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MACROLEVEL INQUIRY PROJECT REPORT

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Introduction

This report opens up an investigation of the short- and long-run effects of the various macroeconomic adjustment measures adopted by the Philippine government in response to the 1983 balance of payments crisis.

Part I contains an exposition of the impacts or short-run effects of money and credit adjustments, devaluation, and budgetary restraints on aggregate measures of economic activity and prices. At the sectoral level, some implications of the adjustment measures on the industrial, agricultural, and service sectors are discussed.

Part II examines the interplay between the adjustment measures and the long-run objectives of the economy and speculates on what the government is likely to do in the transition. The policy setting that has been drawn along the lines of the International Monetary Fund's (IMF) conditionality practices circumscribes governmental actions on a variety of macroeconomic policies. Given the long-term industrial strategies spelled out in the development plans, tension is inherent in this situation.

Finally, Part III explores a host of issues pertinent to development assistance by the United States Agency for International Development (US AID) in the light of the likely impacts and long-term effects of the adjustment measures.

Part I

MACROECONOMIC ADJUSTMENTS IN A CRISIS SITUATION

Control of fluctuations in some aggregate measures of economic activity and prices occupies a major part of macroeconomic theory and policy. For the Philippines, the spelling out of guidelines for the proper conduct of stabilization or macropolicies has taken a sense of urgency in view of the general contraction in economic activity, accompanied by double-digit inflation rates, that followed the declaration by the government of a moratorium on the repayments of principal on its foreign commercial debts last October 1983. To counteract the stagflation, a number of macro adjustment policies have been initiated by the economic authorities. The aim of Part I is to investigate some of the impacts or short-run effects of these adjustments. In the process, we should keep in mind the long-term objectives of maintaining growth of output and employment, stabilizing prices, effecting a more equitable distribution of income and wealth, and safeguarding political freedom.

As a point of departure for the analysis, we can regard the present economic crisis as arising from balance of payments disequilibria, severe enough to cause possible breakdown in some existing institutional structures like the financial markets. To avert the threat of a breakdown, the government must adopt some adjustment measures that will restore equilibrium in the external balance. These measures, however, cannot be taken in isolation, but must be looked at in relation to other variables, such as those affecting the internal balance, meaning,

full employment. In other words, the adjustment measures for restoring equilibrium in the balance of payments must be looked at in terms of their effects on some measures of aggregate economic activity.

The Philippine economy is essentially a small open economy that takes world prices and interest rates as given. It is linked to the world markets via trade in commodities and securities. Being such, it would be useful to carry out an analysis of the macropolicies in the context of a small open economy.

As the economy moves into the second half of the eighties, it is certain that the pursuit of fiscal and monetary policies will be strongly influenced by conditionality practices of the International Monetary Fund (IMF). Since 1974, the country has been experiencing deficits in its balance of payments. Financing the deficits meant a dramatic drop in the level of the country's international reserves, and in 1983, unable to avert a payments crisis, the government turned to the IMF for new standby credits. To avail of the IMF's financial assistance, the government must carry out adjustment measures based on the Fund's conditionality practices.

To understand the Fund's conditionality practices, familiarity with the monetary approach to balance of payments problems is needed. In this approach, monetary elements assume first-order importance in the short-run adjustment process. In the long run, monetary factors diminish in importance, with real factors being the major determinants of the long-run equilibrium.

In the transition to a new equilibrium position, there are aspects of the adjustment process that are of great importance: foreign currency reserves at any instant, output and employment effects, relative price effects (say, between exports and imports, labor and capital, and sectoral terms of trade), and the general price level.

Part I is organized as follows: Section 1 contains a sketch of the features of the country's balance of payments problem and an analysis of the likely impacts of the various adjustment measures, including monetary adjustments, devaluation, and budgetary restraints on aggregate measures of economic activity. Section 2 contains some assessments of the sectoral implications of the adjustment measures. The possible impacts on the industrial, agricultural, and service sectors are explored.

1. Aggregate Implications

This section is an expository approach to the various macroeconomic adjustment policies that the Philippine government has adopted in response to the most recent balance of payments crisis. It aims to familiarize the reader with some of the theoretical foundations behind the monetary and fiscal adjustments and currency depreciation or devaluation.

The Balance of Payments Problem

The broad features of the country's balance of payments problem can be described by looking at the various accounts: trade, service, and capital. The trade and the service accounts make up the current account. The sum of the current and the capital accounts constitutes the balance of payments.

A deficit in the trade account means that expenditures on imports exceed export receipts. The service account records as inflows the receipts arising from items like services from physical capital owned by the country's residents in foreign land and tourist expenditures of foreigners in the Philippines. Payments by Filipinos for use of capital in the Philippines owned by foreigners are outflows. The difference between payments and receipts on these services yields either a deficit or a surplus. The capital account records payments and receipts from items like debt repayments and sales of securities. Foreign borrowings of the government are recorded as inflows in the capital account.

The current account has been in deficit since 1974. Through foreign borrowings the Philippines has managed to run a surplus in its capital account. However, the surplus in the capital account has not been enough to offset the current account deficit. The Philippines is also an aid-receiving country, but aid is not sufficiently big to offset the deficit.

From the money account of the BOP, we observe that financing the payments deficit has meant a steady erosion of foreign reserves. It also indicates a deterioration of the country's net fund position with the IMF.

Deficit countries like the Philippines which are members of the IMF can draw or borrow from the Fund a foreign currency, depositing in exchange some additional quantities of their local currency. Drawings from the IMF are a credit item in the balance of payments, since they constitute receipts of foreign currencies. In case of a surplus, member countries can repurchase their local currencies at the Fund with foreign currencies, and this is a debit item in the balance of payments. All transactions — purchase and repurchase -- on the local currency of a given country can be summed up in a given period to yield the country's net fund position with the IMF. Changes in this net fund position, together with the change in foreign reserves, indicate the country's liquidity position and therefore its capacity to defend its exchange rate.

Monetary Approach to Balance of Payments: Some Basic Ideas

The monetary approach to the balance of payments views a deficit as arising from an excess of aggregate expenditures (absorption) over

aggregate receipts (income) by the country's residents.[1/] Financing the deficit entails the purchase by residents of foreign currency from the foreign-exchange authority, which is reflected in the money account of the balance of payments as a decline in international reserves.

