in the national government budget, accounting for roughly 23 percent of the national budget in 1987–1992. Moreover, in 1990–1991, the average interest rate on T-bills was high, exceeding 20 percent for 91-day bills.

In view of this background, any reduction in the average T-bill rate would tend to reduce the national government deficit and, consequently, benefit private investments. A reduction in the average T-bill rate could also force bank interest rates down, benefiting exporters in need of local financing. These effects form the rationale for the SDP II policy reform in financial resource mobilization.

The specific conditions were the following:

- Tranche 2: the adoption of an action program for improving the access of small savers to government securities; and
- Tranche 3: the design of mechanisms to allow small savers access to government securities.

IMPLEMENTATION

This section summarizes the progress of each component of the reform program and determines the degree to which the measures taken conform to their respective goals.

Foreign Exchange Liberalization

Foreign exchange liberalization can be divided into three parts:

- Broadening the interbank market,
- Liberalizing exchange restrictions for business and individuals, and
- The role of USAID.

Broadening the Interbank Market

The Philippine Dealing System (PDS), an electronic monitor listing quotations and transactions, was created in April 1992. It ties together all the traders, giving them, along with nontrading subscribers, an up-to-the-minute picture of market developments throughout the business day. Technically, the Philippine foreign exchange market is now entering the stage at which better developed markets in other countries have been for some time. The trading "floor" that had been opened for only 30 minutes per day was closed in August 1992. As a result the "reference rate" is the weighted average for daily trading in the PDS. In 1994, Citibank/Manila developed a local dollar-clearing system to substitute for the earlier arrangement of clearing in dollar/peso transactions in New York. This reduced exposure to credit and exchange risks from several days to several hours.

All restrictions on the sale of foreign exchange by nonbank institutions were lifted, and all licensed banks may operate as Authorized Agent Banks (AAB) in foreign exchange trading. The only requirement for nonbanks is a municipal business license. But the participants in the official interbank market remain limited to the members of the Bankers Association of the Philippines (BAP), the organization of which manages the market. BAP has resisted opening its market because of the lack of reciprocal credit lines with nonbanks. The membership has expanded by 4, making a total of 35 since 1992, because some savings institutions have converted to commercial banks and have been designated AABs by the Central Bank. Trading continues to be concentrated among a small number of institutions. The top five (two American, two Hong Kong, and one Philippine bank) account for more than half the volume.

The market has also widened, nevertheless, with the entry of investment houses, finance companies, and some former bankers who have contacts and knowledge of client requirements and believe they can make money from arbitrage. These new entrants compete for the clientele that

previously had to deal with banks—but now they have a choice. Although they are relatively small and tend not to take positions in foreign exchange, their presence has forced banks to establish brokers to compete. The bank-owned brokers are now the major players in the brokering segment of the nonbank market. The best indication that the market offers new opportunities is the establishment in Manila, in March 1995, of a London-based broker.

There are, of course, large foreign exchange dealers, as well as the ubiquitous street corner shops that operated in the parallel market before the liberalization reforms. On the one hand, both these nonbank intermediaries must now compete more strenuously with the banks for overseas worker remittances as a result of the reforms. On the other hand, the reforms also allow foreign exchange dealers to compete with the banks for the repatriated earnings of exporters. Because of continuing Central Bank restrictions on the way banks make payments in foreign exchange, the nonbank market still commands a nominal premium (as of early 1995). The nonbank market also avoids the documentary tax on transactions levied in the bank market.

Greater competition between the banks has brought down commission rates from 1 peso (100 basis points) between bid and offer on the interbank market to 10 basis points currently. In the bank-customer market commissions have dropped from 25 to 15 basis points. Commissions that averaged 50 basis points in the old parallel market have been reduced to 10 currently.

To sum up, the market is broader, more competitive, and more immediately susceptible to the forces of supply and demand. However, the principal traders are still a small number of banks, either in their regular capacities or through their nonbank companies.

Liberalizing Exchange Restrictions

The changes in the exchange control system are more sweeping. An earlier report by Nathan Associates lists the specific measures that were taken from January 1992 to April 1993.³ The current state of the exchange control system is described in Central Bank Circular No. 1389 of April 18, 1993. Since then it has been slightly modified, but not significantly altered, by a number of decisions of the Monetary Board (chaired by the governor), which is the ultimate authority on this subject.

The peso is now *de facto* convertible for all current transactions, namely, exports and imports of goods and services, the payment and receipt of interest, and salaries and remittances. This means that any foreign exchange received as a result of these activities may be retained in that form or converted depending only on what the holder wants to do. For purchases of foreign exchange, however, the Central Bank regulations distinguish between bank-customer and nonbank-customer transactions. Bank-customer transactions need justification—for example, the payment for an import, a requirement for a remittance, a "reasonable" amount for travel—whereas in the nonbank market there is no specific documentation or limits.

There continue to be extensive restrictions on capital movements, with two exceptions: (1) foreign loans and portfolio transactions of less than 1 year's duration and (2) foreign direct investment, which need only be registered because the Central Bank continues to make the same distinction referred to in connection with current payments—that is, the repatriation and servicing of foreign investments and loans can draw on the banking system's foreign exchange only if it originated in a transfer that passed through and was registered by a bank. Although foreign investors need not register, apparently they all do.

³ *Monitoring and Assessment of Tranche 3 of the Philippines Support for Development Program II*, Nathan Associates and Louis Berger International, August 1993.

As part of its responsibility for management of the external debt, the Central Bank requires prior approval for borrowing by the public sector as well as any private borrowing that benefits from a public guaranty and all borrowing with maturities greater than 1 year.

Outward investments by Philippine residents that require purchases of foreign exchange from the banking system are also regulated. However, the automatic limit is now \$6 million, which is fairly substantial by local standards.

Role of USAID and Outlook for Current Policy

The Mission's strategy for reform has two aspects: (1) encouraging greater liberalization and (2) providing technical assistance wherever necessary to implement specific measures. The latter is discussed later in the section "Technical Assistance." The positive gap between the comprehensive achievement of exchange control liberalization and the generalized nature of the commitments is in part the result of the patient negotiations of the USAID project officers building on the success of the first step as well as the dedication of Philippine authorities to the policy.

What is the outlook for continuation of the current policy, which represents a fundamental shift from the orientation until 1992? The Philippines has had other episodes of liberalization since independence in 1946, but all succumbed to balance-of-payments crises. The last episode occurred in the early 1970s when restrictions were light, foreign investment was being encouraged, and there were many foreign brokers operating in the exchange market. These liberalization efforts ended with the balance-of-payments crisis caused by the worldwide surge in oil prices later that decade.

To date no balance-of-payments problem has arisen to plague the most recent liberalization program, mainly because the new program began, in large part because of its success in diverting earnings back into official channels and attracting new sources of foreign capital. But as economic growth picks up, the current account deficit can be expected to widen again and place new pressures on the Central Bank.

Although no definitive forecast is possible, the probability is that liberalization will continue because

- It has been very effective in augmenting the country's foreign exchange resources;
- It fits well with the president's overall economic policy;
- The Philippine government is negotiating with the IMF to give the Philippines Article VIII status, which carries with it recognition by the IMF, the authority on this subject, that there are no exchange restrictions on current transactions; and
- Although the legal apparatus of exchange control remains in place, the number of personnel assigned to enforcement has declined from 550 to 100.

It is clear that the authorities, by virtue of their connection with the IMF, do expect to make the policy permanent. Once they do so their prestige and credibility would be involved in keeping it permanent. Nevertheless, by documentation requirements over payments and controls over capital movements and other reports required from the banks, the authorities can follow very closely what is happening and retain the option to reimpose controls if they thought it necessary.

To sum up, our conclusion is that

- The interbank market is much more open to market forces and is more competitive than it was in 1991; and
- The liberalization of foreign exchange controls has been more extensive than required by SDP II conditions.

In fact, the way the Central Bank has entered into the spirit as well as the letter of the program has made it a principal element in the president's economic policy of opening the Philippine economy to foreign investment.

More Efficient Processing of Tax and Duty Refunds by the One-Stop Shop

On February 7, 1992, Philippine President Corazón Aquino issued Administrative Order (AO) 266, creating the Interagency Tax Credit and Duty Drawback Center, or One-Stop Shop. The purpose of the OSS was to facilitate the processing of applications for duty drawback and tax credit that were then handled by various agencies, namely, BIR, BOC, BOI, and Department of Finance (DOF). AO 266 mandated the OSS to issue tax credit certificates (TCC) within 30 working days of the date of acceptance of completed applications for duty drawback and tax credit.

The OSS formally started operations on May 8, 1992. The audit and verification division of the OSS, which is responsible for the actual processing of duty drawback and tax credit claims, is divided into four groups: the Duty Drawback Group (or BOC group), the Investment Incentives Group (or BOI group), the Tax Refund Group (or BIR group), and the Government Transactions Group (or DOF group).

In the 32 months between May 1992 and December 1994, the OSS performed well, reducing significantly the processing time for duty drawback and VAT credit claims. During this period, the OSS issued 6,580 TCCs worth P10.5 billion. On the average, the value of tax-duty rebates given represented 6.3 percent of the value of associated export receipts (see Table 3-1).

At the same time, the OSS made significant gains in expediting the processing of duty drawback and tax credit applications. From May 1992 to December 1994, the average processing time of claims for duty and tax rebates at the OSS was reduced to 23.3 days in 1992, 29.3 days in 1993, and 26 days in 1994, compared with 1-2 years in the period before its operation (see Table 3-2).

Of the TCCs issued in 1992-1994, 99.3 percent were processed within the OSS's own target of 30 working days from the date completed applications were received. Moreover, processing of the remaining 0.7 percent of TCCs was completed within the SDP II's target of 60 working days. Thus, OSS met the letter as well as the spirit of the performance indicators under Tranches 2 and 3. Although the data presented here show accomplishments of the OSS up to the end of 1994, the Third Tranche Monitoring Report (Nathan Associates 1993) indicates that the Philippine government had fully complied with the SDP II performance indicators on the OSS as early as June 1993.

**Table 3-1. Number and Value of TCCs Issued by the OSS,
May 1992-December 1994**

	Number of TCCs	Value of TCCs (million pesos)	Value of Exports (million pesos)	Ratio of Group Value of TCCs to Value of Exports
BOI Group	4,707 (71.5)	4,380 (41.9)	68,546 (41.4)	6.39
BOC Group	1,471 (22.4)	5,666 (54.2)	50,915 (30.6)	11.13
BIR Group	326 (5.0)	272 (2.6)	45,470 (27.3)	0.60
DOF Group	76 (1.2)	1,376 (1.3)	1,676 (1.0)	8.23
Total	6,580	10,457	166,608	6.28

Note: Numbers in parentheses represent percentage shares of totals.

Source of basic data: OSS.

**Table 3-2. Age of TCC Issuances for Non-VAT Claims,
May 1992–December 1994**

Number of Days to Process	1992	1993	1994	1992–1994
Fewer than or equal to 30	1,032 (99.5)	2,625 (99.2)	2,553 (99.2)	621 (99.3)
31 to 60	5 (0.5)	21 (0.8)	20 (0.8)	46 (0.7)
More than 60	0 (0.0)	0 (0.0)	0 (0.0)	0 (0.0)
Total	1,037	2,646	2,573	6,256
Average number of days to process	23.3	29.3	26.0	26.2

Note: Numbers in parentheses represent percentage shares of totals.

Source of basic data: OSS.

In August 1991, the BIR issued Revenue Administration Memorandum Order (RAMO) 3-91. The intent of RAMO 3-91 was to speed up the processing of exporters' VAT credit claims filed with the VAT Division of the BIR. The order prescribed guidelines on the issuance of tentative TCCs equivalent to 40 percent of the amount being claimed by zero-rated or effectively zero-rated VAT payers within 20 working days of the scheduled test-checking of 20 percent of the input taxes paid and 20 percent of the export sales reported. The TCC for the remaining 60 percent of the amount of VAT credit being claimed is given when the full audit is completed.

The BIR began implementing RAMO 3-91 in February 1992. However, VAT payers were given the option of choosing to have their claims processed under either RAMO 1-91 or RAMO 3-91.⁴

When the OSS was established, the processing of applications for tentative tax credit certificates (covering 40 percent of the claim) under RAMO 3-91 was transferred to the OSS. However, VAT Division of BIR continued to administer applications filed under RAMO 1-91 and the full audit before the release of the remaining 60 percent of the claims filed under RAMO 3-91.

There was some evidence that taxpayers prefer to apply for their VAT credits under RAMO 1-91. In the year between May 1992 and April 1993, the OSS received only 36 applications for VAT credit under RAMO 3-91. In contrast, the VAT Division received 86 applications in the 3-month period covering January–March 1993. This was traced to the reluctance of taxpayers to subject themselves to audit twice under RAMO 3-91 when RAMO 1-91 required only a single audit.

Scrutinizing the length of processing time of VAT credit claims at the VAT Division, it was observed that although 97.3 percent of the 75 TCCs issued in January–March 1993 were processed within 60 working days of the date the last required document was received, only two TCCs were completed within 60 working days of the date of the issuance of the Letter of Authority to audit. In fact, it took the VAT Division 294 days on the average (figured from the date of issuance of the Letter of Authority) to process the 75 TCCs in question.⁵ From this information, it was unclear whether the specific requirements of the Tranche 3 performance indicator for the VAT credit system had been met as of June 1993.

In response to this problem, the Philippine government, specifically the DOF, undertook remedial measures. It transferred the evaluation of direct exporters' applications for VAT credit from the BIR to the OSS effective October 1, 1993. At the same time, the BIR issued RAMO 2-93, which

⁴RAMO 1-91 governed all applications for VAT credit claims before the issuance of RAMO 3-91. Under RAMO 1-91, the TCC for 100 percent of the approved amount of VAT credit claim is awarded only after a full audit is completed.

⁵The difference between these alternative methods of measuring the VAT Division's processing time is traced to the down-time involved when the BIR does not work on the application while waiting for the taxpayer to submit additional documents.

prescribed the guidelines for the processing and issuance of TCCs for VAT credit claims filed at the OSS.

RAMO 2-93 streamlined the two-step processing mandated in RAMO 3-91 by

- Introducing a one-step, full processing of VAT credit claims;
- Not requiring a Letter of Authority issued by the BIR Commissioner before the audit of the claim;
- Simplifying the evaluation reports to be prepared by the examiners;
- Reducing the number of reviewers from 7 to 5; and
- Reducing the number of signatories on the TCCs from 5 to 2.

These changes represent significant procedural improvements in shortening the time required for VAT credit claims.

Between October 1, 1993, and August 31, 1994, the OSS received 470 applications for VAT rebates worth P584.7 million (see Table 3-3). By the end of this period, 296 VAT credit claims worth P350.4 million had been accepted (i.e., checklisted and found to have complete documentation) and 70 of these applications have been issued TCCs worth P88.8 million. Conversely, three claims worth P0.6 million were denied during this period.

Table 3-3. Status of Applications for VAT Credit, October 1, 1993 to August 31, 1994

	Number of Claims	Amount of Claims (million pesos)
Processed	128	183.3
Signed/Released	70	88.8
Denied	3	0.6
Reported/For Signature	13	41.4
For Report	42	52.5
In Process	168	167.1
Field Audit	66	47.0
Office Audit	102	120.1
Subtotal	296	350.4
Filed/Under Checklisting	174	234.3
Total	470	584.7

Source of basic data: OSS.

For the periods ending April, May, June, and July 1994, more than 90 percent of the applications that were approved or denied were completely processed in 60 or fewer working days. However, in August 1994 the OSS's performance registered a slight deterioration. Thus, for the period ending in August, only 88.2 percent of the VAT credit claims that were approved or denied were processed fully within the prescribed time. Thus, it is apparent that the OSS had complied with the Tranche 3 VAT credit indicator by August 1994.

The slowdown in the OSS's pace in August resulted from constraints on the sustainability of OSS operations. These constraints were primarily rooted in the staffing, budgetary, and procedural aspects of the OSS. However, the issuance of AO 138, which makes the OSS a permanent unit of the DOF, augurs well for its continued good performance.

Reducing Debt Servicing Costs by Mobilizing Small Savers

On June 5, 1992, the Secretary of the DOF signed a Department Order creating the Interagency Committee on Small Savers Instrument (IACSSI) to manage the implementation of the Small Savers

Instrument Program. The Department Order also implicitly approved the action plan (largely on the basis of a study supported by the Technical Support Component of SDP II) for improving the access of small savers to government securities.

There were indications that in early 1993 the DOF planned to pursue the issuance of SSIs in the second half of that year. For instance, the 1993 financing program prepared by the Bureau of Treasury during this time contained an entry of P1 billion from SSIs. However, when Secretary Ernest Leung assumed office in June 1993, he raised four reservations concerning the use of SSIs:

1. Security of marketing, holding, and redemption of the instrument;
2. The financial feasibility of SSIs in view of the decline in T-bill rates in 1993;
3. The appropriate denomination of the bond; and
4. The appropriate means of marketing and distribution of the SSI.

With regard to the financial feasibility of the SSI, for the government to benefit from the issue, the gap between the interest rate paid to purchasers of SSIs and the T-bill rate should be large enough to yield savings in interest payments that are greater than the cost of issuing the SSI. From a cost-benefit analysis conducted along the lines suggested by the SSI study, it was found that the cost of issuing SSIs would have exceeded the interest savings from doing so given the lower T-bill rates (12.5 percent) and the rate of inflation (8.3 percent) that actually prevailed in 1993-1994.

Another issue that made the department hesitate was the prospect that Treasury securities might circulate among unsophisticated investors, creating the danger that counterfeiting might become widespread and destroy the credibility of the paper. Whatever the mix of reasons, the project was suspended.

Our earlier assessment (see report on Tranche 3 implementation) was that a good faith effort had been made and that the Philippine government should not be penalized under the circumstances for not proceeding with test marketing.

The real issue in deciding whether to pursue this technique as a means of reducing debt-servicing costs is what time horizon to employ. The official can be justified under the current circumstances, but over a longer period he or she may not be. It is expensive initially to set up a financial network to distribute and service a small denomination security, but it may be worth it as a long-term project because

- Inflation and high interest rates in the future cannot be ruled out in view of the country's history;
- If the securities prove successful, the initial costs can be amortized over a long period; and
- In a country with a very undeveloped financial system outside the major cities, a Treasury security may be the best vehicle to attract savings.

TECHNICAL ASSISTANCE

Technical assistance was provided in four areas:

1. Assisting the Central Bank in managing the expanded interbank foreign exchange market,
2. Streamlining tax and duty refunds,
3. Establishing a small savers instrument, and
4. Improving management information systems.

Foreign Exchange Market Management

Assistance to the Central Bank consisted of providing computers and associated help to enable the bank to monitor the expanded market. In addition, the bank (1) sent three officials to a seminar in the United States to broaden their perspective on economic and trade policies that relate to foreign exchange and the exchange rate and (2) financed an assessment of the Philippine Dealing System. The bank believes that the help it received was effective in facilitating its new role in the foreign exchange market. However, according to the head of the Research Department, the emphasis on monitoring the foreign exchange market meant that the bulk of computer support went to the operational division doing that work. His department felt shortchanged as a result. He hopes for more support under the more recent agreement between USAID and the Central Bank to strengthen the capabilities of the new Central Bank, on the basis of its position as one of the best sources of economic data in the country.

Streamlining of Tax and Duty Refunds

The OSS and the VAT Division received various types of technical assistance during SDP II.

1. The OSS acquired four personal computers under the Technical Support Component (TSC) in the early part of SDP II. This assistance was deemed to be particularly timely because it came when the budgetary and logistics support to the OSS from the government was still uncertain.
2. Senior officials of the OSS were sent on a study tour of the agencies handling duty and tax refunds to exporters in New Zealand, and the Chief of the VAT Division of the BIR went to Indonesia with SDP II support to observe VAT administration there.
3. The TSC funded a study on the management information system requirements of the OSS. Both the VAT Division and the OSS received technical advisory services on the needed procedural improvements in processing duty drawback and VAT credit claims.
4. A number of seminars attended by OSS personnel were sponsored by the TSC, namely, a strategic planning workshop, a team-building workshop, a strategic review seminar, and a VAT strategic management seminar.