The monetary implications of the deficit can be described as follows: To finance the deficit, residents will have to draw down their cash balances in exchange for foreign currency. Once the level of their cash balances reaches a critical minimum, an increase in the demand for cash balances arises, pulling interest rates up, and dampening aggregate expenditures. There is a self-equilibrating mechanism which tends to correct the deficit.

The self-equilibrating mechanism may be derailed if the level of international reserves are low relative to the money supply. The reserves might get depleted before cash balances reach their minimum levels. This is one accepted argument for having large international reserves.

The self-correcting mechanism can also be negated if the Central Bank engages in domestic credit creation to maintain the money supply. If the dishoarding of cash balances is matched by domestic credit

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[1/] The monetary approach to the balance of payments has a long academic history (see Frenkel and Johnson 1976 for an exposition of its origins). Its modern revival may have begun with Meade (1951). Interest in this approach at the IMF was kindled by the need to provide some theoretical foundations for the Fund's practices in dealing with client countries that had balance of payments problems (see Prais 1961).

creation, the tendency for interest rates to go up disappears: the deficit persists accompanied by dwindling reserves.

The preceding discussion brings out the monetary elements of a balance of payments deficit: (1) low international reserves relative to the money supply, and (2) domestic credit creation by monetary authorities.

The monetary phenomena behind the deficit can also be illustrated by looking at the balance sheet statement of the consolidated monetary sector of an open economy:

Assets	Liabilities
D, net domestic assets	H, money base
R, foreign reserves	

The following holds as an identity: $D + R \equiv H$. It follows after differentiation that $dR \equiv dH - dD$. Now, dR is simply the balance of payments and is identical to the difference between the rate of change of the money stock and rate of credit creation.

To transform the above identity into a theory of the balance of payments, the monetary approach postulates a stable demand-for-money function, a stable money supply, and an equilibrium condition (e.g. the equality of money demand and supply). In equilibrium, the arguments of the money demand function are unchanging. Since demand

is equal to supply, the latter is unchanging too. Money supply is a function of the base money. In equilibrium when money supply is unchanging, D is unchanging and given D's level, R is unchanging. In equilibrium, therefore, the balance of payments, dR, is zero.[2/]

The monetary approach to the balance of payments is essentially long run in nature, since it looks at the equilibrium after all adjustments have been made. However, most policymakers are interested in the adjustment process, and how they affect some aggregate measures of economic activity and prices.

The monetary approach recognizes the effects of real factors like the terms of trade. But these real factors are analyzed in terms of how they affect demand for cash balances by the country's residents.

Finally, there is no presumption that the monetary approach precludes other approaches. It is well recognized that the same propositions yielded by the monetary approach can also be obtained by correct theorizing about the behavior of income and aggregate spending.

[2/] This exposition has drawn heavily from Johnson (1968) and Swoboda (1976).

Monetary Adjustments

The government has adopted as a matter of policy a mopping up of excess liquidity or tightening of the money supply. The objective is to bring down the level of reserve money to about ₱31 billion. The instruments for this purpose include open market operations by the Central Bank (sale of treasury bills and CB securities), raising the reserve requirements, and setting limits on the amount of credit creation by two major government banks, the Philippine National Bank (PNB) and Development Bank of the Philippines (DBP).

In the context of the monetary approach to the balance of payments, these moves by the monetary authorities can have salutary effects on the deficit problem. By setting limits on the rate of credit creation by PNB and DBP, CB can raise the foreign reserve/domestic credit ratio. At the moment, the level of foreign reserves is quite low relative to the money stock. This low ratio immobilizes the self-equilibrating mechanism that corrects a payments deficit. If the monetary authorities persist on increasing the rate of credit creation, while residents are dishoarding their cash balances, interest rates will remain at their usual levels. Aggregate expenditures will not be dampened and the deficit will persist.

The sale of CB securities that fetch a 40 percent rate of return has contributed to eliminating the excess liquidity and in raising the interest rates on various types of financial assets. With higher interest rates, residents will have an incentive to move out of goods and cash balances, and shift to interest-bearing financial assets. Moving out of goods means cutting down on imports, and letting go of exports. This has a positive effect on the trade account.

Residents who are holders of foreign securities may be induced to shift to domestic financial assets if the additional gains offset the incremental costs involved in the shift thereby inducing a capital inflow. If the amount of domestic credit is fixed, the capital inflow raises the foreign reserve component of the money stock. The country's position as a net creditor to the rest of the world, however, goes down since residents draw down their foreign claims. The negative effect on the BOP position due to the decline in the capital account, however, may well be offset by the increase in the foreign reserves brought about by the shift to domestic assets. Overall, we can expect the balance of payments to improve as a result of the monetary adjustments.

It is instructive to note some circumstances that can impede the mechanism correcting for the payments deficit even in the absence of money creation. The success of the mechanism described in the

foregoing rests on a perfect capital market which can hardly be presumed to hold in the Philippines. For example, the financial market has been characterized by interest rate repression. Evidence of this phenomenon surfaced very recently. The Bankers Association of the Philippines (BAP) has been trying to exercise some cartelistic actions on the interest rates paid to savings deposits, by trying to thwart efforts of some other banks to raise the rates from previous levels of 9-10%. The cartel appears unstable, though, as more recently a number of banks have announced 15-16% interest rates on savings deposits.

The link of the country to world capital markets that trade in securities is also fairly limited. The cost to small savers of having foreign securities in their portfolio is likely to be high, and one might observe only big savers doing trade in foreign securities through the major unibanks. Whether or not high interest rates here will induce a capital inflow depends on the alternative rates abroad. The capital inflow will not materialize for as long as real interest rates in the U.S. are relatively high.

The stock market is also fairly undeveloped in the Philippines. Trade in equities, which are claims on physical capital, is relatively thin. This limits the available assets that an investor can go into. He will want to move out of bonds if he expects interest rates to go up. But his actions will be limited by the absence of an active stock market.

This turns on some adverse distributional consequences of imperfections in the financial market. To the extent that banks are able to restrain interest rates on savings deposits below market rates, savers are penalized by absorbing a tax on their cash balances held as savings deposits. Savers are heterogeneous and they differ in their capacity to shift their financial assets from savings to say time deposits or CB securities. Small savers typically find it more difficult to shift than big savers, in view of the transaction costs involved.

Tight monetary policy can in the short run create adverse output and employment effects by raising the cost of credit which is the major source of working capital by firms. In the presence of imperfections in the financial market adverse distributional results can be expected. This occurs when the cost of credit intermediation to some groups or sectors is higher than others. Small borrowers normally face higher intermediation costs than big borrowers, to the extent that unit transaction costs decline as the size of loans increases. Rural-based firms compared to urban-based firms are normally at a disadvantage as far as credit intermediation is concerned.

To develop the above point further, one may raise the question--what is the legacy of a recession, like the one that the economy has been going through? A fear of bankruptcy pervades the thinking of most economic agents. There are social costs attached to bankruptcy such as legal and administrative expenses, and private costs attached to

hasty liquidation of assets, so that firms and households have an incentive to avoid it. Banks try to avoid bankruptcy by being selective in the choice of borrowers and by limiting the size of loans. Banks then resort to screening devices to obtain information about borrowers' probability of defaulting.

Credit contracts are cooperative agreements between banks and borrowers that are often repeated. Information about borrowers is a function of the frequency with which the contracts are renegotiated and of the size of the loan. The bigger the loan, the more screening the bank is likely to undertake. On this basis, we can expect banks to be better informed about big borrowers than about small ones. In a tight monetary situation, credit rationing of small borrowers will be the banks' logical recourse.[3/] Projects about which the bank is sufficiently informed, all other things held constant, will get the loans. The small borrowers who are denied or rationed will have to turn to nonbank financial intermediaries or to the informal lending sector. The interest differential is the added cost to them of the tight monetary situation. Casual

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[3/] Credit rationing of small borrowers appears standard and is likely to be practiced by banks even in a nontight monetary situation. For instance, Anderson (1981) reports in a study on small enterprises in the Philippines that the proportion of loans outstanding going to home-, small-, and medium-scale industries as of December 31, 1977 amounted to 2%, 11%, and 11%, respectively. These figures may not even represent resources of commercial banks but are mainly IGLF funds which are being onlent by commercial banks (pp. 16-17). Meanwhile, World Bank estimates place the share of agriculture in total loans granted at only 8% in the late 1970s, down from 20% in the 1960s. The bulk of these agricultural production loans even went to large agribusiness concerns, and mainly for marketing rather than actual production.

observation shows that the level of informal lending rates may run to as much as thrice that of bank lending rates.

One characteristic of projects that banks are careful to assess is average riskiness. If a project is deemed too risky tending to reduce the banks' expected profits, then a loan will be denied. Rural agricultural projects, on the average, carry more risks than urban industrial projects. (The vagaries of the weather add more variability to the output of the former than of the latter, all other things equal.)

The upshot of the above discussion is that the recession instills a fear of bankruptcy, and as agents try to avert it, may lead to the persistence of a recession. A role for government is indicated at this point. To break the liquidity impasse, government can lend to low liquidity agents. The terms at which the government lends should however be carefully studied.

Finally, the need to disinflate the economy is a major valid argument for a tight monetary policy. It is well recognized that the present rate of inflation is quite high for society to tolerate. Since most workers and firms are locked in nominally fixed wage contracts in the short run, optimum consumption and production plans of these agents can hardly be realized.

Devaluation

Another adjustment measure that has been undertaken by the government involves the devaluation of the peso. In October 1983, the peso price of the dollar was adjusted from 11 to 14. In June 1984, the peso was further devalued to 18:1. More recently, the peso was allowed to float against the dollar, but the Central Bank continued to intervene through some quantitative restrictions. Presently, the nominal exchange rate is approximately 18.5.

Of the various adjustment measures adopted by the government to correct payments deficit, the depreciation of the peso appears to have provoked the most heated debates. The issue is being discussed in several forums: at one level, we see politicians, journalists, and so-called nationalists debating; on another level, practitioners and specialists among professionally-trained economists engage in verbal tussles. We dwell on the arguments of the latter.

Using the monetary approach, the effect of a devaluation on the payments deficit can be analyzed by looking at how the depreciation of the currency affects the demand for real cash balance $(m = M/P)$, where M is nominal cash balance and P is the general price level. We invoke the purchasing power parity condition which can be assumed to hold some simplifying assumptions, i.e., $P = eP_f$ where P is the domestic price level, e is the exchange rate in terms of pesos, and P_f is

the foreign price. Substituting $P = eP_f$ into $m = M/P$, we get $m = M/eP_f$ which expresses real cash balance as a function of the money stock, the exchange rate and the foreign price. For a small country like the Philippines, we can assume the foreign price to be given.

Holding M and P_f constant, a devaluation which is equivalent to a rise in e reduces the real cash balance. As citizens try to restore their cash balances to pre-devaluation levels, an upward pressure on interest rates is exerted which tends to dampen aggregate expenditures.

We must note that a decline in the real cash balance can also be achieved by a decrease in the nominal stock of money with the exchange rate held fixed. A devaluation is also pursued, however, for purposes of expenditure switching.

We now turn to the effects of devaluation on the current account, holding the capital account constant. A devaluation changes the relative price of tradeable goods: it raises the price of imports while lowering that of exports. This has the effect of cutting down the country's demand for imports, while stimulating foreign demand for our exports. It also tends to switch demand away from imports to home goods. This expenditure-switching effect of a devaluation can be achieved if the economy has the capacity to accommodate the increased demand for home goods. If the economy is below full capacity, then the increased demand can be met by

harnessing the unemployed resources. However, if the economy is fully employed, the rise in demand for home goods can lead to inflation, unless accompanied by a reduction in aggregate spending.

The circumstances under which a devaluation will not work have been treated at length in the international trade literature. A devaluation may not bring about an improvement in a country's balance of trade if the elasticities of the domestic demand for imports, the foreign demand for exports, the foreign supply of imports, and the domestic supply of exports are low. What have past studies on Philippine trade shown on the likely magnitudes of these elasticities?