Establishment of Small Savers Instrument

A study on small savers instruments was undertaken under the technical assistance component of SDP II. The objectives of this study were to

- Devise a workable way to further the mobilization of small savings, particularly in secondary cities and rural areas;
- Provide a positive real rate of return on savings;
- Encourage the promotion of a savings mentality; and
- Make available to the government a new pool of funds that could be used to finance the public debt at rates less than those of T-bills and with a term of more than one year.

The study identified the following minimum sequential action plan for the issuance of small savers instruments:

1. Appoint a relatively senior official who has relevant experience with countrywide responsibility and full authority to oversee the project;

2. Choose two test markets for conducting controlled experiments, one a secondary city and the other a frontier city;
3. Use the following institutions as testing institutions: the post office (in both Cebu and General Santos); VICTO, a federation of cooperatives in Cebu; a selected rural bank in General Santos; and a selected commercial or thrift bank in Cebu;
4. Establish the interest rate and front-end discount;
5. Design the mechanics of the small savers instrument;
6. Identify and define the distribution system;
7. Identify and define the audit and control procedures; and
8. Identify and appoint a team to design and oversee the implementation of an educational promotion program.

As mentioned earlier, the IACSSI generally agreed to the recommendations of this study. Although there were indications that the Philippine government seriously considered the use of SSI on experimental basis in early 1993, lower interest rates prevailing from 1993 onward prompted it to reconsider the financial feasibility of the SSI. Thus, no SSI test marketing was conducted.

Improvement of Management Information Systems

Improvements in the management information system at OSS were noted earlier. The situation at the National Economic and Development Authority (NEDA) was different and more complex. The management information system was to be improved to let NEDA and DOF monitor closely a whole host of factors and events that could affect the progress of exports. The contractor chose to interpret this mission as revolving around the Philippine Institute of Development Studies' (PIDS) forecasting model. It took credit for modifications in the model that it felt were sufficient to establish the monitoring system. NEDA objected that the changes to the model had already made before the contractor had begun work and that the model alone was insufficient to improve the monitoring system to the point at which NEDA would consider it to be sufficiently useful to do its work.

RELATED PROJECTS

Two other projects relate to the areas of policy reform under consideration here: A.I.D.'s Private Enterprise Policy Support (PEPS) program and the World Bank Economic Integration loan.

A.I.D. Private Enterprise Policy Support Program

The major purposes of the \$79 million PEPS grant in balance-of-payments support were to assist in the implementation of reforms for tariff reduction and restructuring and to encourage foreign investments by limiting the excluded categories and liberalizing foreign equity participation. The grant was scheduled to be disbursed in two tranches of \$39.5 million each, originally to be completed in 1991 and 1992, each tranche conditional on progress achieved in the specified reforms. Monitoring, evaluation, technical assistance, and policy studies in pursuit of the same goals was also provided in the amount of \$828,000.

Two sets of objectives were included in the grant agreement entered into by A.I.D. and the Government of the Philippines in August 1991:

- *Encouragement of Investments*—to stimulate foreign investments by clearly specifying areas in which foreign equity investments are limited, and by liberalizing foreign equity participation for the other areas, including export-oriented industry; and

- **Tariff Reduction and Restructuring**—to encourage international competitiveness and improve tariff administration by reducing the average protection in the economy, improving the protection structure, and simplifying the tariff structure.

During Tranche 1, actions taken in accordance with these tariff and investment objectives included (1) a tariff reduction and liberalization program implemented with the issuance of EO 470 and EO 8; and (2) a new foreign investment law passed by Congress and implementing rules and regulations issued with provisions compatible with the agreed policy objective.

During Tranche 2, although the grant was scheduled to be fully disbursed in 1992, actions taken by the Philippine government that year were setbacks to import trade reform, and payment of the grant was delayed to enable new measures to be taken. Specifically, the first of two actions that USAID/ Manila judged to be contrary to the spirit and letter of the agreement was the passage and implementation of the Magna Charta for Small Farmers, which greatly increased the import duties on several agricultural products. The second action was the globalization of a new "home consumption value" (HCV) method (see next section, "World Bank Economic Integration Loan") of calculating the value of imports, which in effect increased the average protection in the economy, offsetting tariff reductions made under EO 470.

Because the last two actions were not modified, \$15 million of the PEPS grant was deobligated and not transferred as scheduled.

World Bank Economic Integration Loan

In the last several years a series of loans have been made by the International Bank for Reconstruction and Development (IBRD) as part of the international donor community's broad Structural Adjustment Program for the Philippines. In particular, the World Bank's \$200 million Economic Integration Loan (EIL), concluded in 1991, was the most recent IBRD project that clearly linked conditionality to a number of broad economic policy reforms and targets. The broad objectives were (1) the strengthening of the country's industrial base by fostering trade regime reforms and (2) increased domestic and foreign investment to achieve export-oriented economic growth in the pattern of the so-called Asian Tigers. This IBRD loan was matched by a loan of \$200 million from the Export-Import Bank of Japan, linked to the same objectives.

The major policy objectives related to the EIL have been

- Improved macroeconomic management to foster a more stable business climate,
- Broad reduction in import duty rates,
- Reform of the customs valuation system,
- Reduction leading to elimination of reliance on import quotas,
- Reform of BOI and investments laws and regulations to focus on investment promotion rather than regulation and to encourage foreign direct investment, and
- Privatization of the state-owned sector and maritime and land transport reforms.

The first tranche of the EIL, \$160 million, with a similar amount from Japan, was extended in 1993 following an initial set of reforms related to the criteria listed earlier. The concluding tranche, \$40 million, has been released by the IBRD and should be paid out shortly, as will the remaining Japanese government credit. The IBRD acknowledged that the government has not yet fully satisfied the criteria, particularly with respect to trade liberalization and the home consumption value (HCV) method of customs valuation. However, with the Philippines' adherence to the Uruguay Round agreements, including participation in the new World Trade Organization (WTO), there is a commitment to further reduction of tariffs and quotas and abandonment of HCV over the next

several years. The EIL is anticipated to be the last of the broad structural adjustment loans by the Bank to the Philippines.

IMF Extended Fund Agreement

In 1994, the IMF agreed to an extended fund agreement providing for phased disbursements through 1997. Although the monetary and fiscal targets are the primary objectives, the accord also calls for continued progress in the reduction of tariffs after 1995 and the eventual elimination of quantitative restrictions.

4. Economic and Policy Impact

The purpose of this chapter is to measure the economic and policy impact of the SDP II program. We will examine both the effect of specific economic variables (such as the exchange rate, exports, and growth) and the way in which policies related to export competitiveness are conducted. We can approach this measurement problem from two perspectives:

1. Measuring the impact of the transfer of resources provided for by the grant, and
2. Assessing the economic impact of the policy reforms actually implemented.

The first perspective was important in the evaluation of the first SDP program because almost four times as many dollars were spent in one-half the elapsed time. For SDP II, however, the effect on the overall Philippines economy (\$53 billion GDP in 1992) of the expenditure of \$60 million over 3 years is more difficult to trace. Nevertheless, some results are included in the following discussion, along with other conclusions of the simulation.

Our impact analysis will be conducted mainly from the second perspective, that is, assessing the impact of the policy reforms that were implemented. This analysis will employ two techniques. The first technique is to examine the sectoral impact, illustrated to the extent possible by statistics. Examples would be the behavior of the interbank exchange market or the improvement in the return to exporters brought about by the One-Stop Shop (OSS). The second technique is to make use of the PIDS-NEDA Macroeconomic Model to provide simulations of the potential effect that SDP II policies could have on growth, the balance of payments, and the rate of inflation.

On the basis of this analysis, an assessment of overall impact is made along with order-of-magnitude estimates of the costs and benefits of the SDP II program.

IMPACT OF POLICY CONDITIONALITY

Foreign Exchange Liberalization

The impact of this program, which was the principal condition attached to SDP II, has been evident in the balance of payments, the volume of transactions in the interbank exchange market, the Central Bank's intervention policy, and exchange rate behavior.

Table 4-1 sums up the principal elements of the balance-of-payments current account. The economic backdrop is the resumption of Philippine growth in 1992 and 1993, culminating in a 5 percent increase of GNP in 1994. At the same time, the Philippines' principal export markets, the United States, Europe, and finally Japan, were also reviving.

On the one hand, the elimination of most restrictions on current receipts, payments, and short-term capital movements, aided by growing political stability and relatively high internal interest rates, led to a major increase in invisible receipts, inward portfolio investment, and a general preference for peso over dollar assets. On the other hand, the consequent upward pressure on the peso resulted in higher appreciation than would have occurred under the old regime of restrictions, even despite the Central Bank's interventions to stem the tide.

Table 4-1. Current Account (\$ billion)

	1991	1992	1993	1994 ^a
Exports	8.8	9.8	11.4	13.4
Imports	12.1	14.5	17.6	21.3
Trade balance	-3.2	-4.7	-6.2	-7.9
Invisible receipts	5.5	7.5	7.5	10.5
Invisible payments	-4.3	-4.6	-5.3	-6.6
Balance of invisibility	1.4	2.9	2.2	3.9
Net transfers	0.8	0.8	0.7	0.9
Current account balance	-1.0	-1.0	-3.3	-3.1

^aEstimated on the basis of 11 months' data.

Source: Central Bank.

We have not attempted to disentangle the effects of liberalization from the economic conditions in which it took place. The fact that the authorities were carrying out a stabilization program that was keeping interest rates high, restraining inflation, and depressing growth and the demand for imports would by itself have improved the balance of payments and reduced the gap between the official and black-market exchange rates in 1991–1992. Exchange control liberalization bolstered confidence. This positively affected expectations and made the peso relatively more attractive, compared with the dollar, than it had been—not only temporarily but for the longer term. The supply of dollars in the black market increased, and demand fell. The gap disappeared, making most transactions official. By 1993 the stabilization policy had relaxed and demand for foreign exchange increased; however, inward capital movements, stimulated by liberalization, continued.

In addition, the role of interest rates as an independent force has been exaggerated. Most invisible current receipts, such as the repatriation of overseas earnings and tourist spending, are not particularly sensitive to relative interest rates. In addition, Philippine interest rates are always higher than those in the principal money markets. When interest rates are important, as in the case of short-term capital movements, liberalization made it possible for the first time to arbitrage and take advantage of the gap. Even then, much arbitrage would not have taken place without the combined effect of the inflow from all sources and policies giving the arbitrageurs the expectation that exchange-rate risk was low.

Therefore, we believe that the impact of liberalization can be measured by looking at changes in invisible receipts and capital movements whose magnitude allowed the country to resume a respectable rate of growth without suffering from a balance-of-payments crisis. For example, with respect to invisible receipts, the improvement was sufficient to offset \$3 billion of the \$5 billion deterioration in the trade balance between 1991 and 1994 (see Table 4-1 for details).

The two most important items in the category "invisible receipts" are "wages and salaries" and "tourism." To a large degree, although no accurate quantitative measure is possible, the increase represents the fact that the large number of Philippine workers abroad are using banks instead of the parallel market to send home their earnings. As the banks have extended their services overseas and workers have realized that official channels are more reliable, this trend has continued. There has also been a substantial increase in the number of workers abroad.

Tourism receipts, for which the statistic of arrivals is more reliable, are affected both by increased numbers and by the use of the official market now that the premium in the parallel market has disappeared. These two types of earnings, in addition to personal remittances, added \$1.3 billion to receipts from 1991 to 1994. Withdrawals from Foreign Currency Deposit Units (FCDU) represent all types of current earnings that were deposited first into dollar accounts before being converted into pesos. The FCDU accounts allowed legal holders of foreign exchange, who were in the past non-

residents, to defer conversion of their dollars when it was preferable. The much larger volume of conversions since 1992 is an indication that expectations of peso depreciation had diminished.

The most significant short-term capital movements are portfolio investments. The freedom after early 1992 to move in and out of the treasury-bill and stock markets inspired large-scale arbitrage between relatively low dollar interest rates and the higher peso returns as well as increased purchase of local stocks. This is a trend that can be self-reinforcing, that is, an inflow tends to cause the peso to appreciate, making past inflows even more profitable. This can attract more inflows from investors who expect the trend to continue. But even when the peso was depreciating in 1993, capital inflow in these categories continued to gather strength.

In the long term, the rapid growth of foreign direct investments after 1992 in part reflects the advantage of having a more market-oriented exchange rate, but it also reflects fewer restrictions on the type of investments permitted in the 1991 investment act, as well as greater political stability.

Although the new exchange control regime has made Philippine investment abroad through legal channels much easier, it has also encouraged the repatriation of Philippine investments abroad, a trend that only became important in 1994. It is striking that while foreigners were investing in Philippine securities, Filipinos were using their new freedom—up to \$6 million without special authorization—to buy foreign currency-denominated securities.

The net quantitative result of both the improvement of current invisible earnings and the increase in capital inflows by 1994 is an increase of \$4.5 billion, or more than a doubling of the 1991 level. This inflow has enabled the Philippines to finance a much larger trade deficit (see Table 4-2).

Table 4-2. Selected Invisible Receipts and Capital Inflows, 1991–1994 (\$million)

	1991	1992	1993	1994 ^a
Wages and salaries	1,649	2,222	2,276	2,940
Personal remittances	329	315	311	434
Tourism	571	944	1,178	975
FDCU withdrawals ^b	866	1,263	1,680	2,855
Subtotal	3,415	4,744	5,445	7,204
Foreign portfolio investment	227	566	2,257	3,037
Foreign portfolio disinvestment	-102	-411	-1,360	-2,083 ^c
Subtotal	23	255	897	944
Foreign direct investment	130	234	334	802
Reinvested earnings	34	42	43	25
Subtotal	164	276	377	827
Philippine portfolio investment	-15	-115	-1,061	-1,335
Philippine direct investment	-2	-16	-106	-61
Repatriated Philippine investment	15	22	112	652
Subtotal	-2	-109	-1,054	-744
Total	3,600	5,166	5,665	8,051

^aEstimated on the basis of 11 months' data.

^b347/547 dollar amounts.

^cIncludes a small amount of foreign direct investment.

Source: Central Bank.

Table 4-3 summarizes the evolution of the interbank market since 1991, the year before the PDS was established. First, as was hoped, the volume of transactions has risen sharply. More important, transactions by commercial banks have risen from \$10 million a day in 1991 to \$50 million a day in 1994. Central Bank intervention remains important, but the rate is now formed by the interaction of the commercial banks and the bank rather than being dominated by the bank.

By international standards, the volume of transactions is still very small. Speculative inflows and outflows of \$100 or 200 million can destabilize the market and require Central Bank intervention.

Table 4-3. Transactions in the Interbank Foreign Exchange Market, 1991-1994 (\$billion)

	(1) Total Volume	(2) Central Bank Net Position ^a	(3) Commercial Bank Volume ^b	(4) Daily Average ^c	(5) Average Exchange Rate
1991	2.2	1.8	2.3	10	27.5
1992	3.9	2.3	5.1	21	25.5
1993	5.0	-0.1	8.4	35	27.1
1994	7.5	2.9	12.1	50	26.4

^aNet purchases, positive; net sales negative.

^bPurchases plus sales.

^cFigures in this column are obtained by dividing preceding figures in column 3 by 240 working days.

Source: Central Bank.

Although always based on a floating rate, the peso was devalued from about 25/1⁶ to 28/1 in November 1990. From that point the peso appreciated to 24.5/1 in August 1992. In most months in that period, therefore, the Central Bank intervened to slow appreciation by purchasing foreign exchange. Its net purchases for 1991 and 1992 totaled \$4.1 billion. After September 1992 the peso depreciated, reaching a low of 29/1 in October 1993. The bank bought dollars until it reached 26/1 in April, and started to sell thereafter. Over this period net intervention was close to zero—that is, the bank made gross sales and purchases of about \$1 billion each. After November 1993 the peso appreciated, reaching a high of 24/1 in December 1994. Leaning against the trend, the bank bought dollars exclusively in 1994, bringing its net purchases to \$7 billion for the 4 years. The average exchange rate for the whole period was 26.6/1.

In the past four years the behavior of the peso has differed from most of its earlier history. Before, it depreciated at various rates of speed. Since 1991—if we take the average rate of 26.6/1 as a hypothetical "parity"—the peso's extreme movements have been confined within a band of about 10 percent on either side. Because the current account deficit has been manageable in view of capital inflow (except in 1993), the bank has intervened in the market, mostly by buying dollars (selling pesos), which slowed the appreciation of the peso. The bank sold dollars in substantial amounts only from April to November 1993, to brake the depreciation of the peso.

Market intervention is the bank's primary tool for managing the exchange market. The bank is limited in its ability to purchase dollars because such interventions have an expansive impact on internal liquidity, which conflicts with the policy objective of reducing the rate of inflation and the specific commitments the bank has made to the IMF. For that reason, when the Central Bank bought dollars, it typically sold domestic securities in an open market operation to withdraw much of the liquidity injected when buying foreign exchange. Because dollar interest rates were lower than domestic rates, the Central Bank suffered a loss of interest income and, frequently, an exchange loss because the appreciating peso reduced the peso value of dollar holdings. When the Central Bank was burdened with exchange losses of old government foreign debts, this process simply increased the large annual loss. The establishment of the new Central Bank during the 1993 reorganization, combined with the transfer of debts to the government, have given the bank greater freedom to maneuver in the exchange market. Nevertheless, from the point of view of a monetary policy targeted on reducing inflation, the bank is, all other things being equal, biased in favor of appreciation of the peso—a bias that has a depressing effect on exports.

The other weapons the bank possesses are the control of short-term interest rates and further modifications in exchange controls. Raising interest yields in the money market provides an incentive for the conversion of dollars into peso assets; conversely, lowering yields makes dollars

⁶Ratios are expressed in terms of pesos per dollar.

more attractive. Lowering interest rates to fend off excessive capital inflows fits in with the policy since 1991 of promoting domestic investment. Raising interest rates sharply to defend the peso for any length of time conflicts with that objective. The presence of so much short-term investment may also require that the bank use interest rates to convince these investors that the peso will not drop too sharply and precipitate their abrupt withdrawal.

Finally, the bank still has direct controls that it can modify to encourage or discourage the inflow of foreign exchange. For example, in 1994 when the problem was excess inflow, the bank increased the ability of Philippine investors to send money abroad. The bank also curbed forward transactions with nonresidents and started the process of lifting a public form of forward exchange guarantees to oil imports, causing the companies to enter the market to buy their own cover.

The history of the past three years leaves little doubt that the exchange system is much more open and reacts more quickly to demand and supply than it did before 1991 and that the Central Bank can only manage these forces, not dominate them, even briefly. The expectation, when the program was launched, was that liberalization would lead to a depreciation of the exchange rate. So far that has happened only briefly. Consequently, the exchange rate has effectively appreciated. An estimate of the effect of that appreciation on exports is included in the section, later in this chapter, describing the results of the simulation.

The economic impact of foreign exchange liberalization may be summed up as follows:

- A more competitive foreign exchange market, less dominated by the Central Bank;
- Elimination of the parallel market and the redirection of a large quantity of invisible receipts into official channels;
- A major inflow of foreign and to some extent Philippine capital;
- A rebuilding of foreign exchange reserves to comfortable levels; and
- A loss of export competitiveness compared with 1990 as a result of exchange rate appreciation.

Improving the Return to Exporters by Accelerating Refunds

It is difficult to isolate the impact on exports of the streamlining of the duty drawback and the VAT credit systems under SDP II from the impact of other policy reform measures, such as the liberalization of foreign exchange regulations. However, two things are clear. First, relative to the old set-up, the streamlined procedures for the processing of duty drawback and VAT credit claims at the OSS allowed the government to issue more TCCs, which benefit more exporters. Second, a more expeditious rebate system on the net yields to exporters has a positive impact.

The average value of exports associated with duty and tax refunds in 1992–1994 increased 3.7 times over the value in 1985. In that year, duty and tax refunds given by the BOI and the BOC covered 6.9 percent of total exports, whereas those granted by the OSS covered 9.3 percent of total exports in 1992–1993.