In a study which tried to quantify the effects of currency realignments on merchandise trade of the Philippines, for the period of the early fifties up to the mid-seventies, Bautista (1977) estimated export supply and import demand elasticities. The following exports showed supply elasticities (the numbers in parentheses) greater than one: copper concentrates (1.53), molasses (3.76), tobacco (1.26), copra meal and cake (3.36), coconut oil (2.01), and nonprincipal exports (2.35). The value of nonprincipal exports was obtained as a residual, deducting from total export receipts the total value of principal exports, e.g., abaca, copra, copra meal and cake, coconut oil, copper concentrates, canned pineapple, dessicated coconut, logs and lumber, molasses, plywood, tobacco and veneer, and sugar. Nonprincipal exports are an assortment of manufactured products, metallic ores and some agricultural commodities.

Exported commodities which showed elasticities less than one are the following: abaca (0.26), logs and lumber (0.41), and copra (0.29).

Meanwhile, Bautista's estimates of import demand elasticities from the same study show high values for the following: beverages and tobacco (-6.36), mineral fuels (-1.15), basic manufactures (-2.18), and miscellaneous manufactures (-1.70). The imports with less than unitary demand elasticities are food (-0.99), animal and vegetable oils (-0.53), chemicals (-0.46), machinery and equipment (-0.23), and crude (insignificant coefficient). On the whole, the 1971 world currency realignment which effectively devalued the peso vis-a-vis the currencies of the Philippines' major trading partners (as the peso was fixed to the US dollar) had in effect substantially reduced the volume of Philippine imports.

With respect to the foreign supply of Philippine imports and foreign demand for Philippine exports, the small country price-taker assumption is commonly adopted for most of the Philippines' traded commodities. Copra and coconut oil are the only commodities for which the Philippines has a substantial share (of roughly 60 percent) in world exports. But because of the strong substitutability of coconut oil with other vegetable oils and petrochemical products used in the manufacture of synthetic detergents, the amount of Philippine exports is not considered a major determinant of the world prices of copra and coconut oil (Librero 1971).

In another study on exports of primary products, Bautista (1978) corrected for cross-price effects in estimating the elasticities of interrelated export products such as copra and coconut oil. Using a small country model which included an export supply function for a primary product (copra) and an export supply function for a processed agricultural product (coconut oil), Bautista similarly found copra exports to be own-price inelastic and coconut-oil exports to be elastic. An implication derived from his findings is that a peso devaluation favors the exporting of coconut oil over copra. A continued over-valuation of the peso, in turn, biases exports in favor of copra. Bautista's calculations show that the elasticity of export earnings from copra and coconut oil with respect to the exchange rate, although on the low side, is positive at 0.108; a devaluation would still lead to an increase in export revenues from these two commodities.

The distributional consequences of a devaluation may be looked at by looking at the distribution of cash balances of residents. A devaluation is a tax on cash balances held in domestic currencies and a subsidy to cash balances held in foreign currencies. If the initial distribution of cash balances is such that low-income groups hold theirs in domestic currencies, which is very likely, a devaluation worsens their lot. Holding foreign currencies fixed and the money stock fixed, a devaluation is a transfer of cash balances from holders of domestic currencies to those with foreign currencies.

Budgetary Policies

The government has committed itself to reducing the budget deficit to one percent of GNP which ballooned to four percent of GNP in 1982. This adjustment measure is designed to close the deficit in the current account. The current account deficit is identically equal to the sum of the saving-investment gap and the government budgetary deficit. By reducing the budgetary gap, the current account deficit is reduced accordingly, if the saving-investment gap remains fixed.

In the past, financing the government budget deficit was done through borrowing by the government. Money printing is a form of borrowing since currency in circulation is a liability of the Central Bank. When the government resorts to money creation to finance the budget deficit, then monetary policy generates the aggregate demand. Monetary policies can have effects on the level of output and employment in the short run, but are expected to have neutral effects in the long run. Once economic agents have adjusted to the general increase in prices brought about by an expansionary monetary policy, then they will respond only to real factors, rendering monetary factors impotent.

The imposition of a ceiling on the government's budget deficit is thus inevitably linked to the monetary framework that has been spelled out for the Philippine economy. The analysis of the budgetary adjustments may well be carried out in terms of the monetary adjustments.

An expansionary monetary policy to finance government deficits under fixed exchange rates can lead to capital outflow or capital flight. As the money stock is expanded, low domestic interest rates encourage private investors to move capital out of the country in search of higher returns abroad. The implication is that a large proportion of the gross external debt of about $25 billion may have been recycled in capital markets abroad by private investors. The government is the holder of the gross external debt and private investors, who saw the gains which a fixed exchange rate afforded, are now the holders of foreign assets. This situation can be traced to the large budgetary deficits which had to be financed by foreign borrowing.

To avoid this sorry situation from happening again, the fiscal and monetary framework that is appropriate must be one that is characterized by restraint. The exchange rate policy that is consistent with it is a flexible one.

Fiscal instruments are of course the most direct ways of achieving distributional objectives. Through a system of taxes and transfers, the distribution of assets can be affected, which is a way to correct an existing inequality. A fiscal and monetary framework that rests on a competitive framework cannot produce an inequality greater than the inequality arising from the initial distribution of assets.

2. Sectoral Implications

In this section, we turn to the sectoral implications of the macroeconomic adjustments, designed to restore the economy to a more liquid position, that have been discussed in the preceding section. To recapitulate, the tight monetary policy which sets ceilings on the rate of domestic credit creation will have the effect of raising the cost of credit intermediation. This will be reflected in a rise in the nominal interest rates. The devaluation will have the effect of raising the price of imports relative to exports. The ceiling on the government budgetary deficits will mean less expansionary monetary policies. We investigate the short-run impacts of these policy adjustments on the industrial, agricultural, and service sectors.

2.1 Industrial Sector

One way to describe the industrial sector of the economy is in terms of import-substituting and export-oriented industries. Beginning in the 1950s, the government stressed self-reliance or self-sufficiency as an objective, and in terms of an industrial strategy, this objective was expressed through import substitution. More often than not, the substitution of domestic production for foreign production resulted in domestic prices that were above world prices. As a result, protectionist policies for import-substituting industries were instituted. Tariffs for consumption goods were higher than those for intermediate goods.