The intent of duty drawback and VAT credit systems is to free inputs to exports from taxes and duties and, consequently, to put Philippine exporters on a par with their foreign competitors by giving them access to inputs at world market prices. However, even if mechanisms to handle rebates of duties and taxes on inputs into exports are in place, these systems still imply additional cost to exporters because such refunds are not given instantaneously. This additional cost is equal to the cost of working capital used to pay the tariffs and taxes on said inputs, and its magnitude is a function of the rate of interest and the length of time it takes the OSS to issue the TCC covering the claim. Thus, by reducing the time it takes to process the applications for duty drawback and VAT credit, the

establishment of the OSS reduces the capital holding cost of exporters and makes them more competitive.

For example, between May 1992 and December 1994, the OSS issued TCCs covering P10.5 billion of exports. If the processing of duty drawback and VAT credit claims takes 1 year, and if the rate of interest is 13.5 percent (the average rate of interest on 91-day T-bills), the capital cost of working capital required to pay the P10.5 billion in duties and taxes on inputs to exports would have been equal to P1.4 billion in 1992–1994. However, because the duty drawback and VAT credit claims covering said the P10.5 billion of exports were actually processed by the OSS in 1.2 calendar months, the capital holding cost after the establishment of the OSS equaled only P0.1 billion. Thus, the gross saving to exporters arising from the prompt processing of the P10.5 billion worth of TCCs actually issued by the OSS in 1992–1994 was P1.3 billion. After deducting P72 million in fees paid by exporters to the OSS, the net saving to exporters is equal to P1.2 billion. This represents about 0.7 percent of the value of associated exports.

Because the cost of operating the OSS during the period under study was only P22 million (P50 million less than the amount of fees collected by the OSS), the net benefit to society from the streamlining of the duty drawback and VAT credit systems was equal to P1.25 billion.

On a more anecdotal level, a small survey of exporters revealed that exporters themselves perceive a considerable improvement in the processing of their duty drawback and VAT credit claims with the establishment of the OSS. This observation was further validated during a public hearing recently conducted by the Task Force on Tax and Tariff Reform, when the confederation of semiconductor firms expressed their satisfaction with the OSS's record to date. However, in that meeting they also pointed out that the limited negotiability of TCCs severely limits the gains arising from their expeditious processing.

Reducing Debt Servicing Costs and the Small Savers Instruments

The economy experienced no direct effect from the SDP II SSI performance indicator because the small savers instrument was not implemented. Although it is possible that a small effect from its announcement could have occurred, this is unlikely.

The reduction in T-bill rates in 1993–1994 was traced to other factors, including the decline in interest rates in the major industrial countries, the decline in domestic rates of inflation, and the larger inflows of foreign capital as a result of the liberalization of the foreign exchange market. Meanwhile, the increase in deposit rates of interest during the period came about as the government exerted moral suasion on the banking sector.

SIMULATION OF THE BENEFITS OF THE SDP II PROGRAM

Using the PIDS model, four aspects of the SDP II program are simulated:

1. Tax/duty refunds,
2. Additional inflow of capital,
3. Appreciation of the peso, and
4. Combined effects.

Appendix E contains a description of the model, along with assumptions and supporting tables.

The original premise of SDP II was that a depreciating exchange rate resulting from exchange market reforms and accelerated tax and duty refunds would promote exports and growth. The reality was that the reform initially caused the peso to appreciate but stimulated greater capital inflow than expected, whereas the refund mechanism worked about as expected.

The technique of the simulation is to measure deviations from an expected trend. For the period for which data are available, 1992–1994, that means the difference between what happened and what was expected to happen. For the future, 1995–1998, the results reflect only the difference between two hypotheses. Therefore, the result should be regarded as illustrative of tendencies, and specific measurements as subject to a considerable margin of error.

The year 1992 was picked as a starting point because some of the SDP II measures were put into effect then. The end-year (1998) was chosen to allow most effects to be worked out, while not being so distant as to make the assumptions unrealistic.

Essentially, the simulation indicates that in 1992–1994, the depressing effects of the appreciation of the peso (compared with the baseline assumption) outweigh the stimulus of accelerated refunds and capital inflow, with exports and growth lower than the baseline. In 1995–1998, when both scenarios have the same exchange rate, the negative effect is reversed and growth rises above the baseline.

Accelerating Duty Drawback and VAT Refunds

The establishment of an efficient duty drawback system is calculated by Dr. Rosario Manasan (a member of the project team) to be equivalent to a 20 percent reduction in the implicit tariff on imported inputs. The VAT credit-claiming procedure is assumed to be equivalent to a reduction of 10 percent in implicit export tax on the domestic value-added component. These would tend to reduce the costs of production of exporters and, consequently, decrease export prices.

Findings of the evaluation team indicate that only about 10 percent of total exports were covered in 1992–1994. As the procedures become better known to exporters, it is assumed that the coverage will increase to 15 percent in 1995–1996 and 20 percent in 1997–1998, and that the effective stimulus to exports will increase proportionally. (See equation for this section in Appendix E.)

The cost of setting up the OSS is incorporated in the simulations. Initial estimates indicate that the government incurred P4 million in capital outlays corresponding to the cost for the physical infrastructure and equipment.

Simulations show that lower export prices increase exports over the baseline projection by amounts ranging from 0.17 percent in 1992 to 1.07 percent in 1998. Although imports increase because of the important import content of exports, the latter rise faster, resulting in an improvement in the trade balance and current account balance.

In the same period, GNP increases over the baseline, from 0.04 percent in 1992 to 0.21 percent in 1998.

Increased Capital Inflows

The reforms implemented toward liberalizing foreign exchange, together with the improved economic performance of the economy, brought about an increase in capital inflows in 1992–1994. The impact of the net capital flows is calculated by deducting the levels based on historical patterns. Although the additional capital may not be entirely due to SDP II, it is difficult to quantify the contribution of other factors (e.g., political stability) that could also have influenced foreign investors in their decision to bring in their capital. The simulation assumes it is used to purchase equity in new or existing firms.

The results indicate that the additional foreign capital leads to higher domestic investment. The expanded production capacity of the economy results in exports increasing 0.8 percent annually on the average. However, imports grow faster at an average rate of 0.9 percent, to accommodate the higher demand for imported capital equipment and raw materials. Consequently, the trade balance

worsens. The inflow of additional foreign capital, however, more than compensates for the deterioration in the trade balance, resulting in a positive impact on the balance of payments. Higher production capacity leads to higher output growth, with agriculture growing at an average of 0.2 percent annually and manufacturing at 0.8 percent. GNP grows on the average by 0.6 percent annually.

Appreciation of the Peso

The influx of foreign capital led to an appreciation of the peso, which tends to reduce the competitiveness of Philippine exports. The results of the simulation support this conclusion. Merchandise exports declined annually on the average by 1.64 percent in 1992–1994. Merchandise imports, made relatively cheaper by the appreciation, grew by 1.32 percent over the same period. This led to a deterioration in the trade balance and current account deficit. GNP declined by 1.15 percent, whereas employment contracted by 0.28 percent over the same period.

For 1995–1998, the simulation results in an average annual decrease in GNP of 0.7 percent. Exports decline by 1.03 percent, whereas imports increase by 0.5 percent. The smaller differences observed for 1995–1998 stem from the assumption that the exchange rate projection affected by SDP II will converge after 1995 with what would have been the projection in the absence of SDP II.

OVERALL IMPACT

The overall impact of SDP II is evaluated by carrying out a simulation incorporating the impact of the improved duty drawback and VAT systems and the foreign exchange liberalization.

As observed earlier, SDP II has both positive and negative impacts on the key macroeconomic variables. The negative effects on growth and exports are concentrated in 1992–1994. Exports fall about 3 percent while GNP declines 0.85 percent. This is because the appreciation of the peso overwhelms the acceleration of duty drawback and VAT refunds that have a positive impact on the economy primarily through lower costs for exporters. When the difference between the two assumed exchange rates disappears after 1996, this depressing factor is eliminated and growth increases, for a net gain of 1.5 percent for 1992–1998. Employment rises after 1993 for a net increase of 1 percent. The initial adverse impact on exports is offset by the end of the period when exports grow at 1.5 percent per annum faster than the trend.

The exchange rate assumption for 1996–1998 is that higher foreign exchange demand as a result of more rapid GNP growth offsets the more ample supply contributed by capital inflow. There is no net effect on the exchange rate, therefore, in this period.

However, even in the early years, the liberalization of the foreign exchange market, with its accompanying higher capital inflows, has the beneficial effects of increasing investment and, therefore, productive capacity as well as employment, after a short lag.

The positive impact increases for the 1995–1998 period. Value added in manufacturing is assumed to rise 7.5 percent over trend for a 7-year period, with a positive impact on exports, total output, and employment. One highly favorable effect of the appreciation of the peso in the first four years of the forecast period is its depressing impact on consumer price increases. For the whole 7-year period prices are 8 percent lower than they would be otherwise. This trend benefits exporters by lowering their costs and consumers by cutting the prices they have to pay.

As measured by the impact on growth, exports, and employment, the results indicate that SDP II has a small negative impact on the economy in 1992–1994. But even in this period prices are lower, manufacturing capacity greater, and consumption higher than the baseline. After 1995, the net impact for almost all indicators, especially growth and exports, is positive. There is no doubt that (1)

the net effect for 1992–1998 is to improve the performance of the Philippine economy and (2) the favorable impact would be larger if the projection were extended.

A COST–BENEFIT ANALYSIS

Employing to cost–benefit analysis, the calculation uses constant prices for 1985, the base year for the national income accounts series. The direct cost of the SDP II program is \$60 million, or P834 million, at the 1985 exchange rate (P13.9=\$1.00) over the 4 years from 1991 to 1994. The "benefits" in this case are defined and measured by the incremental annual increase in national income for 1991–1998, which is P15.4 billion. The undiscounted net benefits for 1991–1998 amount to P14.7 billion. Because net benefits continue to grow after 1998, extrapolating the series further into the future would increase total net benefits, but expected benefits in the next four years are already substantial. Projected annual benefits are presented in Table 4–4. The negative entries reflect both the program costs and the negative impact on GDP, both of which are concentrated in the period 1991–1994.

**Table 4–4. Projected Annual Benefits
(millions of pesos at constant 1985 prices)**

Year	Net Annual Benefits ^a			IRR
	Undiscounted	Discounted		
	@0 percent	@15 percent ^b	@20 percent	
1991	-355	-308	-296	
1992	-2,878	-2,252	-2,068	
1993	-1,867	-1,293	-1,138	
1994	-1,420	-812	-685	
1995	1,174	583	472	
1996	5,600	2,421	1,875	
1997	7,067	2,658	1,972	
1998	7,491	2,449	1,742	
Total	14,612	3,445	1,874	31 percent

^aFor 1991–1994, Net Annual Benefits = Actual National Income with SDP II program less Projected National Income without SDP II program less direct costs of SDP II program. For 1995–1998, Net Annual Benefits = Projected National Income with SDP II program less Projected National Income without SDP II program.

^b15 percent = Opportunity Cost of Capital used by Philippines National Economic Development Authority (NEDA).

Source: Consultant calculations.

Even over the brief 8-year projection period, estimated net benefits for SDP II are quite high. Using a 15 percent discount rate, which corresponds to the opportunity cost of capital used by NEDA, the discount net present worth (projected annual benefits less projected annual costs) amounts to P3.44 billion, at 1985 prices, or the equivalent of \$248 million dollars, net of SDP's \$60 million costs. From 1991–1998, the Philippine economy is expected to show 5 dollars of incremental increase in national income for each dollar of SDP II's program cost. A simple IRR calculation on the stream of net benefits from 1991 to 1998 yields an IRR of 31 percent.

5. The Economy in 1995 versus 1991

Having evaluated both the implementation and economic and policy impact of SDP II, we can now take stock of where the Philippine economy is now and what progress has been made since 1991 in ameliorating problems closely related to export competitiveness. The chapter is divided into three parts:

1. The state of the economy;
2. The current position on the four policy issues analyzed in Chapter 2—exchange rate realism, labor cost, foreign and private investment policy, and protectionism; and
3. The overall behavior of exports and sectoral trends.

STATE OF THE ECONOMY

At the beginning of 1995, the economy was in a far healthier state than it was at the end of 1991 (see Table 5-1). It is more stable—inflation and interest rates are noticeably lower and exchange reserves higher. At the same time the economy is growing faster than it has in 5 years. The balance-of-payments current account deficit has widened, but it has been financed without difficulty mostly by the inflow of long- and medium-term lending, foreign direct investment, and the repatriation of Philippine capital from abroad. Although this inflow has been a benefit, there is an element of vulnerability that underlies increasing dependence on inflows of portfolio investment to finance current account deficits. Portfolio investment contains some "hot money" that can leave as quickly as it arrived.

Table 5-1. Selected Economic Indicators (percent)

	1991	1992	1993	1994
1. GNP	0.7	1.4	2.6	5.1
2. Savings/GNP	17.7	19.0	17.9	16.7
3. CA/GDP ^a	2.3	2.0	6.0	5.0
4. CPSD/GNP ^b	1.6	2.0	3.0	0.1
5. M3 growth	15	11	25	23
6. COL	19	9	8	9
7. 91-day Treasury bills	21	16	12	14

Note: The COL and Treasury bill series are annual averages.

^aCA = current account.

^bCPSD = consolidated public sector deficit.

Sources: NEDA, BSP.

With respect to inflation, consumer prices in January 1995 were 6.2 percent higher than in January 1994, a major improvement compared with the situation in 1991, when average consumer prices rose by nearly 19 percent. This rate represents the continuation of a downward trend that tended to level off in 1994 when price jumps early in the year raised annual average inflation to 9 percent. The slowing of price increases was due in part to the turnaround in the National Government budget, which registered a surplus of P18.1 billion in 1994, or 1.0 percent of GNP. This

compares with a peak deficit of P37.2 billion in 1990 and an average deficit of P21.4 billion in 1991–1993. The consolidated public sector continued to show a deficit in 1994, but at P9.1 billion, or 0.5 percent of GNP, it was by far the smallest in a decade. The privatization program—which has accelerated in the past two years by increasing sales of government assets to the private sector—accounts for some of the improvement. Interest rates declined to 12.8 percent for 91-day T-bills for the first five months of 1995.

As noted in Chapter 4, the trade account deficit increased by \$5 billion from 1991 to 1994, but the balance on invisibles improved by \$3 billion, leaving a net deterioration in the current account of US\$2 billion. Exports rose from about P9 billion to more than P13 billion, and imports grew from P12 to P21 billion.

Real GDP in 1994 increased by 4.3 percent, rising from a decline of –0.2 percent in 1991 and increases of 0.3 percent in 1992 and 2.1 percent in 1993. Growth in 1995 is forecast to be between 6 and 6.5 percent. Real GNP, because of expanding net factor income from overseas workers, grew faster in all years, attaining an increase of 5.1 percent in 1994. All sectors shared in this growth: agricultural output rose by an estimated 2.5 percent in 1994, and industrial production grew by 8.1 percent, with the manufacturing component growing at a lower rate of 5 percent. Construction expanded in 1994 by an impressive 10.8 percent, and utilities 13.9 percent, largely as a result of the surge in electric power construction stimulated by the Philippine government's decision to allow private investment in this area. The service sector also expanded by 3.8 percent, which was more than double the 1991–1993 average annual increase but still well below the high growth rate of the late 1980s. Per capita real GNP increased in 1994 by 2.6 percent, a substantially better figure than the negative per capita performance of the preceding three years. Gross investment continued its upward trend since 1992, reaching (as a percentage of GNP) 23.6 percent. A significant portion of the increase is attributable to private investment in the electric power sector.

The economic recovery did not translate immediately into a reduction in the unemployment rate. Instead, the unemployment rate actually increased from 9.3 percent in 1993 to 9.5 percent in 1994. The average number of new jobs created in 1994 was lower than in 1993. However, whereas industry was a net loser of employment in 1993, the industrial sector became a significant net labor absorber.

The contribution of the SDP II program to this favorable result is twofold: primarily, through its promotion of higher invisible earnings and capital inflow, which has financed the much larger trade deficit that GDP growth has required while increasing exchange reserves; and secondarily, through its moderating effect on price increase.

STRUCTURAL ISSUES RELATED TO EXPORT COMPETITIVENESS

Realism of the Exchange Rate

As discussed in Chapter 4, although it was expected that more market-oriented exchange rate policies would lead to a depreciation, the contrary has occurred. In Table 5-2, this movement is measured by the real effective exchange rate (REER) using three different formulas. The dollar/peso exchange rate is inadequate as a guide to competitive changes because it takes into account neither the variable relation of the dollar to other major currencies in a world of floating rates nor the difference in the rate of inflation between the Philippines and the relevant foreign economies. A rise in the index means an appreciation of the peso (i.e., a loss of competitiveness), a fall implies the converse (i.e., a gain in competitiveness) during the base period.

Because the index can measure only relative movement, an understanding of the competitive situation in the base period is essential to understand what is going on. The original base of this

Table 5-2. Real Effective Exchange Rate of the Philippine Peso (1990 = 100)

Year	Major Trading Partners ^a	REER Compared with Competing Countries	
		Broad ^b	Narrow ^c
1990	100	100	100
1991	99	97	101
1992	110	107	117
1993	108	105	111
1994	116	111	121

^aUnited States, Japan, Germany, United Kingdom.

^bSingapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia, Hong Kong.

^cIndonesia, Thailand, Malaysia.

Source: Central Bank.

series is December 1980, not a very competitive period. To measure the change in the years relevant to this study we rebased the annual results on the year 1990. The peso recovered much of its competitiveness in that year, depreciating more than 25 percent against the dollar. There has been a deterioration in competitiveness (i.e., an appreciation of the REER) since 1990 in all three columns of Table 5-2, a deterioration that averages 16 percent by 1994. Without liberalization, the exchange rate would almost certainly not have appreciated to this extent and exports would probably have grown faster than they actually did. These reasonable expectations were confirmed by simulation runs as we showed earlier in the results of the simulation.

The result, while disappointing in the short term, is not evidence that an exchange market more open to supply and demand is not the best mechanism in the longer run for producing a more realistic exchange rate. The point is that the Central Bank has shown that it is able and willing to work with, not against, market forces. The bank does not appear to be determined to fix the rate artificially, nor in fact does it have the resources to do so. Over the next couple of years, an economy growing at 5 to 6 percent per year will put constant strain on the trade balance. The additional demand for imports and the likelihood that portfolio investment and interest arbitrage will diminish imply a drawdown on exchange reserves likely to exceed the level of new direct investment in the near future. Finally, the Philippines' net borrowing capacity is limited in view of existing debt servicing requirements.

There is little doubt that the peso will depreciate eventually; the questions are how fast, how soon, and how much. These will depend not only on market forces but the often implicit assumptions about what a proper exchange rate should be. The rate that will keep existing exporters or central bankers happy and in business may be too high to stimulate new or more marginal operators, particularly those that do not have privileged access to inputs at world prices. The appropriate rate may be quite outside the range that those two groups would regard as acceptable. Yet it is the entrance of new firms and new products that makes for steady growth.

The Trend in Labor Costs

Table 5-3 indicates that the trend of productivity is rather irregular. Wages, on the other hand, surged 37 percent in the late 1980s, as the initial reading for 1990 shows. The encouraging news, in terms of export competitiveness, is that real wages are falling back to their levels of some years ago. The "cost" column in the table combines the indices from the "productivity" and "wages" columns to form a rough indication of labor cost in manufacturing—in this case, an irregularly declining trend.

Table 5-3. Indices of Productivity and Wages in Philippine Manufacturing (at constant prices, 1985 = 100)

	Productivity	Wages	Cost
1990	112	137	122
1991	102	114	112
1992	94	112	119
1993	99	105	106

Sources: Intal and Jovellanos (1995), ADB, 1991 Yearbook of Labor Statistics and Current Labor Statistics, various issues.