This created incentives to produce consumption goods mainly for the domestic market. It also led to capital-intensive industrialization which militated against the labor resource advantage of the country.

The import-substituting industries also relied heavily on imported intermediate goods which created incentives for fixing the exchange rate. The need to keep interest rates low for the protected, import-substituting industries led to expansionary monetary policies. Expansionary monetary policies, pursued under fixed exchange rates, led to inflation and to capital outflows.

At the fixed exchange rate, the expansionary monetary policies led to a depletion of the international reserves. In January 1962, the government was forced to institute decontrol measures, which meant a devaluation of the peso. The nominal exchange rate floated against the dollar at a rate of about 4:1; some months later, the exchange rate was pegged again.

At the pegged exchange rate, essentially the same commercial, fiscal and monetary policies were pursued. Another balance-of-payments crisis occurred in the late sixties which culminated in another devaluation in 1970. Six months later, the exchange rate was pegged again. There were attempts to promote labor-intensive, export-oriented industries in the seventies. However, the political objectives of the government under martial law regime seem to have favored the more

visible and capital-intensive symbols of economic power. Big industrial projects were carried out financed by foreign borrowing. To keep money flowing to these projects at low interest rates, expansionary monetary policies were pursued by the Central Bank. These policies resulted in the continued depletion of international reserves which reached crisis proportions in 1983.

The general setting for the industrial sector can thus be described as one wherein import-substituting industries which are heavily protected dominate the sector. Some of these industries include dairy, textile, paper, industrial chemicals, non-metallic minerals, basic metals, and electrical machinery. Some of the export-oriented industries are in furniture, leather manufacture, garments, and electronics.

The adverse impacts of the devaluation have been felt heavily by the import-substituting industries. The high cost of imported intermediate inputs has raised their production costs considerably. Since they sell most of their output in the domestic markets, the higher relative price of their output reduced the demand for them. The drop in output of the import-substituting industries led to a general contraction in the output of the industrial sector, because the export-oriented sector is not large enough to offset the output decline of the import substitutes. Another factor that prevents the export-oriented sector to pick up rapidly is the relative immobility of capital between

the two sectors in the short run. It may well be the case that there is excess capacity in the import-substituting sector, while there is an excess demand for capital in the export-oriented sector. However, the latter is prevented from narrowing this excess demand in view of the high nominal interest rates brought about by the tight credit situation. It is therefore necessary that inflationary expectations be dampened so that a decline in nominal interest rates will follow.

Studies on capital utilization in the Philippine manufacturing sector are quite limited (see Romeo Bautista 1972 and Benjamin Diokno 1974). To be sure, these two studies showed some evidence of excess capacity. Bautista estimated capacity utilization rates for 1961 and 1969 and his findings showed a dramatic decline in the capacity utilization measure for the following industries: Food manufacturing declined from 70% to 46%; beverage, from 88% to 59%; footwear, from 76% to 49%; furniture, from 79% to 52%; leather, from 53% to 26%; chemicals, from 72% to 48%; nonmetallic minerals, from 84% to 44%; machinery, from 89% to 53%. It is useful to note that 1961 is associated with the beginning of a decontrol period for, among others, foreign exchange. Prior to the export thrust initiated in the seventies, most manufacturing industries were import-substituting in nature, dependent on imported raw materials, and selling mainly in the domestic market. Bautista's findings appear to highlight the adverse effect of a peso devaluation on capital utilization in the import-substituting industries of the manufacturing sector.

Diokno's study tried to measure capacity utilization rates for export-oriented firms which received government incentives, using information from a primary survey of 91 firms. In his regression analysis, capital utilization rate was positively correlated with export orientation at a 20% level of significance. The weak significance renders the results very tentative.

No direct tests of the effect of devaluation on capital utilization rates by import-substituting and export-oriented industries were put forth by Bautista and Diokno and at this point, pending a closer study of capital utilization rates, most statements about capital utilization and devaluation must remain conjectures. An early piece of conjecture in this regard was advanced by Power and Sicat (1971). The two authors held the opinion that decontrol permitted a fuller utilization of resources (p. 11).

The rise in interest rates may adversely affect manufacturers in the industrial sector who are faced with interest-elastic demand for their output. These include firms engaged in the manufacture of consumer durables like cars, household appliances, and houses. With the rise in nominal interest rates, we can also expect a rise in mortgage rates, which dampens the demand for these products. We can thus expect a decline in the levels of output and employment of these industries. From a purely economic view, one could form the expectation that in the near- to medium-term, there will likely be initially high levels of both

unemployment and inflation.

Once freer currency trading is adopted, and considering the smaller net resource flows that are likely to arrive during the period, currency depreciation will initially be inevitable. This will, in turn, make itself felt chiefly through the cost side, and will be reflected in higher prices for firms whose products have a high direct and indirect import content. The sources of foreign exchange to finance imports will also be hard to find for those firms which have hitherto been oriented primarily to the domestic market, or which have no multinational tieups.

Credit restraints are likely to be reflected in borrowing costs, and these too will be manifested incipiently in higher prices. Firms which have access to preferential credit (e.g. those which form part of large "groups" which are served by banks) or are able to self-finance would be placed in a better position. If, as is likely, the import surcharges are eventually lifted, and tariff reforms continue as scheduled, then those activities and sectors which are faced with a reduction in effective protection (e.g., those in the consumer goods industries) face a limit to the extent they may pass on higher costs in the form of higher prices. Tariff reforms, therefore, are potentially a way of staving off part of the inflationary impact of currency depreciation. On the other hand, to the extent that such firms are unable to pass on higher costs, their profitability tends to decline, and some will inevitably fold up. Displaced workers from such activities

will add to the pool of the unemployed. Undoubtedly, those firms which are unable to compete and/or are inefficient will be weeded out. This does not imply, however, that the monopolistic structure of many industries will necessarily be dismantled. Firms may survive which are not necessarily efficient, simply because they have access to some resource (e.g. cheap credit) which is not available to others. Government intervention in behalf of some interests may also modify these results.

Conversely, activities will be encouraged which are export-oriented and are more efficient in the use of credit and foreign exchange. The investment priorities plan details the type of activities which are to be given fiscal incentives. The tariff restructuring program and currency depreciation have an immediate beneficial impact on exporters of new manufactures. The latter affects traditional exporters favorably as well (e.g. mining), especially after the "stabilization" tax was suspended. Currency depreciation increases the profitability of export activities, encouraging more resources to enter these. The overall impact of the tariff restructuring program on export activities is generally to reduce the costs of imported inputs (e.g. imported textiles). This is likely to expand their scope and scale, and to encourage greater backward linkages. It is hoped eventually that these new manufactured export industries will expand enough to take up the employment slack in the declining import-substituting

industries.

However, the potential impact of the manufactured-export sector on output and employment growth is limited, at least in the medium term, by the small size of that sector: it accounted for no more than 14 percent of gross value added in manufacturing in 1983, while domestic market-oriented industries contributed 86 percent (World Bank 1984, p. 42). The small size of the export sector in manufacturing is itself the result of past policies which have favored the domestic market over exports (e.g., in the form of overvalued currency and an uneven tariff structure). To the extent that the exigencies of the crisis have compelled the government to address these structural issues, one may expect an improvement in the performance of the export industries, world conditions permitting. Nevertheless, the improvements may be perceptible only much later, given the fixity and specificity of productive factors in the short period. At the moment, a desired output expansion in this sector can be achieved mainly through the more productive use of existing capital stock. Investment in new capital equipment is severely constrained by the shortage of foreign exchange.

While the hope has often been expressed that the import-substituting industries can become "world-competitive" eventually, this can hardly be expected to happen overnight, even if excess capacity presently existed (as an example, one might consider the continuing difficulties of the textile industry in adjusting to a freer trading

atmosphere despite the availability of World Bank credit for its modernization). A shift towards a more liberal trading policy ultimately involves a revaluation of existing assets in line with world prices; inevitably there will be impending large capital losses in those sectors which have heretofore been heavily protected (i.e. in which free trade value-added is low). These capital losses are likely to be resisted by present asset-owners, so that for the time being, especially if it is perceived that some results might be had from lobbying, they might prefer to see their assets remaining idle rather than disposed of at a loss. So from this viewpoint as well, it should not be expected that the problem of excess capacity in the import-substituting industries will go away once the immediate features of the crisis (e.g. the foreign exchange shortage) disappear. Structural adjustment problems will remain quite apart from financial difficulties.

It should, however, be acknowledged that structural problems and cyclical difficulties beset export-producing as well as import-substituting industries. This observation can be roughly inferred from the evidence provided by estimates of total factor productivity in the manufacturing sector prior to the 1983 economic crisis. Preliminary estimates by Hooley (1984) indicate very low and sometimes even negative contributions of total factor productivity to output growth across three-digit manufacturing industries. The average for the period 1976-1980 ranged from -0.087 for petroleum products to 0.058 for footwear.

It has been suggested that from a longer-term viewpoint, the country has a good opportunity to cash in on markets in the NICs such as Korea, Taiwan, and Singapore, especially in terms of their food requirements and the takeover of the labor-intensive processes which these countries have "outgrown" with the advent of rising wages.[4/] These new markets could contribute in the diversification of both final destination, and product composition of Philippine exports. The thrust in agriculture will possibly have spillovers in industry in terms of greater processing of agricultural products for export. To take full advantage of these prospects, however, greater market research and technical assistance and transfer are required.

A word about industrial or market structure. Philippine manufacturing has for a long time been heavily concentrated. The high level

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[4/] In 1976, the ratio of the average hourly wage rate (in U.S. dollars) in Singapore to that in the Philippines was 2.53; by 1980 this ratio had risen to 2.83. The corresponding ratios for South Korean wages over Philippine wages were 2.41 in 1976 and 3.71 in 1980. With the heavy depreciation of the peso since 1980, and with nominal wages in the Philippines not having risen proportionately, the wage-competitiveness of the Philippines relative to the NICs must have been enhanced.

For Singapore, earnings per hour were taken from the Yearbook of International Labour Statistics and converted into U.S. dollars at the average exchange rate for the year. For South Korea, won earnings per month and number of hours worked per week were taken. Hours per week were multiplied by four and used to divide monthly earnings to obtain hourly rates, which were then converted into U.S. dollars. For the Philippines, daily rates were converted into hourly rates by assuming an average eight-hour working day. Dollar conversion rates were obtained from the ADB Key Indicators.

of concentration in Philippine manufacturing even in the 1960s has been well-documented in studies by Lindsey (1974, 1978) and Sicat and Villaroel (1974). Looking at establishment data in 1960, Sicat and Villaroel find that value-added concentration was highest for rubber products and nonelectric machinery, followed by basic metal products, tobacco, and nonmetallic mineral products. Low concentration was found for footwear and wearing apparel, wood and cork products, printed and published materials, and manufactured food. Lindsey (1974) also took a look at basically the same data for 1970 and arrived at the conclusion that the average level of concentration in value-added (36 percent) and employment (25 percent), measured as a three-firm concentration ratio, was high enough to describe the manufacturing sector as "monopolistic". This is bolstered by a significant relationship between higher concentra tion and price-cost markups.

Between 1960 and 1970, the average level of concentration fell by about 2.52 percentage points for value-added, and a much larger 5.86 percentage points for employment. Significant determinants of changes in concentration appeared to be the initial level of concentration, industry size, and (perversely) capital intensity, which worked to reduce concentration, while industry growth rates and larger average size of establishments tended to raise it (Lindsey 1978). Import competition turned out to be an insignificant variable, although it is easy to see how a protective foreign trade regime could increase

concentration. Lindsey concludes that a crucial condition for a continued reduction in concentration is the expansion of the market relative to the technology in use, in order continually to attract new entrants. Relative stagnation in markets could conceivably lead to a reduction of participants, although cartelistic agreements could sustain a larger number of firms producing with excess capacity.