Foreign and Private Investment Policy

The scope for private sector activity has widened in four ways since 1991. First, the government has accelerated its sales of public companies, partially or wholly. Second, it has opened areas that were public monopolies. Third, it has loosened up private monopolies and cartels to greater competition. Finally, it has greatly broadened access of foreign investors so that foreign investors are on the same footing as domestic ones in many more sectors.

Privatization is best exemplified by the BOT (build–operate–transfer) and similar schemes that have been instrumental in harnessing foreign and domestic private investments in infrastructure. Most of the BOT investments have so far been power projects because they were the most urgent to address the crippling power outages during the early 1990s. Recent BOT proposals and approvals include transportation projects (expressways; light rail transit). Private participation primarily through the BOT law, has helped to significantly address the infrastructural constraints facing the Philippines.

Liberalization of foreign equity constraints as well as liberalization of the regulatory climate (i.e., competition policy) in the utilities, transportation, and communication sectors have contributed to the increased interest in foreign investment recently. The opening up of the telecommunications sector has sparked joint ventures between Philippine and foreign firms. The sharp rise in activity in 1993 and 1994 reflects the large investments put into the sector during the past two years. The consequence has been greatly improved and expanded service. Similarly, the liberalization in routes and rates for both land and water transportation has seen marked increases in investments—primarily local—in upgrading and expanding the existing transport stock.

Implementation of the Foreign Investment Act of 1991 has been outward-oriented. Strategic industries were opened to 100 percent foreign ownership. No industry was included in the negative list C of the Act, which restricted foreign entry into areas "adequately served by domestic firms." In banking, where there had been no new foreign entrants since independence in 1946, 10 foreign banks have been allowed to open up to 6 branches for each bank under a new law that was passed in early 1994.

The more than doubling of the actual inflow of net foreign investment in 1994 over 1993 reflects the improved policy environment for foreign investment in the country as well as greater political and economic stability. Investment intentions, as indicated by the project cost and equity investments in BOI-registered firms, show even sharper increase: the total project cost of approved BOI projects rose fourfold from 92.5 billion pesos in 1993 to 485 billion pesos in 1994; foreign equity investments in BOI-approved projects increased more than threefold during the same period. BOI estimates that implementation is equal to about 60 percent of proposals on the average.

These developments potentially assist export competitiveness by improving the efficiency of resource allocation and lowering costs of production. But if the incentive structure still produces

higher profits in domestic activities only remotely related to exporting or in import-substitution activities, the ultimate effect on exports may be quite small.

In a few cases the relationship is quite direct. In nearly all the industries that registered dramatic increases in export growth, (e.g., semiconductors, electrical equipment, wiring harnesses, transmissions), the rise in foreign investment led to an increase of production capacity geared for exports. The investment in these industries reflects the shift in comparative advantage in the region where the Philippines is increasingly finding its niche in skilled labor-intensive industries, but with labor representing a small share of total cost of production.

As noted in Chapter 2, the 1987 Investment Act has shifted incentives relatively away from exporting to domestic production and sale. By 1990, only about 25 percent of the cost of all the projects approved by BOI were aimed at export. It has fluctuated about that level since but fell to 14 percent in 1994, when the peso appreciated sharply. Because export-type firms are generally smaller, the percentage of the number of companies has fallen from only 70 to 60 percent.

Looking only at foreign direct investment, the share of project cost directed to exporting was 47 percent in 1990, 35–40 percent in 1992–1993, and finally 21 percent in 1994. (See Appendix D for more details.)

The conclusions are (1) that the relative interest in investing for exporting has continued to decline on the part of both Filipino and foreign investors, despite the great increase in the total volume of investment; and (2) within that trend are fluctuations related to the perceived long-run stability and competitiveness of the exchange rate.

Protectionism

The Ramos Administration has maintained the trade liberalization goal of its predecessor, making it part of the Medium-Term Development Plan. Two separate processes were in operation in 1991–1994. The first is the phased tariff reduction through 1996, authorized by EO 470 in 1991. The second is the continued elimination of QRs and their replacement by initially quite high tariffs, embodied in Central Bank Circulars 1347 and 1356 and EO 8. Thus, during the first year of implementation, tariffs on affected commodities were generally raised—most to 60 percent, some to 100 percent. The effect of the EO 8 modification and the more recent decision to establish a minimum tariff on all imports is projected by the Tariff Commission to reduce rate classes to between 3 and 30 percent (seven classes) by 1996, except for 211 items that will be assessed at 50 percent.

A further exception to this process was made by EO 61 and Memo Order 95. The EO sets the tariff rates, whereas the Memorandum Order imposes quantitative restrictions. They affect four sectors in general: corn (input-output matrix sector 3 in 1983), poultry (sector 16), hogs and pork (sector 34), and meat and meat products (sector 35).

Tariffs on poultry and poultry products and meat and meat products were untouched by EO 61, which means that raising tariffs on these products under EO 8 remains effective while their importation has been re-restricted. Thus, no liberalization occurred on these sectors (except for beef and beef products) and their book rates have been raised (although scheduled to go down to EO 470 level by 1996). If tariffs were redundant (and/or the tariff equivalent of the QR were lower than the tariff rate), nominal and effective protection would remain the same. In this context, it is not surprising that demands for protection were loudest from the agricultural sector during the Senate deliberations of the GATT Uruguay Round Agreements in 1994.

Another complicating factor is the use of home consumption value as a basis for assessing tariffs, instead of the invoice transaction value (ITV). Although the legal authorization for this procedure

goes back several years, it has only been seriously enforced since March 1992, when Customs asked the Société Générale Suisse (SGS)—which did the pre-inspection of exports to the Philippines—to inspect all of them (except items worth US\$500 or less) rather than just a sample. It is estimated that, on the average, that the ratio of HCV to ITV is 1.1. In about 50 percent of the cases, transaction value is accepted, which means that it is considerably and, it appears, arbitrarily higher for other imports. Therefore, the effective rates of protection shown below underestimate the real levels. The government has promised to abolish this procedure, which is unique to the Philippines, but even with its entry into the WTO, it has up to 5 years to do so. (See Appendix G for details.)

As explained in Chapter 2, Table 5-4 reflects not tariffs but the effective rates of protection that tariffs (and, in a few cases, quotas) give to imports. The Philippine protection system enables manufacturers to buy raw materials, semimanufactures, and, in some cases, machinery at world prices at low tariff levels while putting a much higher tariff on the finished product. This creates effective protection rates that substantially exceed the actual tariff rate, as the data in the table indicate.

Table 5-4. Changes in Effective Rates of Protection, 1991–1994 (percent)

	1991	1994
All sectors		
Exportables	-7	-6
Importables	70	63
Agriculture		
Exportables	-1	-6
Importables	50	41
Manufacturing		
Exportables	-8	-7
Importables	74	67
Food		
Exportables	-11	-10
Importables	43	36
Textiles		
Exportables	-19	-17
Importables	88	67
Paper, rubber, etc.		
Exportables	-24	-24
Importables	150	117
Basic metals		
Exportables	-15	-15
Importables	80	61
Machinery		
Exportables	-2	-2
Importables	59	48

Note: Figures are based on price comparisons without taking into account the duty drawback except textiles, garments and semi-conductors (exportables).

Source: Tan 1994.

Our conclusions on the progress in eliminating protectionism, its current incidence, and the outlook for further improvement are the following:

- Effective protection levels on imports, including agriculture, were significantly reduced across the board from 1991–1994.

- The bias against products that are primarily exported is practically unchanged.
- Import quotas have been eliminated as a general protective instrument and confined to a small number of special cases.
- Two other factors affect the current level of protection:
 - The Customs use of HCV as a basis for assessing tariffs rather than transaction value (TV), raising effective rates by about 10 percent in general but with a very uneven sectoral application; and
 - The overvaluation of the exchange rate, which lowers effective rates of protection on imports (conceivably by as much as 15 to 20 percent) but raises them by the same proportion on exports.
- Further progress in the reduction of tariffs and the elimination of quotas has been announced, programmed, and pledged to donors. Although the intent of official policy is to continue liberalization beyond completion of SDP-II, and the Tariff Task Force's ambitious goal of a more uniform tariff structure of 5 percent by the year 2004 is to be announced shortly, the history of the past five years suggests that progress will be slow.
- If the last conclusion proves correct, Philippine growth will continue to be held hostage to the balance-of-payments constraint unless it can manage an extraordinary real devaluation of the peso.

OVERALL BEHAVIOR OF EXPORTS AND SECTORAL TRENDS

The purpose of this section is to analyze the behavior of Philippine exports since 1990—both in overall terms and with respect to the trends in the leading subsectors—to determine, if possible, how competitive factors influence them.

The value of Philippine exports has grown fairly rapidly in the past four years. Recent expansion continues the shift toward manufactures, which grew from 47 percent of the total in 1983 to 70 percent in 1990 and 80 percent in 1994. With a few notable exceptions, traditional Philippine exports such as sugar, coconut products, and other agro-based commodities; forest products, and minerals have stagnated or declined. There remain several natural resource-based sectors—mainly fishery products (primarily shrimp) and bananas and other fruits—that are doing well.

Within the manufacturing category of exports, the share of electronics and garments has risen from 46 percent in 1990 to 55 percent in 1994. Other branches of manufacturing are stagnating or growing slowly except for machinery and transport equipment, shoes, processed foods and baby carriages, toys, and games.

Table 5-5 provides data in four main series that track growth in Philippine exports and growth in imports by countries that are major trading partners of the Philippines.

- Series 1 tracks percentage growth in export sales in dollars.
- Series 2 tracks percentage change in the constant-price national income series for exports, deflated for Philippine inflation.
- Series 3 also tracks percentage change in merchandise exports deflated using an IMF methodology of inflation in Philippine partner countries' import prices to deflate the value of Philippine exports in dollars to estimate real potential demand for Philippine exports.
- Series 4 is an IMF series that tracks growth in non-oil imports (constant prices) by major trading partners of the Philippines.

The following conclusions may be drawn from this table:

- The rise in exports is heavily concentrated in electronics, which increased its share of all sales from 24 percent in 1990 to 37 percent in 1994.
- The Philippines has been favored by rising foreign demand since 1992 (line 4).
- The extent to which the volume of Philippine exports has increased as a result of foreign demand depends on the constant price series that is used: in 1990–1994 foreign markets increased about 35 percent, whereas the national accounts series expanded about one third; but the other series rose 50 percent.

Table 5-5. Export Growth in the Philippines and Growth in Foreign Demand for Philippine Exports, 1990–1994
(annual change in percent)

	1990	1991	1992	1993	1994
Export sales in current dollars	5	9	11	16	19
of which electronics	12	17	20	29	40
Merchandise exports (NIA) ^a	1.3	7.5	1.2	7.9	14.4
Merchandise exports (IMF methodology) ^b	5.7	6.0	6.0	18.1	13.1
of which manufacturing	8	10	11	19.5	17.4
Foreign markets demand ^c	3.2	1.7	8.0	7.8	12.3

^aNational accounts in constant prices, fixed weights.

^bDollar export sales deflated by trading partner import price indices, variable weights (IMF methodology).

^cPhilippine partner country non-oil import volume (IMF series).

Source: NEDA, Central Bank.

- A percentage gain equal to the increase in foreign demand means that the Philippines held its market share, which is what the national accounts indicate; however, on the basis of the Central Bank data series, market share has risen.
- In one case, competitiveness seems to be unchanged; in the other, it seems to improve.
- Either interpretation depends on the behavior of electronics, which are produced in an enclave benefiting from duty-free inputs. Having the least value-added (10–15 percent) of all the important export sectors, the electronics sector is relatively immune from all but the most violent swings in the exchange rate.

In order to understand what has happened, a look at specific sectors will be necessary. Table 5-6 has the basic information.

Electrical and Electronics Industry

In the Philippines' electrical and electronics industry, the processing of semiconductors and related electronic components makes up a major portion of the export market. Total exports of this group of companies was \$2 billion in 1992, of which more than \$1.2 billion was from materials imported on consignment. The electronics components industry, in a study using 1992 data, was made up of 28 companies in two categories: 13 captive manufacturers—multinationals, mainly affiliated with major U.S., Japanese, and European computer companies and totally dedicated to processing for the overseas partner; and 15 independent manufacturers—and contractors that provided similar processing service on components, mainly for overseas markets per job or contract. By 1994, 34 firms in both categories were registered at BOI; several large companies such as NEC (Japan) and National Semiconductor (United States) were not registered. Most of these plants are located in special export processing zones, largely in the environs of Manila. Total employment in the electrical and electronics sector is estimated at 75,000, with about 28,000 employed by the semiconductor industry.

Table 5-6. Exports of Major Philippine Commodities, 1990-1993 (US\$ million)

Commodity Group	(US\$ million)				Percentage Change, 1990-1993
	1990	1991	1992	1993	
Coconut products	503	447	643	532	+6
Sugar and products	133	136	110	129	_3
Fruits and vegetables	326	393	371	439	+35
Fresh fish/preser.	294	353	290	343	+17
Forest products	94	73	57	45	-52
Mineral products	723	610	633	686	-5
Manufactures	5,707	6,403	7,298	8,729	+53
Electronics/electrical equipment	1,964	2,293	2,753	3,551	+91
Garments	1,776	1,861	2,140	2,272	+28
Textiles	93	100	121	118	+27
Footwear	109	141	144	168	+54
Wood products/ furniture	306	294	294	308	+0.6
Chemicals	261	304	268	262	—
Processed food/beverages	207	233	220	271	+31
Machinery and transport equipment	150	181	288	363	+141
Baby carriages/toys/sporting goods	67	117	149	168	+151
Misc. manufactures, n.e.s. and other	469	585	632	925	+97
Total exports	8,186	8,840	9,824	11,375	+39

Note: Data do not add to totals because several small categories have been omitted.

Source: Central Bank.

Aside from semiconductors and related processing, there are three other parts of a significant and growing, but relatively less important, portion of the Philippine electrical and electronics industry in terms of exports: (1) computers and related equipment, involving more assembly and manufacturing and greater value-added; (2) telecommunications equipment; and (3) consumer electronics equipment. All three subsectors include major foreign companies, including a growing presence of the Japanese giants looking to expand and deepen their operations in an area with lower labor costs. These include subsidiaries of a number of major foreign multinationals (such as Sony, General Electric, and Goldstar), involved in part in the manufacture or assembly of consumer goods for the Philippine market, that in the early 1990s also began to use the Philippines for their own and third markets.

Important objectives of the government and the Philippine computer industry are to deepen capacity for the production of more advanced products in the computer industry, such as (1) hard drives, printed circuit boards, and monitors, as well as (2) home consumer goods in the manner of the Newly Industrialized Countries, Singapore, and Malaysia. A major concern of the industry is the reduction of import duties on imported components for these products while continuing effective protection for finished products manufactured in the Philippines.

Major product lines that have begun to be exported from the Philippines include televisions, refrigerators, car stereos, and washing machines—but in 1992 the volume was still low, totaling less than 1 percent (\$41.6 million) of total electronic exports, according to one report. However, by 1993 NSO Export Trade data show apparently substantial growth in a number of categories:

- Exports of automobile radios and tape decks (\$30 million);
- Other radios and tape decks (\$39 million);
- Sound recording and receiving equipment (\$26 million); and
- Radio and telephone transmission and receiving equipment (\$174 million, of which telephone sets were \$61 million).

No data are yet available on the extent of manufacture of components compared with assembly of imported parts from elsewhere.

Two recently expanded consumer electronics operations of Fujitsu and Sony of Japan are said to be 100 percent export-oriented and taking advantage of recent changes in investment rules that allow higher levels of foreign ownership.

Another phenomenon noted in 1990–1993 is the wide variability from year to year in products and product mix among the processed semiconductor products, particularly for consigned goods. This is presumably a reflection of the rapidly changing needs of the foreign firms and the fast-evolving worldwide computer industry. The United States was by far the largest recipient of Philippine electronic exports overall and in most of the individual categories. However, Japan, Singapore, Malaysia, Thailand, and the European Union were all significant destinations for many products and components for further assembly into finished goods. Exports to nearby ASEAN destinations have recently shown particularly high rates of growth.

Nearly one-half of new and expansion investment projects approved by the BOI in 1993 and 1994 were in the electrical and electronic products field; plans totaled about P30 billion (\$1.2 billion), with projected new employment of some 30,000 workers. A Central Bank industry study in 1993 projected continued rapid growth of this export industry to 1998, with total export earnings of nearly \$8 billion. However, the proportion between "regular" and "consigned" electronics was forecast to remain about the same, with only a modest decrease in the "consigned" category.

Computer Software

In a Philippines 2000 report from the Confederation of Philippine Exporters (Philexport),⁷ a good case was made for the Philippine computer software industry to have excellent prospects for growth domestically and even more on the world market. This report claimed a count of 30,000 software professionals in the Philippines and 10,000 more Filipinos employed abroad in the industry, \$40 million in export fees registered in 1992, and a projected \$60 million in 1993. It stated the industry's strengths to be a large pool of educated and trainable manpower, inexpensive labor costs, English proficiency, and a large number of training facilities. In this field, the study pointed to the great comparative advantage of Philippine professionals' labor costs, which were about 35 percent of those in the United States, 29 percent of those in Germany and Switzerland, and about 50 percent those of Singapore and Hong Kong.

If the study's estimates are correct, there are almost as many Philippine software professionals in the export enclave industries that process the integrated circuits, transistors, and diodes as there are low-skilled workers. Although data are not available on this point, it is almost certain that the value added by software employees is much greater than that added by low-skilled workers. It should be noted that this is the largest export sector, by product value, in the country.

Garments

Although the Philippines has been a significant supplier of many kinds of embroidered goods and baby and other clothing for many decades, this industry has grown considerably more slowly than the electronics industry. However, taking advantage of long-developed skills, garment manufacturers in various parts of the world have established or made extensive use of consignment plants for assembling garments that are often cut and sometimes finished elsewhere. As late as 1994, significantly more than one-half of the garment exports were in the category of apparel and parts

⁷Philexport, *The Philippine Computer Software Industry—Philippines 2000*, no date.

imported on consignment for processing and re-export, of a total of \$2.3 billion. Nonconsignment articles of apparel and clothing accessories for men, women, and children were the other major category, accounting for more than \$800 million in foreign sales in 1993.

Major items of consignment goods re-exports in 1993 were gloves (\$117 million), brassieres (\$97 million), women's wear of textiles (\$428 million), men's and boys' wear (\$383 million), and children's and babies' wear (\$391 million). Major nonconsignment goods were men's and boys' coats, suits, and other articles (\$135 million); women's and girls' coats, pants, dresses, and other articles (\$125 million); knitted and crocheted goods (\$191 million); and other textile apparel including children's (\$348 million).

In terms of destinations, the United States has traditionally accounted for about 60 percent of the export market for garments, with the European Union and Canada together accounting for 20 percent, mainly under Multi-Fiber Agreement (MFA) quotas. The other approximately 20 percent was divided rather widely in non-MFA markets throughout the Asian region and beyond. Growth of the markets in the United States, Canada, and the European Union has clearly been greatly constrained by the MFA, and it is too soon to know how the phasing out of this agreement will affect the opportunities for expansion of Philippine garment markets.

The garment industry, unlike its electronics counterpart, is made up of many small firms. There were 1,038 garment manufacturer—exporters registered with the Garment and Textile Export Board (GTEB) in 1991, with 2,923 subcontractors registered in 1990. There were an estimated 400,000 workers directly employed by the industry, plus an unknown but important group of thousands of small contractors and homeowners also employing workers.

In the early 1990s, 60 percent of total garment exports were manufactured from imported and consigned raw materials. One of the weaknesses of the garment industry as a source of growth is this reliance on foreign textiles, which exists because domestic textiles have not been very competitive. Philippine competitors such as Thailand, Indonesia, and Malaysia are said to be stronger in this respect.

Domestic textile production is largely geared to local consumption. Of the 1990 total, 72 percent of domestic production was consumed locally, 11 percent was exported directly, and 17 percent went to garment manufacturer-exporters. The textile industry is also not concentrated—in 1989 there were at least 210 companies, with a total of 90,000 employees. Export earnings were estimated at \$520 million in 1990, of which textile content in garments was \$500 million.