The 1970s as well as the recent crisis bring to bear new influences on the problem of concentration in manufacturing. Of course the most significant change has been the larger role of the public sector in business itself, although unfortunately there have not been any new efforts to study concentration for the 1970s and early 1980s. If government itself is a large participant in business, it may benefit from concentration, which would make it more difficult to persuade it to promote a more competitive environment. This is especially true when government corporations are a source of positive net incomes, during this time when government itself is hardpressed to raise revenues. On the other hand, it may be willing to divest in areas which it finds unprofitable. The present crisis also affects industrial concentration through its reduction of market size, especially for those firms which are oriented to the domestic market. A shrinkage of the market would, on the one hand, weed out the more inefficient firms and this would be a step forward, insofar as some sectors have in the past grown beyond optimum size. On the other hand, this would increase concentration and market power among the firms that do remain.

Actually, the question goes further than just the manufacturing sector, since the "groups" typically span finance, manufacturing, and agriculture, although perhaps the most important is financial concentration, since it determines the allocation of credit which is often the crucial factor. Lack of access to credit, because of financial concentration, represents an important barrier to entry in manufacturing The financial reforms notwithstanding, financial concentration is still high. In fact, the present credit crunch in connection with IMF conditionality has the externality of hastening the process, as only the large domestic and multinational banks stand a good chance of retaining much of the custom.[5/]

In theory the participation of government in the commercial banking system and in development banking should have served as countervailing power. In the present context, however, it is obvious that they did not, but were rather used to promote additional monopolization. The current restrictions on the lending of PNB and DBP also limit their potential effect on the process, and these limits are likely to remain even long after the present crisis has passed. A distinct possibility, therefore, is that due to the initially high concentration already

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[5/] To quote Monsod and Monsod (1985, p. 36), "The foreign banks have certainly gotten the better end of the deal -- from June 1983 to September 1984, their total deposits increased by 83%, while the deposits of local banks increased by 8%."

established, as well as the side-effects of the present adjustment and structural reforms, industrial concentration could increase. This need not be something adverse as far as the balance of payments problem is concerned (e.g., even monopolistic firms earn foreign exchange); however, it could have a severe impact in the longer run on income distribution, and whether or not it will have any potential political expression is another question.

Finally, one should address the nationality question, if only because it is sensitive politically. Given the restricted flows of foreign lending, which may be expected to persist for some time, it is likely that the regime will turn increasingly towards direct foreign investments to make up for future gaps in foreign exchange, and that this will be done through more fiscal incentives. (Of course it is also possible that a regime may in the future cut down on its spending so drastically that deficits are kept to a minimum; in that case the present discussion would apply less.) An example of this is the presidential decree which allowed raw materials exports of domestic firms to be treated as foreign equity infusions. This has met with a wide front of opposition. The effectivity of the decree has run out and has not been extended since. It is likely further relaxations of nationality requirements would be seen in the same light. To the extent there is no large

change in the regime's spending behavior, the financing of budget and current account deficits will heighten the need for attracting such foreign investments.

From all indications, the inflow of foreign investments under the above mentioned decree has not been substantial; this would suggest that incentives given to foreign investments may not be a significant factor in the investment decisions of foreigners. Rather, it would seem to be a matter of basic confidence in the economy's prospects. Previous empirical studies seem to indicate that investment incentives are at best only minor determinants of investment, subsidiary to such variables as market growth. Given the low response as well as the high political costs which such measures exact, it would not seem advisable to reinstate similar policies in the future. This, however, should not be taken to mean that alternative strategies for attracting equity investments from abroad should be left unexplored. Aside from the typical technology transfer argument, direct foreign investment may have an advantage over foreign loans if the objective is easing the balance of payments problem. A devaluation of the peso, for example, may lessen the burden on the host country of the profit remittances from the direct foreign investments, but it may not affect (in some cases, it may even aggravate) the burden of interest payments on foreign loans.

In addition to this, in the trend towards concentration already alluded to, the transnationals will undoubtedly come out with an enhanced share. Related to this is the improved position of foreign banks operating locally, and the bid of offshore banking units that they be allowed greater banking powers (e.g. peso deposit-taking and full branch banking powers in general). In this event, the issue of nationality could become very prominent, and eventually might reflect on the relationship between the regime and the U.S.

The impact of the debt crisis has been particularly severe on the industrial sector, which is to be expected, since this sector has been the most import-dependent. Industry here is defined to include manufacturing, construction, utilities and mining.

Previous to the present crisis, the impact of the world recession had already been felt in the industrial sector as a whole. As the table below shows, industrial output began to decelerate between 1978 and 1980, when its growth rate fell from 8.8 to 3.7 percent. However, this trend was partially offset in 1980-81, as a result of the increase in the growth of construction output, most of which was done in consonance with the government's "countercyclical" policy during the period. This raised the growth rate of industrial output by about one percentage point only, however, since the other sectors were reeling from the effects of the recession. Eventually these construction expenditures by the government reflected themselves in an enlarged budget and current

Table 1

GROWTH RATES OF THE INDUSTRIAL SECTOR AND ITS SUBSECTORS
1978-1983

	1978-79	1979-80	1980-81	1981-82	1982-83[a]
All Industry	8.8	3.7	4.8	2.6	0.7
Mining	16.7	4.8	0.0	-4.5	-2.5
Manufacturing	5.7	4.5	3.4	2.1	2.3
Utilities	0.0	12.5	11.1	10.0	10.0
Construction	18.3	0.0	9.8	5.1	-4.8

Source: ADB Indicators, except for 1982-83.

[a]Taken from the Updated Philippine Development Plan 1984-1987.

account deficit, which in turn had to be financed through foreign borrowing.

By 1983, even the construction subsector experienced negative growth of -4.8 percent, and together with declining output-growth in mining, this pulled down the growth rate of industrial output to 0.7 percent for 1982-83, which compares very poorly with the plan target of 7.6 percent.

The manufacturing sector, which accounts for 25 percent of the value of the industrial sector, witnessed a slight uptrend in 1982-83 and continued to grow positively. The effects of the debt and foreign exchange crisis on various manufacturing subsectors varied, however,

and this is shown in the change in total and subsectoral manufacturing employment in the period covered by the crisis.