A Central Bank study in 1993 projected an annual 15–20 percent growth rate for garment exports through 1998, and an even greater advance of up to 30 percent for textiles in the same period. Overall garment exports grew at a considerably slower pace, however—slightly more than 5 percent per year from 1990 through the first 10 months of 1994.

Future of the Enclave Industries

The problem of the electronics and the garment industries as potential engines of broader growth and employment in the Philippine economy is that they are both largely foreign-enclave industries, established in considerable measure in special export zones. In both cases, the unfinished product is usually shipped in, processed by low-paid employees (with relatively little local value-added content other than labor), and re-exported. One source in Philexport indicated that the value-added in electronics might be about 15 percent, whereas that of garments is somewhat higher, 20–30 percent. Although these two "enclaves" generate perhaps one-third of total Philippine exports by export value, the impact on the economy is only some fraction of the \$3 billion or so. Aside from the question of value-added and net export earnings, the total number of employees working on

54
consignment products is only several hundred thousand, mostly in garments, and most wages paid are at unskilled or at best semiskilled levels.

There is mainly anecdotal evidence of a trend to higher value added. There is evidence of employment of some more highly skilled and more highly paid staff being employed in the computer component industry. The Timex watch company is an American firm that reportedly has moved its entire manufacturing operation to the Philippines, and some Japanese firms are beginning to export consumer electronic goods. In the case of the garment industry, there is probably a shift to the use of more Philippine woven cloth and other textiles. Exports of textile yarns and fabrics have also expanded substantially in the last few years.

Resource-Based Exports

The wood and furniture industry is a traditional one. The main problem for the furniture industry, despite skilled craftsmen, has been the decline of forests for wood and rattan, and the necessity of either importing wood products or developing new tree plantations with fast-growing varieties. The recently imposed strict restrictions on the export of logs and on the harvesting of forests because of historic overcutting and environmental degradation have essentially ended lumber, plywood, and veneer exports. Moreover, the shortage of quality wood places great limits on the entire wood-based industry—including furniture, where the Philippines would appear to have great comparative advantage in skills and labor costs.

Although the traditional agricultural exports like sugar and associated products have been declining, coconut products have remained approximately level for 20 years, in the \$500 to \$600 million range. The most significant upward trends in agro-based products are in fresh and processed fruits (\$439 million in 1993) and fresh and processed fish, mainly shrimp (\$476 million in 1993). These two categories grew at a healthy rate of 35 percent and 17 percent, respectively, from 1990 to 1993. Fresh bananas are the most important in the fruit category, growing to \$226 million, up 48 percent. There is a growing regional market.

The weak performance of agricultural exports is a reflection of low productivity and slowly growing domestic production. For example, per capita food production in the Philippines in 1991 was 10.9 percent lower than in 1981. In contrast, the per capita food production figures for Indonesia, China, Vietnam, and India in 1991 were 27 percent, 35 percent, 22 percent, and 18 percent higher, respectively, than in 1981. The Philippines became a net importer of agriculture, fishery, and forestry products in 1990, probably for the first time in the country's history. In contrast, Thailand, Malaysia, and Indonesia increased their level of net exports during the 1980s. In addition, both China and Vietnam turned from being net agricultural importers in the early 1980s to being net agricultural exporters in the late 1980s.

Agriculture is important because its competitiveness (or lack thereof) determines the health of food manufacturing industries (the largest subsector in manufacturing) and food availability. Food prices influence indirectly the competitiveness of labor-intensive manufacturing industries. The Philippine agriculture sector was the worst performer in East and South Asia during the 1980s. In virtually all export crop categories, the Philippines lost market share in the world. The gap between the coconut and sugar industries and their foreign competitors, in terms of cost competitiveness, has been widening.

It is not yet clear whether the fisheries resources in nearby waters are sufficient to allow increased production. Moreover, with increased population and standards of living in the Philippines, substantial growth of ocean fisheries exports is doubtful. Shrimp grown in large-scale onshore fish

farms offer new opportunities for growth in a lucrative foreign market, but there is competition for use of the land.

Minerals (copper, gold, and iron ore) have traditionally been important export products of the Philippines. However, this too is a sector that has remained largely level as a source of export earnings for 20 years. Its total share of exports was \$633 million in 1983 (13 percent), \$723 million (9 percent) in 1990, and \$686 million (6 percent) in 1993. The only important change was the shift from copper concentrates to copper metal as refining facilities were built in the Philippines. Copper products accounted for 54 percent (\$373 million) of mineral exports in 1993 and have shown considerable fluctuation in recent years, presumably as a result of shifting copper prices in the world market.

Apart from low world metal prices, a major reason for the secular decline of the mining sector during the 1980s and early 1990s has been the lack of new investments in the sector, even though the Philippines is among the countries best endowed with minerals. Uncertainties in the wake of the 1987 Constitution with respect to the new government—private sector profit-sharing arrangements and equity rules in mining—have discouraged a number of foreign investors from coming in. Foreign investment interest has started to increase because of the finalization of terms and rules on financial and technical assistance agreements (which allow for 100 percent foreign ownership). Approval of the new Mining Code—which would formalize the new arrangements of cooperation between the government and the private sector and liberalize foreign direct investment under specific financial and technical assistance agreements—is under consideration and appears likely.

By 1992 a growing, but still small, portion of the electronic export market was dedicated to the production of finished consumer electronics products, including televisions, refrigerators, car stereos, and washing machines.

Tourism: Invisible Earnings

As an actual and potential source of "export" revenues, tourism and business visits together make up one of the top earners of foreign exchange in the Philippines. Among nonmerchandise trade items, income from travel was nearly \$1.2 billion in 1993. This was a 25 percent increase over the previous year and more than 1½ times the 1990 figure. As a major source of foreign earnings income from travel now ranks lower than only (1) exports of electronics and ready-made garments and (2) remittances from overseas Filipinos. Perhaps more important, it claims to employ upwards of 1 million workers in operating and supporting the industry.

Visitor arrivals increased by 34 percent from 1990 to 1993, from approximately 1.0 million to 1.4 million, and rose another 16 percent in 1994 (10 months). Roughly 10 percent of the visitors are returning Filipinos resident abroad. Travelers from East Asia (including members of the Association of Southeast Asian Nations [ASEAN]) numbered 627,000 in 1993, or 50 percent of the total (of non-Filipino visitors), with 89 percent of these from Japan, Hong Kong, Korea and Taiwan; other main origins of tourists in 1993 were the United States (22 percent) and Europe (13 percent). All areas showed substantial increases from 1990 to 1993 except Australia and New Zealand.

Because available figures do not distinguish between business and tourism arrivals, it is assumed that a significant share of the increase is accounted for by business travelers as a result of the substantial improvement in the business climate and increased trade and investment, particularly from the East Asian region.

The Philippines has for many years been an important tourist destination for Americans and Europeans. Asian visitors began coming in greater numbers in the last two decades, but the political and economic disruptions of the 1980s dealt a serious blow to the industry. As Philippine tourism

largely stagnated, there was a vast increase in travel to almost all of the nearby Asian destinations in the last decade, particularly to Indonesia (Bali), Thailand, and Malaysia. With a substantial inventory of first-class hotels (though overwhelmingly in Manila) and a growing availability of good resort facilities in the Visayas and elsewhere, the Philippines has achieved a significant increase from a low base in the last several years. Clearly the country today is a much more attractive and stable tourist destination.

The challenges and problems of Philippine tourism today would still seem to center on how to sell the country as a unique and different destination, or on making it more of a stopping off place for cruises and others tours through Southeast Asia.

Currently, to many, Manila has not yet built a reputation as a comfortable and attractive enough place to justify the extra travel required to get there from nearby countries. There is still a perception of violence and substantial poverty in some places, and Manila has not quite lived down its reputation for attracting a certain class of tourists coming mainly for the night life. The country clearly has not taken full advantage of what its friendly, hospitable, talented, English-speaking people can offer.

A number of new resorts and many additional island and beach areas have the potential for further development. However, currently the Philippines does not attract large numbers of tourists traveling out from Manila, where most tourists arrive. The outer islands and other tourist destinations outside Manila do not seem as well publicized and as well known internationally as they should be. The Philippines might also try to emphasize budget tourism: it certainly has lower labor costs than many nearby competing countries.

CONCLUSION

Examination of the policies affecting export competitiveness and the behavior of exports suggests the following conclusions:

- The exchange rate, realistically measured, had appreciated significantly by the end of 1994.
- The labor cost of production, however, has fallen somewhat.
- Although the new freedom for foreign investors to do business should increase competition and improve technology, the incentives offered by BOI still favor investments aimed at the domestic market. What favorable impact there has been on exporting is still probably not very significant.
- Although there has been a continued (albeit slow) reduction in effective rates of protection from 1991 to 1994, protection levels are likely to remain high enough for the rest of this decade to maintain the anti-export bias.
- Although exports have risen as fast or slightly faster than foreign import demand in 1990–1994, that result has depended heavily on electronics exports, whose domestic value-added content ranges from 10 to 15 percent. Because their domestic content is so low, exports of electronics are little affected by exchange rate changes but, for the same reason, produce little net foreign exchange to pay for imports.
- Therefore, overall export competitiveness has probably declined compared with 3 years ago, particularly when compared with that of the Philippines' neighbors, Indonesia, Thailand, and Malaysia.

6. Lessons Learned and Recommendations for Future Action

This chapter presents the lessons learned from the successful implementation of the SDP II program; determines what can be done, with USAID/Manila's limited resources, to further SDP II's goal of export competitiveness; and recommends studies whose purpose is to change the way export promotion policy is made and carried out.

The recommendations build on the recent positive and more optimistic atmosphere for economic growth and the opening of the Philippines to the world economy that has begun to occur. Efforts by all levels of government, including President Ramos, have successfully focused national attention on the "Year 2000" goal and the need for much greater attention to foreign investment, export growth, and the building of a more competitive economy. Both leaders and the general public seem more aware that substantial reform is required if the nation is to provide employment to its burgeoning population and begin to keep up with its more prosperous and wealthy ASEAN neighbors. National pride is more and more visibly at stake.

What is needed now is a more comprehensive and sophisticated approach to export competitiveness and expansion. More critical scrutiny of national assets and liabilities is required, as is a willingness to make tough policy choices. Possibly the Philippine pattern of growth will be very different from that of Korea, Malaysia, or Indonesia. Each country has greatly different resource endowments and different physical and human comparative advantages. To succeed as part of the world economy, the Philippines must identify exactly where it wants to be in the decades ahead, then develop the competitive niches and coherent export policy that will help the country get there.

LESSONS LEARNED

The object of SDP II was to make Philippine exports more competitive through a program that concentrated on a few objectives that would increase the return to exporters by raising their peso (but not dollar) prices and reducing costs. It was expected that foreign exchange liberalization would depreciate the peso and reduce transaction costs, quicker tax and duty refunds would cut the cost of working capital, a new security for small savers (the SSI) would help lower the level of interest rates, and more competition in domestic shipping would lower domestic transport costs. The ultimate goal, for which export competitiveness was the instrument, was loosening the foreign exchange bottleneck to promote Philippine growth and employment.

The program goals for foreign exchange and refunds described in Chapter 2 were accomplished within or even before the agreed schedule, with one small exception: performance on the VAT refund, which held up release of Tranche 3. The SSI project was suspended after it was determined that the general fall in interest rates no longer made it feasible. The technical assistance was helpful and generally appreciated, with one serious exception: NEDA's dissatisfaction with the proposed improvements to its information management system.

The first lesson is that establishing an institution is a more efficient way of modifying a policy than simply changing the rules. This is because creating an institution promotes self-reinforcing behavior and interests. The creation of the One-Stop Shop (OSS), now part of the permanent

government establishment, to accelerate refunds has accomplished much more than an executive order to existing bureaucracies to do the same thing. On a larger scale, the new exchange market, operating in the framework of foreign exchange liberalization, has made trading more responsive to supply and demand and basically modified the behavior of traders, exporters, importers, investors, and especially the Central Bank.

Once under way, the rules and procedures take on a life of their own. Participants develop vested interests in carrying out their roles. The consequence is that the intended policy develops a momentum that it would not have possessed without the institutional framework to support it.

A second lesson is that concentrating on a small number of objectives united under a single theme is more effective than a multiple-goal program. There is less bureaucratic proliferation required by both recipient and donor. In this case, the Philippine authorities and USAID/Manila have designated small groups that have been able to concentrate on real problems. Finally, the single theme allows the results to be more easily evaluated.

RECOMMENDATIONS

Rationale

The recommended study projects that follow rest on three assumptions:

1. An export promotion strategy is essential to a sustained rate of growth that generates employment and rising standards of living and the appropriate framework for a functioning democracy.
2. The Philippines still lacks an overall export policy, as distinct from specific policies that promote some aspect of exporting or that have indirect effects on exporting in the pursuit of other objectives.
3. With limited resources at its command, USAID/Manila can in the Philippines play the role in which it has often cast itself elsewhere: helping the authorities to rethink the premises of aspects of their economic policies.

An export promotion policy has three legs. The first leg is a stable economy. The Philippines has accomplished much in this area in the past four years and is working with the IMF to do more.

The second leg is a competitive exchange rate. The peso exchange rate is not currently competitive, but the institutional mechanism is in place that will produce a competitive rate as continued growth puts a strain on the economy and encourages more imports.

The third leg encompasses the incentives that are aimed at promoting exports or are aspects of other policies that affect the profitability of exporting. The following recommendations are all directed to improvements in this area:

1. Many existing policies are inconsistent with a thoroughgoing export promotion policy. The approach to thinking about exports needs to be updated and a more precise information system needs to be put into place to measure progress. Although politicians today endorse export promotion almost as frequently as they stand up for motherhood, the thinking and reactions inspired by more than 40 years of import substitution policy are not easily eliminated. The following are examples of inconsistency:
 - The BOI system of incentives encourages private investment generally, but the choice of sectors to promote tends to favor production for domestic sale.
 - For the same reason, opening new areas to foreign investors tends to attract the investors to the internal market.

- The current protective system works in the same direction by favoring import substitution, and the proposed general reduction in tariffs to take place after 1996 will not, even if implemented, reduce protection enough to change the situation until after the year 2000.
 - Increased protection for corn production since 1992 simply delays the conversion of Philippine agriculture into a more efficient contributor to exports.
 - A congressional initiative to give subsidies to exports is accepted even though its approach and costs may not be appropriate.
2. An example of outmoded thinking is the conventional view—based, it seems, on exporter reactions—that 26 or 27 pesos per dollar is an appropriate exchange rate. This approach can amount to a self-fulfilling prophecy: although the major existing exporters, who make the most noise, will be content, others that are more marginal will not be, and enterprises that might have considered exporting at a more depreciated rate will not export. The mark of a really competitive exchange rate is that new enterprises and new products are constantly drawn into the international market.
 3. An example of the lack of adequate tools to analyze and measure the competitiveness of actual Philippine exports is the absence of one office in the government that looks at (a) data from the national accounts, (b) the results of Central Bank calculations matching exports to the growth of foreign markets, and (c) product marketing information to obtain a global estimate buttressed by sectoral information.

Institutional Recommendation

Consistent with the lessons learned from SDP II is the conviction that further reforms and new policies in support of increasing exports will require an institutional vehicle for implementation and support. The Export Development Act (EDA) passed at the end of 1994 potentially gives to the Export Development Council, a cabinet level body with private representation, the power to establish a comprehensive export plan. It also provides established exporters with a forum in which to express their views. (See Appendix H for details.) Combined with a think tank—either NEDA or its affiliate, PIDS—with the collaboration of the Central Bank, it could become the policy planning forum.

Project Recommendations

Four projects are recommended. The role of outside consultants is in part technical but more importantly to provide external perspectives independent local policy views and bureaucratic politics.

1. The first project to consider would involve assisting NEDA in drawing up an export strategy. This would supplement shorter-term concentration on marketing problems by staff of the Export Development Council's Department of Trade and Industry by
 - Determining which strategic factors affecting export growth (e.g., the protection system, investment incentives) should be changed on a priority basis;
 - Deciding on the types of information necessary to measure the global and sectoral competitiveness of Philippine exports, and establishing an appropriate information collection system;

— Establishing a timely public report on export trends and the factors behind them to educate other officials, businessmen, and politicians on how to think about exports.

The Philippine government is quite decentralized, especially with the new independence of the Central Bank. No one department dominates. NEDA has the most global view and is probably in the best position to influence opinion, but its talents are more properly strategic than tactical.

There is also a real need for information. In this study, for example, we have found two different ways to calculate the volume of exports, with results that sometimes differ considerably.

This project could initially be established by a small team of U.S. and Filipino macroeconomists and trade specialists over a period of a couple of months. It might involve the supply of some computers and software to NEDA, the Central Bank and other relevant agencies like the statistics office, customs etc. that are important sources of information. It would probably require other specialists as it developed. The object would be to shape the laundry list in the EDA into something pragmatic and feasible.

2. The second project would be to examine, for selected industries, the bias against exporting in the trade protection system and BOI's incentives and how it might be eliminated. Examples might be the electronics and garments sectors. It seems fairly obvious that value-added is so low because manufacturers, given duty-free privileges, find it cheaper to import rather than procure locally. The technique would be to sample businesses to find out what they would buy in-country if prices were competitive and then determine from potential local suppliers how trade and investment restrictions raise their costs.

This would be a 2- to 3-month assignment for a team of three professionals (both local and expatriate)—an industrial expert in each of the two sectors together with an industrial economist, aided by some local statisticians and clerks to carry out the surveys.

3. The converse approach would be to look at export sectors that have done well (such as automobile parts for U.S. and Japanese companies and footwear) to see how they have avoided the anti-export bias. It would look primarily into the policy environment that seemed to favor these sectors, such as competitive factors in nearby ASEAN nations and the decisions of foreign companies to establish major plants in the Philippines.

A team of two, possibly a macroeconomist and a trade economist or export specialist, should be assigned to carry out a 2-month survey on export growth in selected sectors other than garments and electronics.

4. Finally, agriculture has been sadly neglected. Discussion of the subject of exports is often seen to be confined to manufactures. A country like the Philippines could have a comparative advantage in many specialized branches of agriculture derived from its climate and manpower. This project would identify actual or potential products (from the experience of similar countries) and determine the barriers in the policy environment.

The team would be a combination of economists and agricultural and trade specialists who, given the lack of development in this area, might require several months to develop the necessary data.

CONCLUSION

To sum up, the objectives are

- To establish a set of analytical standards by which to judge what is happening in the export sector, and
- To explore the current policy environment sector by sector to determine the incentives and disincentives it provides to exporters.

This is hardly the whole export problem: it omits training, technology, infrastructure, marketing, and other areas. It assumes, however, that improvements in those areas will not be sufficient and effective unless the policy framework allows market forces to operate without distortion.

The stakes are high. Export competitiveness is a major element in the government's economic program. On its success depends the feasibility of a growth rate high enough to reduce unemployment and poverty. To achieve that goal much remains to be done. USAID/Manila can help by assisting the authorities in formulating some of the policy questions as well as appropriate answers.

Appendix A
SCOPE OF WORK

Specific tasks of the Contractor include the following:

Task 1: Evaluation of SDP II Objectives and Implementation

1. Develop the methodology and approach for conducting the evaluation, with particular emphasis on the following:
 - Assess achievements of SDP II purpose and policy objectives;
 - Assess effectiveness of SDP II policy conditions and technical assistance activities; and
 - Assess economic impact of SDP II on the Philippine economy, including employment generation and income distribution effects.
2. Collect and apply economic and social data bearing on number one above.
3. Review SDP II implementation.
4. Analyze the effectiveness of the SDP II policy reforms and technical support activities vis-à-vis planned objectives and determine if the SDP II policy objectives were achieved. For example, the evaluation should attempt to answer questions such as the following:
 - Did the SDP II policy conditions influence liberalization of the foreign exchange market? of the streamlining of duty drawback and VAT tax credit systems? of savings mobilization?
 - Did the policy conditions achieve SDP II's purpose of competitive exports in world markets? Of SDP II's objectives of market determined exchange rate, access to inputs at world prices and efficient financial resource mobilization?
 - Did the technical assistance activities provide the GOP with the empirical and analytical basis or tools to allow them to evaluate the need for liberalization, streamlining and resource mobilization?
 - Were the foreign exchange study and Philippine Dealing System study useful to the Central Bank's decision to free up the foreign exchange market?
 - Was IPC helpful to the Bureau of Internal Revenue (BIR) and the OSS in streamlining the duty drawback and VAT tax credit systems? Was IPC effective in its assistance to the National Economic and Development Authority (NEDA)?
 - Was the small savers study of help to the Department of Finance (DOF) and the Central Bank in drawing up resource mobilization policies and programs?
 - Was the commodity support, in terms of computer equipment and system software, effective in enhancing the foreign exchange liberalization policy of the Central Bank?
 - Was the commodity support, in terms of computer equipment, effective in helping the OSS streamline its duty and tax rebate operations?
 - Was the training of Central Bank staff at the economics Institute effective in enhancing the staff's capability in economic analysis and monetary policy formulation?
5. Assess facilitating as well as constraining factors (both external and internal to the GOP), administrative problems and implementation bottlenecks which influenced the results and effectiveness of SDP II policy reforms and technical assistance.

6. Assess the degree of complementarity/overlap of SDP II with other policy-based, BOP support programs of A.I.D. (e.g. Private Enterprise Policy Support (PEPS) program) and with other donor projects/programs (e.g. World Bank, IMF, ADB) impacting on the macroeconomic policy agenda of the GOP.
7. Identify lessons learned in SDP II policy reform and technical assistance.
8. Assess whether the effects of SDP II are likely to be sustained in the future.

Task 2: Determination of SDP II Economic Impact

1. Develop the methodology and approach for conducting the economic impact analysis of SDP II.
2. Analyze and estimate, qualitatively and quantitatively¹ the economic impact of SDP II policy reform actions on the economy as a whole:
 - It is expected that the impact analysis will contain estimates and/or validation of previously prepared projections of the short term and long term effects of SDP II, in conjunction with other donor projects/programs, on GNP growth, inflation, exchange rate, interest rates, export performance and other pertinent macroeconomic variables and GOP targets. The quantitative assessment will include an economic benefit-cost analysis of the SDP II resources vis-à-vis the economic benefits of the GOP implementation of SDP II policy reform actions.
3. Assess the employment and income distribution impacts of SDP II policy reform actions.
4. Analyze the economic contribution of SDP II technical assistance activities on the capability building of and the institutional changes in the GOP.
5. Conduct an overall review and assessment of the status of Philippine development, structural adjustment and economic prospects, macroeconomic and policy interventions by other major donors (e.g. IMF/WB/ADB) just before and during the period of SDP II design and implementation. This general review and assessment of the Philippine policy performance and the country's short and long term economic prospects will serve as background for the SDP II impact analysis and measurements of benefits.

Task 3: Recommendations for Future Assistance

1. Based on the lessons learned and implications derived from the SDP II evaluation, prepare recommendations on how to sustain SDP II supported policy actions.
2. Identify other policy reforms that are of critical importance and specific technical assistance activities that USAID may support in the medium term, taking into account the expected status of Philippine structural adjustment, economic prospects, and GOP development efforts.

¹The quantitative measurement of SDP II economic impact will be based on the PIDS econometric model. It is expected that PIDS will collaborate with the contractor for the use of the model as was done under the SDP evaluation.

Appendix B
PERSONS INTERVIEWED

GOVERNMENT OF THE PHILIPPINES

Central Bank of the Philippines

Rico Alfiler, Director, Foreign Exchange Department
Sergio Gonzalez Edeza, Officer in Charge, Treasury Department
Wilhelmina C. Manalac, Deputy Director, Department of Economic Research
Mrs. Santos, Department of Economic Research
Amando Tetangco, Jr., Managing Director, Department of Economic Research

Department of Finance (DOF)

Uldarico Andutan, Director, One Stop Shop (Inter-Agency Tax Credit and Duty Drawback Center)
Romeo Bernardo, Undersecretary
Majid John R. Bola, Chief Tax Specialist, One Stop Shop
Rosalia V. Deleon, Planning Officer V, International Finance Group
Christopher B. Gomez, Chief Economic Development Specialist, International Economic Research
Roberto Tan, Deputy Undersecretary

National Economic Development Authority (NEDA)

Ofelia Templo, Director Planning and Policy

University of the Philippines

Ruperto P. Alonzo, Professor, School of Economics
Jose Encarnacion, Jr., Professor, School of Economics

MULTILATERAL AGENCIES

Asian Development Bank

Rahul Khullar, Economist (Philippines),
Dr. Werner Schelzig, Program Manager
Thomas P. Walsh, Senior Program Officer

World Bank

Lani J. Azarcon, Economic Analyst, Manila
Sanjay Dhar, Principal Country Economist, East Asia and Pacific Region, Washington

Hisanobu Shishido, Senior Country Economist, East Asia and Pacific Region, World Bank,
Washington

International Monetary Fund

Howard P.G. Handy, Senior Resident Representative, International Monetary Fund

PRIVATE SECTOR REPRESENTATIVES

Topper Coronel, Executive Secretary, Bankers Association of the Philippines
Richard A. Curry, Construction Manager, ICF Kaiser Engineering and Construction Group
Gilbert D. Gardner, Vice President, ICF Kaiser Engineering and Construction Group
Phil Gielczyk, Executive Director, U.S. ASEAN Business Council/Philippines
Vaughn F. Montes, Vice President/Senior Economist
Sergio Ortiz-Luis, President, Confederation of Philippine Exporters (Philexport), Manila
Nilo L. Pacheco, Jr., Senior Vice President, United Coconut Planters Bank
Cesar C. Sanatos, Jr, Vice President, Citibank
Robert M. Sears, Executive Director, American Chamber of Commerce of the Philippines

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

John C. Chang, Assistant Program Economist, OPE
James L. Mudge, Director, Office of Program Economics
Brad Wallach, Deputy Director, Private Enterprise

OTHER U. S. GOVERNMENT AGENCIES

Jeff Cunningham, Economic Officer, American Embassy, Manila
Cinnamon Dornseife, Deputy U. S. Executive Director, Asian Development Bank, Manila
August Maffry, Jr, Commercial Counselor, American Embassy, Manila
Donald McConville, Economic Minister, American Embassy, Manila

Appendix C
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Appendix D
**PHILIPPINE INVESTMENT
INCENTIVE SYSTEM**

HISTORICAL BACKGROUND

Investment incentives were available as early as 1946. The earliest version offered exemption from all internal revenue taxes for a period of 4 years to "new and necessary" industries, the same set of industries the ensuing trade and exchange controls would protect. In the 1950s, incentives in the form of liberal importation of raw materials and intermediate inputs were added. In the 1960s, exemption from duties on imported equipment was made available to "basic" industries.

The system of investment incentives was formally institutionalized in 1967 with the enactment of the Investment Incentives Act of 1967. Priority areas were selected and "measured capacity" established for these areas. Incentives were geared mainly towards the production for the domestic market. They were additionally given further incentives in the form of tariff and/or import control protection (import licensing requirement or outright import ban).

In 1970, incentives were extended to nontraditional exports with the passing of the Export Incentives Act (RA 6135). Since then, the investment incentives act has been amended and codified three times, culminating with the Executive Order 226 or the 1987 Omnibus Investment Code (OIC). EO 226 superseded Batas Pambansa 391 (BP 391) passed in 1983. BP 391 introduced an innovative form of incentives—a tax credit equivalent to a certain percentage of net value-added earned (for domestic producers) and local content (for export producers). This was replaced by the income tax holiday for a duration ranging from 3 to 8 years under EO 226.

Remaining Issues

A review of the investment incentive system by Manasan (1989) examined the effects of the OIC on profitability of hypothetical firms. Manasan estimated the impact on the internal rate of return of the important provisions of BP 391 and EO 226 on a hypothetical BOI registered firm. Her results show that the increment on the IRR of exporters is three to four times as large as that of non-exporters under BP 391 while EO 226 differentiates only between pioneer and non-pioneer enterprises. Consequently, the inducements given to exporters is reduced by half while benefits made available to non-exporters almost doubled under the new OIC.

The income tax holiday and the tax-free importation of capital equipment rank as the key incentives in the new Code. As already noted, these are uniform for exporters and non-exporters alike. This contrasts with the 1983 Code which explicitly aimed incentives at mitigating, if not overcoming, the bias against exports from the protection system. Thus the new Code, insofar as tax incentives are concerned, is virtually neutral between exporters and non-exporters. The duty-free importation of imported inputs serves as the only advantage of exporters which is available to all exporters, whether registered or not with the BOI.

Looking at some statistics on BOI-approved projects provides some insights on the impact of the changes in the investment incentive system. The first major observation is the declining share of export-oriented firms in BOI-approved projects. Between 1983 to 1986 (the BP 391 era), export producers accounted for more than 70 percent of project cost. This went down to 25 percent in 1993

and further down to only 15 percent in 1994 (see Tables D-1a and D-1b). The figures are not as bad in terms of number of firms, where exporters still account for more than 50 percent, because exporting firms are much smaller in terms of project cost. Nonetheless, these figures show that the removal of the preference for exports, brought about by the change in the incentives system from BP 391 to EO 226, has had a corresponding impact in the types of projects approved by the BOI.

Table D-1a. Percentage Share in Total Project Cost of BOI-Approved Projects, by Type of Producer

Year	Type of Producer			
	Agriculture	Domestic	Export	Others
1981	23.3	31.1	45.3	0.3
1983	6.4	68.4	25.2	0.0
1986	19.3	9.1	71.6	0.0
1990	0.0	26.8	26.0	47.2
1991	0.0	51.2	14.7	34.0
1992	0.0	37.7	21.6	40.7
1993	0.0	32.6	25.6	41.8
1994	0.0	34.0	14.1	52.0
Value (P million)				
1981	2,650	3,534	5,151	30
1994	0	153,223	63,625	234,506

Notes: "Others" includes service, agricultural farm services, infrastructure/industrial service facilities, public utilities, export traders, research and development activities, energy-related projects, tourism-oriented projects, and commerce. For 1988-1994, agricultural producers are included in domestic producers.

Source: Board of Investments.

Table D-1b. Percentage Share in Number of Firms Approved for BOI Registration, by Type of Producer

Year	Type of Producer			
	Agriculture	Domestic	Export	Others
1981	21	17	61	1
1983	13	22	65	0
1986	14	4	82	0
1990	0	13	70	17
1991	0	16	72	12
1992	0	13	76	11
1993	0	15	70	14
1994	0	15	59	26
Number of Firms				
1981	40	34	118	1
1994	0	110	426	192

Notes: "Others" includes service, agricultural farm services, infrastructure/industrial service facilities, public utilities, export traders, research and development activities, energy-related projects, tourism-oriented projects, and commerce. For 1988-1994, agricultural producers are included in domestic producers.

Source: Board of Investments.

**Table D-1c. Capital/Labor Ratio of
BOI-Approved Projects,
by Type of Producer (P thousand)**

Year	Type of Producer			
	Agriculture	Domestic	Export	Others
1981	249	378	156	254
1983	175	782	100	0
1986	198	844	66	0
1990	0	2,240	308	2,756
1991	0	4,888	233	4,777
1992	0	3,700	211	7,816
1993	0	3,514	399	8,051
1994	0	7,903	712	6,374

Notes: "Others" includes service, agricultural farm services, infrastructure/industrial service facilities, public utilities, export traders, research and development activities, energy-related projects, tourism-oriented projects, and commerce. From 1988-1994, agricultural producers are included in domestic producers.
Source: Board of Investments.

A relevant question is, Has the same bias resulted in the case of direct foreign investment? This appears to be the case. The trend in the distribution of foreign equity of BOI-approved projects replicates that of the distribution of project cost of BOI-approved projects over the period considered. In 1995, around 97 percent of foreign equity investments of BOI-approved projects are export-oriented. The share declined to around 40 percent in 1993 and further down to 21 percent by 1994 (see Table D-4).

Such a shift in orientation has serious implications in at least two areas. One, although exporting activities in terms of number of firms still account for more than 50 percent of total BOI-approved projects, protection to the export sector is effectively diluted. Giving substantial incentives to other (domestic oriented) activities runs counter to the objective of making exporting relatively more attractive. Second, the larger share in terms of project costs of domestic oriented BOI-approved project implies huge revenue forgone which has macroeconomic implications. Such revenue foregone from investment incentives to exporting could be justified (e. g., on externality grounds and distortions created by the trade regime.) The same is not as clear in the case of domestic oriented projects. Indeed, the PIDS-DIA study shows that activities within the IPP appear to be more inefficient savers of foreign exchange, their DRC/SER ratio being greater than one and larger even than the average for manufacturing (see Exhibit D-1). Faced with a budget constraint, limiting revenue forgone from investment incentives to domestic producers would be most prudent and judicious.

Tables D-2 and D-3 show the distribution of BOI-approved projects by type of activity. In 1985, export manufacturing accounted for around 74 percent of project cost. This is down to only 13 percent in 1994. In contrast, domestic-oriented manufacturing went up from less than 1 percent in 1985 to around 33 percent in 1994. Within manufacturing, exporting electronic and electronic products accounted for more than half the share of total manufacturing projects approved by BOI in 1985. The share has gone down to only 11 percent of manufacturing projects. There appears to be a tendency for incentives to be highly concentrated in specific exporting activities. And the reach and coverage of incentives to exports is limited. Domestic market-oriented construction/housing components took the largest share of around 36 percent in 1994.

**Table D-2. Percentage Share in Total
BOI-Approved Project Cost, by Sector**

	1986	1990	1004
Manufacturing	8.4	18.8	33.0
Agriculture, forestry, and fisheries	19.3	0.8	0.5
Mining	0.0	7.2	0.4
Energy-related projects	0.7	23.4	26.2
Tourism-oriented projects	0.0	12.9	1.9
Public utilities	0.0	3.5	19.0
Others	0.0	7.4	4.9
Total domestic	28.4	74.0	85.9
Manufacturing	67.6	23.0	13.0
Agriculture, forestry, and fisheries	0.9	0.4	0.3
Mining	0.0	2.6	0.8
Energy-related projects	3.1	0.0	0.0
Tourism-oriented projects	0.0	0.0	0.0
Public utilities	0.0	0.0	0.0
Others	0.0	0.0	0.0
Total export	71.6	26.0	14.1
Total	100.0	100.0	100.0

Notes: "Others" includes service, agricultural farm services, infrastructure/ industrial service facilities, export traders, and research and development activities.

Source: Board of Investments.

Table D-3. Percentage Share in Total BOI-Approved Project Cost in Manufacturing

	1986		1990		1994	
	Domestic	Export	Domestic	Export	Domestic	Export
Processed foods	—	7.7	1.9	1.7	0.1	1.2
Wood and wood products	—	2.2	1.0	0.6	0.1	1.4
Paper and paper products	—	—	0.4	1.9	0.0	1.0
Textiles and textile products	11.0	8.4	0.3	17.2	0.0	3.4
Other textile products	—	0.6	—	0.2	0.1	0.1
Weaving apparel	—	7.5	—	1.3	—	0.3
Footwear	—	0.6	—	0.3	—	0.1
Leather and leather products	—	0.3	—	0.0	—	0.0
Chemical fertilizers	—	—	0.1	—	—	0.0
Basic industrial chemicals	—	1.7	3.8	0.4	7.2	2.0
Synthetic resins	—	—	—	—	9.1	0.0
Synthetic yarns and fibers	—	—	—	0.1	—	—
Drugs and pharmaceuticals	—	—	0.9	0.1	0.0	0.1
Miscellaneous chemical products	—	0.6	2.0	0.2	0.2	0.1
Petroleum products	—	—	—	0.1	12.3	1.3
Rubber products	—	—	—	—	—	0.0
Plastic products	—	4.0	2.6	1.0	—	0.7
Nonmetallic mineral products	—	—	3.5	0.6	0.7	0.0
Construction and housing components	—	2.2	22.4	1.3	36.8	0.4
Basic metal products	—	—	4.6	—	2.9	0.8
Fabricated metal products	—	—	0.5	1.1	0.0	0.9
Machinery and equipment	—	0.1	0.1	1.7	0.2	0.1
Electrical and electronic products	—	40.8	0.1	11.2	1.1	11.4
Shipbuilding/repair/breaking	—	—	—	—	0.7	—
CVDP	—	—	1.0	11.5	0.1	2.5
PMMP/PCMP	—	10.3	—	—	—	0.0
Professional and scientific equipment	—	—	—	0.1	—	—
Miscellaneous manufactured products	—	1.8	0.0	1.8	—	0.3
Printing and publishing	—	—	—	0.0	—	0.0
Aircraft and components manufacturing	—	—	—	—	—	—
Other products	—	0.2	—	0.1	0.0	0.0
Total	11.0	89.0	45.1	54.9	71.7	28.3

Exhibit D-1. Excerpt from PIDS-DIA Study on the Social Profitability of IPP Activities

"... One could, however, make some judgment about how optimally (or otherwise) the IPP has reallocated investments by comparing some measure of social profitability for those industries within and without the IPP. If those industries within the IPP prove more socially profitable, then at the very least, the IPP has had no adverse effect in resource allocation, and could very well even have led to a better investment allocation. Otherwise, it would be a clear indication of error, on the whole, in the selection of industries.

"This was done for this study, using some rough estimate of the domestic resource cost (DRC) and some approximation of where the IPP activity belongs in the 5-digit PSIC classification of manufacturing industries. The DRC, which is the value of domestic resources used, in shadow prices (i. e., real scarcity value, or social value), per unit of net foreign exchange earned or saved, is taken as a ratio to the Shadow Exchange Rate (SER) to indicate comparative advantage. Results show that, using 1988 NSO establishment data from the census of manufacturing establishments, the industries included in the IPP have even higher DRC/SER—2.3 for those industries including the IPP compared to only 1.5 for all manufacturing. (See table below)"

**Table B-1. DRC/SER, EPR & BVP of Projects
Included in IPP (1988)**

	DRC/SER	EPR
Industries within IPP (1988)	2.3	35.6
All Industries within and outside IPP	1.5	28.3

**Table D-4. Percentage Share in
Total Foreign Equity Investments of
BOI-Approved Projects, by Type of Producer**

Year	Agriculture	Domestic	Export	Others
1985	0.3	2.6	97.1	0.0
1986	3.6	12.8	81.0	2.5
1988	7.8	32.0	57.0	3.2
1990	0.0	14.8	47.2	37.9
1991	0.0	52.3	15.9	31.8
1992	0.0	27.1	35.6	37.2
1993	0.2	23.7	39.6	36.5
1994	0.0	33.0	21.3	45.7

Notes: For 1994, total equity investment = P157,338 million; total foreign equity investment = P61,287 million. "Others" includes service, agricultural farm services, infrastructure/industrial service facilities, public utilities, export traders, research and development activities, energy-related projects, tourism-oriented projects, and commerce. During 1988-1994, agricultural producers are included in domestic producers

Source: Board of Investments.

Another major observation is on the capital-labor ratio of BOI-approved projects. As shown in Table D-1c, the capital-labor ratio (K/L), which is estimated by the project cost divided by employment, fell drastically during the period from 1983 to 1986, when BP 391 was in effect—P512,740 per employee in 1982 down to only P83,660 in 1986, both in nominal terms. (The decline is even more drastic using constant prices.) Since then, the figure for K/L continue to rise rapidly, reaching P1.27 million by 1993. The large differences clearly indicate the capital bias of the investment incentive system under the 1987 OIC vis-à-vis BP 391.

Some weaknesses in the incentives provided have been noted in the PIDS-DIA study. One major conclusion is that the key incentives of the OIC—income tax holiday and tax-free importation of capital equipment—have reintroduced the bias toward capital-intensity. Moreover, the income tax

holiday incentive will not benefit much those enterprises that need help, possibly incurring income losses in the early years (which is likely to be the case for many new enterprises). Rather the principal beneficiaries will be those enterprises that are amply profitable from the outset and, therefore, might not have, in the first place, needed incentives.

What seems more critical, however, is the selection of activities to be included in the IPP, which is becoming more geared towards the domestic market. Aside from the removal of preference for exporting activities effected by the change from BP 391 to EO 226, the selection process for IPP inclusion itself, deliberate or not, may have been directly a factor in such a change in orientation. The process appears ad hoc. A firm applies for inclusion in the IPP and BOI incentives for a certain activity. The BOI reviews the application and decides for the inclusion or rejection. Although the evaluation criteria could be objective, such an ad hoc system could only be a fragmented and weak means of carrying out the ideal role of investment incentives. This is manifested in the large number of activities included in the IPP. In 1989, there were 234 investment areas included. This went down to 60 in 1994—still a large number of areas.

Clearly, there is a need to rationalize the investment incentives system for it to serve its ideal role. The rationale for the investment incentive system is not to induce additional investment in itself. This, if needed, is the responsibility of the overall fiscal and monetary policy. The objective is to channel investments to the desired sectors within industry which will maximize the potential of the industrial sector in the development process. Basically, this means providing investment incentives which will correct for market failures and distortions which prevent such optimal flow of investments.

The most recognized market failures include the presence of externalities, economies of scale, imperfect capital markets. However, what has turned out to have caused the more serious distortion is the protection system. The details of this have been chronicled many times. It would suffice here to focus on the most important bias in the protection system—the bias against exports. Moreover, not only is it penalized by the protection system, it also involves externalities. Export orientation keeps industries abreast in the adoption of best-practice technologies, resulting in faster productivity increases. The rationale for promoting exports is thus clear. And this has not been adequately answered by the current system, as the statistics show. Several proposals have been suggested by the PIDS-DIA study. In general, it recommends limiting the number of activities selected for promotion in the IPP to a few, say three to five industries at a time, and that the incentives be timebound. The small number would reduce the probability of errors in judgment that could be made, and should a mistake be made, limit the magnitude of losses.

Appendix E

**STATISTICAL TABLES AND OTHER
SUPPORTING MATERIALS**

METHODOLOGY FOR THE QUANTITATIVE IMPACT ASSESSMENT

The assessment of the quantitative impact of SDP II was implemented with the use of the Philippine Institute of Development Studies (PIDS) macroeconomic model. The following discussion covers the structure of the PIDS macro model, the methodology for determining the impact of the establishment of the duty drawback and OSS, and the approach taken in measuring the impact of foreign exchange liberalization.

PIDS Macroeconomic Model

The PIDS macro model consists of 72 behavioral equations and 54 identities. There are four major blocks in the current version of the model, namely, (1) the real sector consisting of production, expenditure, and employment, wages and prices; (2) the fiscal sector; (3) the financial sector; and (4) the external sector.

The major components of the real sector are linked through aggregate expenditure categories which appear as determinants of quantity demand in the production subsector. In agriculture, quantity supplied adjusts to clear the level of quantity demanded, while in the industrial sector a price equation functions as a supply equation with output determined by the level of demand. In turn, output determines the level of prices and employment. The financial sector affects output via the interest rate, the amount of net foreign assets and the liquidity variable which enters the wholesale price index equation. The fiscal sector influences the monetary base and interest rate through the method of financing the budget deficit. It also affects the real sector through expenditures on capital and operating expenses which partly determine the level of output. The external sector affects the other sectors of the economy through the linkage of the various current account components with output and expenditures, as well as its contribution to net foreign assets via the BOP account.

The external block of the model replicates the flow of goods, services, capital, and transfers in and out of the Philippine territory. This block consists of import and export demand equations, the corresponding import and export price equations, and the balance of payments identities.

Export demand is assumed to be negatively related to an export price deflator (P) divided by the official exchange rate (ER) and positively related to a proxy for economic activities in countries that demand the particular commodity. The variable P actually measures the production cost of exporters. The variable P/ER shows that higher costs of production that dampen export production can be offset by a devaluation. Similarly, lower costs of production that tend to promote exports can be offset by an appreciation of the peso. Insofar as our exports are import intensive, another hypothesized determinant is the supply of merchandise imports. Moreover, export price equations are specified as a function of domestic input price index—either a commodity specific price index or the general price index.

The parameters are based on time-series data from 1967 to 1991. It is likely that the introduction of policy reforms in recent years would have altered the structure of the economy, so that in

simulations, the magnitudes of the deviation from the baseline might change. Nevertheless, we are confident that the direction of change would remain the same.

Methodology for Assessing Impact of Duty Drawback and One-Stop Center

The establishment of an efficient duty drawback center and OSS translates to a reduction in the costs of production of exporters. In addition, allowing the exporters to retain their export earnings and being able to borrow foreign currency loans would also reduce their costs. These measures imply lower export prices. These lower export prices are used in the simulations. The results are shown in Table E-1.

Table E-1. Breakdown for Imported, Domestic, and Value-Added Components and Price Reduction Coefficient of Exports

Exported Product	Import Coefficient	Domestic Coefficient	Value Added	Inefficient Price	Percentage Price Reduction
Agricultural products	0.34	0.26	0.40	1.09	9
Semiconductors	0.80	0.00	0.20	1.16	16
Garments	0.56	0.14	0.30	1.13	13
Other manufactures	0.35	0.35	0.30	1.11	11
Other goods	0.33	0.33	0.34	1.10	10

Source: Consultant.

Determination of Export Prices

Reductions in export prices resulting from policy reforms are determined using the following formula:

$$PX = a M + (1 + TED) + b D * (1 + TEV) + VA$$

$$\Delta PX = 1 - PX$$

where

PX = inefficient price of exports

a M = import coefficient indicating imported component in product

b D = domestic coefficient indicating domestic component in product

TED = tariff equivalent for inefficient duty drawback system

TEV = tax equivalent for inefficient VAT credit system

VA = value added component of product

ΔPX = reduction in export price as a result of improved systems

Manasan estimated TED to be 20 percent and TEV to be 10 percent. The estimated reductions in export prices for the five export categories are shown in Table E-1.

However, not all exports will benefit from this. It is estimated that between 1992–1994, only about 10 percent of the exports benefited from this. The proportion is expected to go up over time. For this simulation, we assume that the proportion will increase to 15 percent in 1995–1995, and 20 percent in 1997–1998.

The results of the simulation are presented in Table E-2.

**Table E-2. Impact of Streamlining of Duty Drawback and VAT Systems
(percent deviation from baseline)**

Variable	1992	1993	1994	1995	1996	1997	1998
GNP	0.04	0.06	0.08	0.12	0.14	0.19	0.21
GDP	0.04	0.06	0.08	0.13	0.15	0.19	0.22
Exports	0.17	0.34	0.44	0.67	0.75	0.97	1.07
Imports	0.03	0.07	0.10	0.16	0.20	0.26	0.31
Trade balance	-0.27	-0.53	-0.59	-0.92	-1.03	-1.42	-1.60
Current account balance	-4.02	-2.10	-1.86	-3.28	-5.37	-18.63	17.13
Balance of payments	1.12	1.54	3.27	8.55	3.96	4.26	3.31
Value added in agriculture	0.00	0.02	0.04	0.07	0.09	0.12	0.14
Value added in manufacturing	0.08	0.12	0.14	0.20	0.23	0.30	0.34
Employment	0.01	0.02	0.02	0.03	0.02	0.03	0.03
Consumer price index	-0.02	-0.01	-0.01	-0.02	-0.02	-0.02	-0.03
Budget deficit	-0.20	-0.29	-0.31	-0.42	-0.44	-0.55	-0.61
Government revenue	0.01	0.04	0.06	0.09	0.12	0.16	0.19
Personal consumption	0.01	0.02	0.03	0.04	0.05	0.06	0.08

Source: Consultant.

Additional Capital Inflows

The policy reforms that came with SDP II paved the way for higher capital flows into the country. To determine the capital flows attributable to SDP II, figures for 1991 to 2000 are estimated based on historical patterns of net foreign direct investment and net portfolio investment. The following categories from the BOP accounts of the Bangko Sentral ng Pilipinas are used to determine the net foreign investment:

- Inflows:
 - New foreign investments in the Philippines
 - Portfolio investments
- Outflows:
 - Capital withdrawal form the Philippines
 - Portfolio investment

The net foreign investment is the difference between the inflows and the outflows.

The average values in the period preceding SDP II are used as the baseline. The mean net foreign investment for 1981 to 1990 is \$43 million. The actual values for 1991 to 1994 are obtained from the BOP accounts of the Bangko Sentral ng Pilipinas. For 1995 to 1998, the assumptions of NEDA regarding the net foreign investment are used.

Using this approach, the additional capital inflows attributable to SDP II are as follows:

Year	Additional NINDF
1992	231
1993	140
1994	273
1995	342
1996	458
1997	483
1998	506

The simulation results are presented in Table E-3.

Table E-3. Impact of Capital Inflows (percent deviation from baseline)

	1992	1993	1994	1995	1996	1997	1998
GNP	0.54	0.33	0.56	0.63	0.79	0.76	0.70
GDP	0.54	0.33	0.80	0.76	0.71	1.24	1.31
Exports	0.51	0.46	0.64	0.77	0.95	1.03	1.08
Imports	0.60	0.55	0.72	0.87	1.06	1.15	1.19
Trade balance	-0.76	-0.75	-0.87	-1.05	-1.30	-1.43	-1.47
Current account balance	-16.43	-3.63	-3.17	-4.72	-10.75	-139.13	10.21
Balance of payments	14.21	6.37	46.73	56.99	24.26	17.62	11.77
Value added in agriculture	0.19	0.13	0.18	0.21	0.26	0.25	0.22
Value added in manufacturing	0.70	0.45	0.76	0.86	1.08	1.06	1.01
Employment	0.12	0.05	0.19	0.20	0.26	0.26	0.28
Consumer price index	-0.38	-0.22	-0.39	-0.44	-0.55	-0.52	-0.47
Budget deficit	-1.80	-1.69	-1.37	-1.57	-1.64	-1.77	-1.75
Government revenue	0.23	0.23	0.28	0.34	0.45	0.50	0.52
Personal consumption	0.18	0.13	0.18	0.21	0.26	0.26	0.24

Source: Consultant.

Investments abroad made by Philippine residents could also be affected by the foreign exchange liberalization. In this case, we need to include withdrawal of foreign investments abroad (representing a capital inflow) and capital for investment abroad (representing a capital outflow). The magnitudes are relatively small at this stage and the net inflow resulting from these categories amount to \$13 million in 1991, \$6 million in 1992, and \$6 million in 1993. The pattern does not suggest an increasing trend in the net inflow. We do not expect it figure prominently in the near future. Thus, excluding them in the simulations will not alter the results significantly.

Impact of Peso Appreciation

The impact of the appreciation of the peso is evaluated by comparing the values of the key macroeconomic variables with the values resulting from the scenario where the domestic currency did not appreciate. In the with SDP II case, we took the actual values of the exchange rate from 1992 to 1994. Then, we assume that it would depreciate by 3 percent every year from 1995 to 1998. In the without SDP II case, we assumed that the exchange rate would be P28/US\$1 from 1992 to 1994 and take on the same values from 1995 to 1998 as in the case with SDP II.

Year	Exchange Rate	
	With SDP II	Without SDP II
1992	25.51	26.00
1993	27.12	26.00
1994	26.61	26.00
1995	27.21	26.00
1996	28.03	26.03
1997	28.87	26.87
1998	29.74	29.74

The simulation results indicate that the appreciation of the peso leads to lower exports and higher imports. This has a negative impact on the trade balance and GNP. The results are shown in Table E-4.

Table E-4. Impact of Peso Appreciation (percent deviation from baseline)

	1992	1993	1994	1995	1996	1997	1998
GNP	-1.38	-0.95	-1.11	-0.91	-0.33	-0.14	-0.07
GDP	-1.39	-0.95	-1.11	-0.92	-0.33	-0.14	-0.07
Exports	-2.29	-1.10	-1.53	-0.98	-0.45	-0.45	-0.44
Imports	2.10	0.96	0.90	0.81	-0.37	-0.59	-0.55
Trade balance	12.89	5.92	6.43	4.97	-0.10	-0.87	-0.84
Current account balance	-227.03	30.06	25.24	21.68	-0.70	-11.44	11.35
Balance of payments	-33.15	-14.51	-26.18	-32	0.52	3.04	2.01
Value added in agriculture	-0.88	-1.19	-1.26	-1.27	-0.81	-0.45	-0.27
Value added in manufacturing	-1.65	-0.49	-0.84	-0.51	0.05	-0.02	-0.07
Employment	-0.54	-0.13	-0.18	-0.09	0.12	0.10	0.07
Consumer price index	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Budget deficit	22.72	9.29	10.02	2.73	0.71	0.95	0.80
Government revenue	-2.20	-1.06	-1.66	-0.56	-0.20	-0.28	-0.25
Personal consumption	-0.25	-0.25	-0.26	-0.27	-0.14	-0.06	-0.02

Source: Consultant.

Overall Impact of SDP II

To assess the overall impact of SDP II, a simulation is undertaken incorporating the impact of the duty drawback and the One-Stop Shop (OSS), and the foreign exchange liberalization. The reduction in export prices, the additional capital inflows, and the foreign exchange movements resulting from these reforms are incorporated in one simulation.

The results of the simulation are presented in Table E-5. Because the model is non-linear, the results may not coincide exactly with the sum of the separate effects. Moreover, the base runs used in the different simulations are not identical so it is not correct to add the percent deviation from baseline of the three earlier simulations to get the overall effect.

Table E-5. Overall impact of SDP II (percent deviation from baseline)

	1992	1993	1994	1995	1996	1997	1998
GDP	-0.37	-0.26	-0.15	0.14	0.63	0.75	0.75
GDP	-0.41	-0.27	-0.17	0.13	0.64	0.76	0.75
Exports	-1.83	-0.53	-0.76	-0.05	0.83	1.21	1.40
Imports	2.19	1.26	1.51	1.23	0.77	0.82	0.93
Trade Balance	11.60	5.41	6.46	4.03	0.68	-0.10	-0.24
Current Account Balance	-439.08	26.01	24.16	16.54	4.16	0.36	1.09
BOP	-20.85	-7.00	25.41	22.02	36.69	28.89	17.94
Value Added in Agriculture	-0.57	-0.86	-0.87	-0.76	-0.37	-0.09	0.02
Value Added in Manufacturing	0.19	0.62	0.82	1.21	1.68	1.56	1.43
Employment	-0.20	-0.07	0.02	0.14	0.32	0.32	0.32
Consumer Price Index	-2.21	-1.21	-1.58	-1.20	-0.55	-0.42	-0.35
Budget Deficit	27.82	12.58	11.85	6.49	0.69	-0.41	-1.08
Government Revenue	-2.54	-1.33	-1.84	-1.22	-0.18	0.12	0.34
Personal Consumption	0.10	0.11	0.16	0.21	0.26	0.27	0.26

Source: Consultant.

Appendix F

TRADE POLICY REFORMS

HISTORICAL BACKGROUND

By and large, the Philippines began adopting a restrictive trade regime, mainly to promote import-substituting industries, as early as the 1950s. The pattern of protection has been highly uneven, a situation brought about by escalating tariffs (high for finishing stages and lower for lower stages of production) reinforced by a similar pattern of quantitative restriction (mainly in the form of import licensing requirements). Generally, there was a very high effective protection rate for finishing/assembly types of operation, low protection for intermediate and capital goods production, and negative or zero protection for the export sector. As such, the past trade policy regime created serious distortions and biases that became deeply embedded after more than three decades of such protection system. It was only in the 1980s that major trade reforms began to be undertaken.

This restrictive trade policy created serious distortions which prevented the efficient functioning of the market and resource allocation. These adverse effects are aside from the dynamic costs of protection in terms of possible efficiency losses and the lagging behind of our industrial sector compared to that of other countries with the absence of foreign competition. Such losses may even be the more serious legacy of a long-running protectionist regime. With inadequate exposure to the world market, the Philippines would lack the experience to deal with its intricate nature and lose out to the other more mature world traders.

The restrictive trade regime not been able to provide a real solution to the BOP problems. Artificially making certain import substituting industries relatively more profitable through tariffs and QRs automatically has made potentially profitable exports less attractive. Scarce resources were induced to flow towards the protected sectors, leaving less resources for the potentially more profitable export sector. And because the cost of saving foreign exchange at the margin, under a protectionist regime, was much greater than the cost of producing foreign exchange (as previous studies have shown), improving the trade balance under such conditions has been more costly and difficult.

These bad side effects are borne out by the poor performance of the industrial sector after three decades of protection. Although the share of manufactured exports grew, they remain highly concentrated (in garments and semi-conductors). And the economy experienced recurrent BOP problems.

Thus, the move toward greater trade liberalization starting in the 1980s is considered among the most basic reforms to attain overall efficiency and sustained economic growth. By ridding the market of distortions, trade liberalization would espouse greater reliance on the market, foster competition, and provide an even playing field which would induce to reveal and encourage to develop industries with real comparative advantage.

The Aquino administration made substantial achievements in reducing import restrictions (mainly in the form of import licensing requirements or outright import ban) from 1986 to 1989, and with the implementation of EO (Executive Order) 470, the tariff range will further be narrowed down. From 1986 to 1989, import restrictions on some 1,471 PSCC lines were lifted. This reduced

the number of regulated items as a percentage of total number of PSCC lines from around 34.1 percent in 1985 to only 8.0 percent by the end of 1989. This percentage went down further to less than 5 percent by 1993. (See Table F-1.) Then, the second phase of the tariff reform program started to be implemented with the passing of EO 470. This further narrows down the tariff range, with the majority of the tariff lines falling within the 3 to 30 percent range by the year 1995. (See Table F-2.) Indeed, the progress made under the EO 470 has been part of the PEPS (private enterprise project) Review which noted the improvements (as indicated by the lowering and leveling of the EPR or effective protection rates across sectors) in the tariff structure as a result of the EO.

Table F-1. Quantitative Restrictions on Imports in the Philippines, 1980-1993

Year	Number of QRS (end-year)	Percentage Change (per annum)	Percentage of Import Items Subject to Restriction	Import Restricted Items as Percentage of Total Imports
1980	2,901	—	51.8	—
1981	2,638	-9	47.1	33.0
1982	2,051	-22	36.6	35.2
1983	2,014	-2	36.0	34.7
1984	2,041	1	36.4	29.4
1985	1,967	-4	35.1	32.9
1986	973	-51	17.4	21.0
1987	802	-18	14.3	17.2
1988	579	-28	10.3	14.5
1989	420	-6	7.5	13.0
1990	447	-23	8.0	13.6
1991	291	-31	5.2	—
1992	126	-57	2.5 ^a	—
1993	183	45	—	—

^aMaximum percentage of import items subject to restrictions.

Source: World Bank Basic Economic Report, *The Philippines: An Opening for Sustained Growth* (April 1993). Updated by Philippine authorities.

Table F-2. Frequency Distribution of Tariff Rates

Rate Level (percent)	No. of HS Lines ^b					
	1990 ^a	1991	1992	1993	1994	1995
0	33	45	43	43	43	43
3	0	277	277	304	304	285
5	42	11	11	16	16	16
10	1,635	1,589	1,971	1,948	1,957	1,957
15	0	3	3	6	32	26
20	1,273	970	743	885	912	1,036
25	0	30	30	102	132	19
30	1,226	978	850	1,042	1,013	1,971
35	7	0	102	47	622	0
40	544	485	376	667	32	0
45	2	0	624	0	0	0
50	1,431	1,173	531	501	498	208
Total	6,193	5,561	5,561	5,561	5,561	5,561

^aBefore Executive Order 470.

^bUnder Executive Order 470.

Source: Tariff Commission, August 1, 1991.

Studies under the PIDS Development Incentives Assessment (DIA) also noted these improvements in the tariff and protection structure. Furthermore, the project provided empirical evidence on the positive impact of the trade reforms.

The DIA Project shows that for the whole manufacturing sector, the DRC/SER (domestic resource cost as a ratio to the shadow exchange rate)¹ went down from around 1.7 in 1983 to around 1.5 in 1988, clearly an indication of an increase in the overall level of competitiveness of the manufacturing sector. To illustrate further, the share of establishments whose DRC/SER ratio fall within the range of zero and one (i. e., those with allocative efficiency) rose substantially between 1983 and 1988, in terms of both value of output and number of firms. In terms of value of output, the share of efficient firms increased significantly from 18.8 percent in 1983 to 39.5 percent in 1988. Furthermore, there was very significant correlation between the change in EPR and the change in DRC/SER between the 2 years.

MORE RECENT DEVELOPMENTS: REFORMS UNDER THE RAMOS ADMINISTRATION

Trade liberalization remains part of the Ramos Administration's policy agenda. This is enunciated in the Medium-Term Development Plan. There was a series of EOs and CB circulars passed including EO 1, EO 2, EO 5, EO 8, and EO 61 among the executive orders and CB Circulars 1347, 1356 and 1365 among the Central Bank Circulars affecting trade policy.

CB Circulars 1347 and 1356, with EO 8 are basically import liberalization measures where import restrictions are initially and partly replaced by tariffs. Thus, during the first year of implementation, tariffs on affected commodities were generally raised—most to 60 percent, some to 100 percent. These are scheduled to be reduced over five years to within the 0 to 30 percent range. (See Tables F-3 and F-4.)

Shortly after being passed, certain provisions of EO 8 and CB Circular 1356 were suspended following strong objections from various sectors. (Farmer groups, with the blessings of the Department of Agriculture, invoked the Magna Charta for Small Farmers to prevent liberalization of corn imports.) In particular, these resulted in (1) a court injunction on EO 8 for livestock, poultry and meat, (2) CB Circular 1365 deferring liberalization for corn, and (3) Memorandum Order No. 60 freezing the tariff on corn until February 1993.

On February 27, 1993, decisions on these products were made with the passing of EO 61 (effective 30 days after) and Memo Order No. 95 (effective immediately). The EO sets the tariff rates while the Memo Order imposes quantitative restrictions. EO 61 and Memo Order 95 affect 4 sectors in general: corn, poultry, hogs and pork and meat and meat products. Thus, no liberalization occurred in these sectors (except for beef and beef products) while book rates have been raised (although scheduled to go down to EO 470 level by 1996). Possibly, protection on these products even rose after these changes.

¹The measure of efficiency used in this project is the ratio of the domestic resource cost (DRC) to the shadow exchange rate (SER). The former indicates the value of domestic resources used to produce a unit of net foreign exchange while the latter indicates how society truly values foreign exchange. Thus, a ratio of one, or less than one, indicates efficiency since the activity is using domestic resources, whose cost is lower than value of the net foreign exchange it earned or saved. The lower the DRC/SER ratio, the higher the allocative efficiency.

Table F-3. Frequency Distribution of Tariff Rates (Executive Order 8)

Rate (percent)	1992	1993	1994	1995	1996
0	43	43	43	43	43
3	279	306	306	287	287
5	11	16	16	16	16
10	1,973	1,950	1,959	1,960	1,950
15	3	6	32	26	26
20	743	886	915	1,037	1,040
25	30	103	133	20	19
30	769	964	927	1,988	2,004
35	101	48	578	14	—
40	381	615	95	—	—
45	580	—	14	2	—
50	526	568	514	213	211
55	—	14	2	—	—
60	—	2	—	—	—
65	—	2	—	—	—
70	—	14	—	—	—
75	7	—	—	—	—
80	12	68	—	—	—
100	68	—	—	—	—
Total	5,606	5,606	5,606	5,606	5,606

Note: The total number of HS lines should be 5,610 but there are 4 lines with specific rates that are not included.

Source: Elizabeth S. Tan, Research Paper Series No. 94-11, Table 7.

Table F-4. Tariffication Under Executive Order 8

PSCC	Description	No. of Lines	Average Tariff Rate in Executive Order 470 in 1992 (percent)	Average Tariff Rate in Executive Order 8 in 1992 (percent)
00	Live Animals for Food	6	28	57
01	Meat and Preparations	32	35	71
03	Fish and Preparations	29	38	82
04	Cereals and Preparations	3	23	75
06	Sugar, Honey, and Preparations	1	50	75
72	Specialized Industrial Machinery and Equipment	1	45	100
74	Non-Electric Machinery	6	28	60
77	Electric Machinery and Apparel	11	43	91
78	Motor Vehicles	24	30	56
Total		113		

Source: Elizabeth S. Tan, Research Paper Series No. 94-11, Table 6.

REMAINING ISSUES

Thus, there has been some wavering in the implementation of further trade reforms, with the suspension then revisions in executive orders and CB Circulars issued. Still, at least, the intent to continue with the trade reforms remains, manifested in the pronouncements and recommendations by

the Tariff Task Force which is setting out to implement a lower and a more uniform tariff structure by the year 2003.

It is easy enough to set the overall trade policy direction. However, while a move towards a more uniform tariff structure and a more liberal trade regime is ideal, from the point of view of overall policy making, the task is not as simple as recommending a uniform five percent by the year 2003. Further studies need to be done about its political and economic (both macro and micro) ramifications. From the political point of view, for example, how feasible is this? Who are the winners and losers? From the economic point of view, there are even more questions. What are the implications on the domestic tax system and on the overall fiscal situation? What is the appropriate tariff level from the perspective of such macro analysis? How will the agricultural sector which receive high protection be affected? How should the adjustment process be conducted? What measures should be adopted to minimize the adjustment costs? Given all these considerations, what is the best tariff and trade policy scenario? What schedule should be followed? Should it be a uniform 5, 10 or 20 percent? perhaps varying levels over the years? Or, perhaps we should settle for a two-tier system—e.g., 5 and 10, or 10 and 20. These are difficult questions to answer which require more in depth studies.

While trade policy is moving in the right direction, (which is perhaps the single most important factor in removing the overall bias against exports), it still has a great distance to go before reduction in the levels of protection make a significant difference to the decision to invest in exporting as against serving the domestic market or substituting for imports. The situation is worse with regard to the implementation of the investment incentive system. There appears to be contrary movements in the area of investment policy where the domestic-market orientation of BOI-approved projects is increasing. (The share of export activities in terms of project cost has dwindled to around 15 percent by 1994.) The BOI insists on post-operative tariff protection (which is needed only by domestic market oriented firms.) There is thus a need to review this policy area more closely in order to implement appropriate reforms.

Appendix G

THE SHIFT FROM THE HOME CONSUMPTION VALUE

HISTORICAL BACKGROUND

A number of presidential decrees and executive orders on the country's valuation system have been passed since 1909. However, despite the modifications and changes in terminology embodied by these laws, no substantial change has been made in the country's overall valuation system. Instead, the Philippines has continued to rely on home consumption value as the basis for assessing the value of imported goods, except during the period when RA 1937 was in effect (1958–1972) when the invoice value was used in practice as the general basis for levying duties and taxes.

Since the globalization of SGS pre-inspection system in March 1992, there have been mounting complaints against the use of Home Consumption Value (HCV) as the customs valuation base, owing to the increased assessment and resulting tax especially on imports coming from the United States and the EC. There came an increasing clamor for a shift away from HCV both from local business and foreign chambers of commerce. The government seemed amenable to such a change but was wary because of possible revenue losses.

IMPACT OF HCV

The use of HCV has other "non-revenue" impact which could also be substantial. For one, it entails additional cost of doing business in the Philippines. For example, having to submit appeals in the BOC-SGS grievance committee could be very costly in terms of time and money. It has a nuisance effect on the flow of foreign direct investment, not only because of the increased cost of doing business in the Philippines but probably even more because investors have to adjust to a very different system (especially in the case of new investors unused to an HCV system) the Philippines being the only country using it.

Even more important, however, is the distortion created by the HCV on the protection system. From the viewpoint of policy toward greater trade facilitation, the use of transactions value is superior.

What turns out to be the more serious and overriding objection is the possible revenue impact of shifting from HCV to a transaction valuation base.

The study by Medalla et al (1991) assesses the effects of HCV valuation on the protection structure and estimates possible revenue effects of a change in valuation system from HCV to a "transactions-based" customs valuation.

To assess the impact on the protection structure, the study estimates the gap between HCV and the transactions value (TV) using the Bureau of Customs/Invoice Value (BOC/IV) ratio. The BOC value is the final assessed value and the IV the invoice value from the import declaration, both excluding freight and insurance. Although the BOC value may not, in certain cases and for various reasons, be the actual HCV (or SGS-CRF), this is deemed appropriate because this is the HCV-based result in valuation, and hence, the impact of the HCV regime. The weakness is in using the IV in the import entry. The IV is prone to false invoicing, and the declared IV under an HCV regime

may differ from a transactions-based one. Nonetheless, these are the only data with solid documentation and still the best data to use.

To estimate the possible revenue effects of moving away from HCV, the study uses the elasticities approach (import demand elasticity) which is sufficient in the short run, and far superior to assuming zero import demand elasticity. The implicit assumptions in the estimation are (1) the BOC/IV ratio will go down to 1 with the change from HCV to a transactions based valuation, and (2) everything else is the same. In words, the change in revenues is the net effect of the loss in revenues resulting from the change in valuation from HCV to IV and revenue gains resulting from an increase in imports arising from a lower price of imports.

The study estimated the BOC/IV ratio from a randomly generated sample of some 2,600 import entries. The results of the study show high variations in the BOC/IV ratio, with a simple average of 1.29 and standard deviation of 0.713 after the Global Customs Inspection and Surveillance System (GCISS). The unevenness in the ratios implies an uneven (and thus distortionary) impact on the overall protection structure. There is, of course, the question of undervaluation (in IV) which would mitigate some of the distortion imposed by HCV. It is, however, difficult to estimate the degree of undervaluation. A comparison between exports to the Philippines (data from trading partner) and imports to the Philippines (Philippine data) for selected countries do not show overall undervaluation (except for Singapore. The ratio of exports to imports were close to 1 for the US, Japan, South Korea, etc.). Still, whether or not there has been undervaluation, HCV valuation, from the point of view of trade policy, is distortionary because of its uneven application.

The study found, however, a low weighted (by import value shares) HCV/IV ratio of only around 1.07 to 1.11, before and after globalization respectively. This is due to a high proportion of the value of imports whose ratio is around unity. For around 50 percent of imports, the BOC accepts the Invoice value as the "HCV." In any case, this brings about an estimate of the revenue impact of a change from HCV to IV, using zero to high import elasticity estimates (and assuming everything else constant), of around 3.9 to 6.5 percent, which translates to around P2.8 B to P4.7 B based on 1992 revenues, or around P4.1 B to P6.9 B based on targeted tariff revenues of P106 B for 1994. These are much lower than the BOC estimate of P16 B to P26 B.

Nonetheless, even if the revenue impact has indeed been underestimated, the other positive benefits of moving away from HCV are enough incentives. The shift away from HCV to transactions value would reduce trade distortions and would result in substantial trade facilitation which is perhaps as important as the gains from some of the more immediate plans for tariff reforms. Although possibly with some time lag, such loss in tariff revenues would have been translated into internal/income tax revenue gains, effecting on the whole an increase in the overall tax revenues.

As early as two years ago, there were indications that the government is favoring a change in valuation system from home consumption value (HCV) to an export price valuation base. Two bills being considered (a House version and a Senate version) propose a change to transactions value. More recent pronouncements, however, show the government losing some will to push through with the change, again for fear of a large negative revenue impact. Indeed, so strong was the government's reluctance to shift away from HCV that it was willing to forego several million US dollars rather than fulfill this policy conditionality.

The shift from HCV remains controversial. Although bound by the Philippines ratification of the WTO to shift to a transaction valuation base, the government seems reluctant to do so. Without outside pressure, it appears that the government would rather exhaust the five year period allowed for transition. At this stage, it would probably help the government implement the change more quickly if studies could be made which would make more concrete recommendations seeking to smoothen the adjustment process and minimize possible revenue costs. One such study could perhaps look at the experience of other countries using the GATT valuation system, particularly with

regards to how much technical smuggling is caused and how it is able to successfully deal with it. What institutional reforms, personnel capability build-up, operational systems, etc., are required during the transition.

Appendix H

SOME NOTES ON THE EXPORT DEVELOPMENT ACT, REPUBLIC ACT NO. 7844

In the early part of 1994, there was a growing sentiment among exporters that the overall macroeconomic environment, specifically the foreign exchange rate policy, was not conducive to the sustained growth of exports. This perspective gained more ground as the real effective exchange rate continued to appreciate in the course of the year.

Initially, the exporters, particularly the members of the Philippine Exporters Confederation (Philexport), advocated that the government take direct measures to address the exchange rate issue. Not making much progress in this regard, they then started to draft, with the help of the Department of Trade and Industry, the preliminary version what came to be legislated as the Export Development Act.

WHAT THE EXPORT DEVELOPMENT ACT PROVIDES

The Export Development Act (EDA) spells out a the principal elements of macroeconomic policy framework that is supportive of export development. The key components of this policy package include (1) monetary and foreign exchange policy that maintains a competitive exchange rate; (2) fiscal and credit policies that provide adequate funds to public and private investments and which maintain the cost of credit at an internationally comparable level; (3) trade, tariff and customs policies that engender competitiveness of domestic industries and facilitate their participation in international trade; (4) agricultural policies that build up competitiveness of agricultural sectors and facilitate their linkage with industry; (5) technical support services, particularly those relating to technology transfer, R&D, technical training, that improve the quality of export products; (6) provision of adequate infrastructure to support flow of goods and services; (7) labor and industrial policies that enhance labor-management relations for sustained increase in productivity and competitiveness; and (8) simplification of procedures to minimize bureaucratic red tape.

To support the establishment of said policy environment, RA 7844 mandates the Export Development Council (EDC)¹ to perform the following functions among others: coordinate, monitor and assess the implementation of the Philippine Export Development Plan (PEDP), review and assess the country's export performance, problems and prospects, identify the main bottlenecks and constraints to the development of exports, mandate specific departments and agencies to attend to said problems, recommend to Congress any proposed legislation that would contribute to export development, and formulate the policies for the granting of incentives to exporters.

¹The EDC is composed of the Secretary of Trade and Industry (DTI) as chairman, the Director General of the National Economic and Development Authority (NEDA), the Governor of the Bangko Sentral ng Pilipinas (BSP), the Secretaries of the Department of Finance (DOF), the Department of Science and Technology (DOST), the Department of Agriculture (DA), the Department of Foreign Affairs (DFA), and the Department of Labor and Employment (DOLE) and nine representatives from the private sector.

The EDA also decrees that the EDC should make the necessary legal and feasibility study on the creation of an Eximbank. In the interim, while an Eximbank is not yet operational, RA 7844 mandates the EDC to formulate credit programs for exporters.

Finally, the EDA provides the following incentives to exporters in addition to incentives that BOI registered exporters may avail of:² (1) exemption from the advance payment of customs duties; (2) duty free importation of machinery, equipment and accompanying spare parts until December 31, 1997; (3) tax credit for imported inputs, raw materials and equipment used for the production and packaging of export goods which are not readily available locally until December 31, 1999; (4) tax credit for increase in current export revenues;³ and (5) tax credit equal to 25 percent of duties that would have been paid had locally produced raw materials, capital equipment and spare parts used in the manufacture of non-traditional goods been imported.

ASSESSMENT

It should be emphasized that the macroeconomic policy framework for export development that is enunciated in the EDA contains all the lofty ideals and motherhood statements that are associated with this goal. What is not clear, however, is how a group like the EDC, which is composed of almost all the members of the Cabinet (with some representatives from the private sector), can translate these general principles into pragmatic measures that truly support export growth. But from a practical perspective, the EDA is important in terms of three things. First, it institutionalizes a forum through which exporters can air their concerns directly to policy makers in government, including the President. Second, it grants additional fiscal incentives to exporters. Third, it paves the way for the establishment of an Eximbank.

Fiscal Incentives to Exports

Standard economic analysis suggests that fiscal incentives may be given to industry for the purpose of correcting genuine market failures and/or policy-originating distortions. Undoubtedly, the most important distortion caused by the protectionist regime is the penalty on exports. The first best solution to this problem is the radical revamp of the structure of protection. In the absence of such a reform, as a second best solution, fiscal incentives may be introduced to compensate for the anti-export bias of the system of tariffs and non-tariff measures.⁴

In principle, redressing the bias against exports may be achieved by undertaking two types of adjustments (1) giving exporters access to intermediate and capital inputs at world market prices;

²It should be emphasized that exporters registered with both the EDA and the BOI are not allowed to claim the same incentive twice (in case of incentives that are available under both the EDA and the Omnibus Investments Code).

³This tax incentive provides a tax credit equal to 2.5 percent of the incremental export revenue for the first 5 percent increase in annual export revenue over the previous year; a tax credit of 5 percent for the next 5 percent increase in export revenue; a tax credit of 7.5 percent for the next 5 percent increase in export revenue and a tax credit of 10 percent for increase in export revenue in excess of 15 percent.

⁴One may also assert that exporting has positive externalities, in the sense that it brings about a new way of thinking and doing things, i.e., to maintain their competitive edge exports are forced to keep up with new technologies and international best practice. This argument by itself provides another reason why exports deserve to be given fiscal incentives.

and (2) compensating exporters for the penalty implied by an overvalued exchange rate (Manasan 1990). Essentially, the first adjustment involves setting to zero the implicit tariffs on intermediate inputs to exports. This may be done by exempting from duty imported capital equipment and raw materials used in the production of export products, or, by rebating the duties paid on said items. In addition to this, the first adjustment also requires that exporters be granted a rebate equal to the tariff that would have been paid if domestically sourced importable (but locally produced) intermediate and capital inputs been imported. This is important because tariff and non-tariff measures drive a wedge between the border price and the domestic price of the importable input regardless of whether the imported or the locally produced version is used in export production. This last adjustment is necessary to avoid the discrimination against domestically produced importable inputs that arise if only the duties on inputs that are actually imported are exempted/rebated.

On the other hand, the second adjustment requires that the export activity be given an incentive equal to the product of the foreign exchange rate premium⁵ and the free trade value added on the export activity.

How does the EDA incentives compare with this ideal set of tax breaks for exporters? First, it is important to point out that the tariff free importation of capital equipment under the BOI scheme expired as of December 31, 1994. Second, the BOI does not provide tax credits for locally produced raw material and equipment used in export production. Thus, the relevant EDA provisions in this regard are essential if exports are to be provided access to capital and intermediate inputs at free trade prices. However, the discussion above implies that the duty free importation of capital equipment should not be limited to three years. Also, limiting the tax credit for using import substitutes to non-traditional exports does not appear to be justified on economic grounds. Moreover, as discussed above, the tax credit should, in principle, be equal to 100 percent (not 25 percent) of the duties that would have been paid on the said inputs. Given this perspective, it is, thus, unfortunate that the implementation of this incentive has been deferred pending the formulation of a list of qualified non-traditional exports. Such a deferral appears to have originated from the DOF's concern on the magnitude of the revenue foregone from this incentives. In this regard, it is important that such apprehensions may be mitigated if the amount of incentives granted by the BOI to firms that are domestic market oriented are reduced as other studies suggests.

Third, note, in contrast, that BOI grants registered exporters drawback of duty on imported raw materials and supplies for an indefinite period. This implies that the duty drawback provision of the EDA is redundant for BOI registered exporters. Moreover, it does not make sense to limit this incentive to 5 years as the EDA does. Fourth, the BOI offers exporters a 4- to 8-year income tax holiday. One may argue that this incentive provides the exchange rate adjustment that exporters need to be fully competitive with their foreign counterparts. If one accepts this argument then the EDA incentives on incremental export sales additional appears to be excessive.

Finally, it should be pointed out that from an institutional perspective it is rather cumbersome to allow exports to register with both the BOI and the EDA/EDC. Thus, putting the incentive giving function to exports under one roof should be explored in the future.

⁵The foreign exchange rate premium is the proportional difference between the shadow exchange rate and the official exchange rate.