Table 2 confirms the expectation that the hardest-hit industries would be those which were oriented mainly to the domestic market, and those which were dependent on imports. Cutbacks in employment in those industries were consequently the most severe. Among these are: transport equipment, electrical machinery, nonmetallic mineral products, and tobacco. Also worth noting is the large employment gain in such export-oriented and/or labor-intensive industries such as wearing apparel and wood and its products.

Table 2

CHANGES IN MANUFACTURING EMPLOYMENT (IN PERCENT)
(March 1983-March 1984; 3rd Quarter 1983-1st Quarter 1984)

	March 1983-March 1984	3rd Quarter 1983-1st Quarter 1984
All Manufacturing	- 1.64	- 2.8[illegible]
Food	- 5.80	0.30
Beverage	1.09	- 2.99
Textiles	- 0.90	- 1.24
Tobacco	-11.90	- 7.43
Wearing Apparel	33.90	7.58
Wood and Products	16.26	4.86
Paper and Products	7.90	7.69
Chemicals and Products	- 3.33	- 2.54
Rubber Products	- 1.13	- 3.48
Petroleum Products	4.93	0.71
Nonmetallic Mineral Products	-14.59	-12.76
Basic Metal Products	-12.62	- 0.14
Transport Equipment	-41.91	-38.49
Electrical Machinery	-22.30	-21.57
Miscellaneous	23.91	- 4.82

Source of basic data: Business Day.

Also for future plans, the Updated Philippine Development Plan 1984-1987 has the following statements (p. 13):

"The industrial sector will continuously be rationalized and developed toward the establishment of world-competitive industries that will enhance foreign exchange generation, strengthen linkage with the countrysides and encourage the production of domestic industrial goods which are less foreign exchange-intensive. The thrust will be on the promotion of small, labor-intensive and quick-gestating livelihood activities particularly in less-developed areas and regions. Prudence shall be exercised in the implementation of major industrial projects which have been deferred."

The following nontraditional exports are also to be given priority: (a) garments; (b) furniture; (c) electronics; (d) gifts and housewares; (e) construction services; (f) fresh and processed foods; and (g) footwear and leather goods.

Five major industrial projects are being pushed through or have in the meantime become operational. These are: (a) the copper smelter; (b) the diesel engine manufacturing plant; (c) cement industry expansion; (d) the phosphatic fertilizer plant; and (e) coconut industry rationalization (fatty acid plant). The amount of revenues and/or subsidies that will arise as a result of supporting these large projects still needs a fair amount of study. One may make a case for continuing with these activities over the longer term, assuming they will yield net

gains, and allowing for redistributional effects. However, one cannot rule out the short-term effects of such projects on the government's deficits.

As for the nontraditional manufactured exports, it is clear that their level of success and the deepening of their effects on the rest of the economy cannot be independent of the macroeconomic measures which are adopted by the government. Demand restraints and exchange rate flexibility ought to be called for, as well as the continuation of the tariff restructuring program so as not to penalize exporters.

Also worth noting is the government's commitment to the KKK and KSS as a means of promoting "small, labor-intensive and quick-gestating livelihood activities". While unexceptionable in principle, the actual means by which funds are disbursed through those two "institutions" and their actual uses would bear some scrutiny. Should these programs result in large inefficiencies in the uses of funds, the effects on the government's deficits and eventually on the balance of payments could make such programs unsustainable, to say the least. It must be asked whether the large bureaucracy existing ostensibly to provide such "economic services" is compatible with the government's verbal commitment to allow the private sector to lead the way. So long as such a bureaucracy exists, and regardless of the government's commitment, a dirigist or interventionist role on the part of the government would seem inevitable. There is, at present, still no clear delineation of the types of

activities which will be encompassed under the KKK and KSS for industry, what the source of the funding will be, and whether the government intends to take a rather prominent role in its implementation or not.

The large cutbacks in government-ordered construction will likely continue, given the constraints imposed by fiscal, monetary and external targets in connection with the stabilization program. This makes it likely that construction activity will not be relied upon to provide a "quick fix" to the doldrums of industry; total infrastructure expenditure by the government is projected as declining from 1983 to 1987 in the Updated Philippine Development Plan.

From this it will be clear that a turnaround in industry is to be expected only from the manufacturing and the mining sectors. However, given the short-to-medium effects of the crisis on the domestic market (e.g., higher interest rates, depressed demand, etc.), obviously only the export sector in manufacturing can be expected to make a large contribution to both output and employment growth. On the other hand, the mining industry's performance will proximately depend on the improvement in world prices. The industrial restructuring encompassing the tariff reforms and the various chances in industrial organization will determine to a great extent by how much the country can take advantage of the world recovery. The problem is, however, that many of these changes are liable to be postponed or hindered, to the extent that they give rise to short-term difficulties relating to the

stabilization (e.g. lowering tariffs for some commodities may increase imports of those and widen the payments gap) or to political resistance (e.g. the case of some markets which politically connected individuals have come to monopolize).

What is the likely scenario for small and medium industries? Going by employment size, industrial establishments may be grouped into household, small- (below 20 employees), medium- (20-200) and large-scale (over 200). The secular trend has been towards a slower growth, if not an impending absolute reduction, in the size of the household sector, even if this continues to provide employment to the greatest number of people (i.e. 53 percent of manufacturing employment in 1975). On the other hand, its share of value added is minuscule, which indicates the generally low productivity of jobs in that sector. Household production is almost never a primary source of income, is closely associated with production for own consumption, and is distinguished mainly by its exclusive use of family labor (Anderson 1981, p. 79). Its eventual, albeit gradual, decline is an expected consequence of the spread of market and wage relations and the decline in subsistence production, and as income from formal employment increases enough to cover workers' subsistence. One might generalize, therefore, that the size of the household sector is inversely related to indicators of economic development.

The role of small- and medium-scale industries, on the other hand, would seem more active and integral to the development process. In 1975, 14.7 and 9.2 percent of manufacturing employment were provided by small-scale and medium-scale industries, respectively. Between 1967 and 1975, employment in smaller categories grew significantly faster than in larger ones, with small-scale industries growing fastest. It would appear that the relevant variables are market- or source-proximity on the one hand, and scale economies, on the other (Anderson 1981, p. 86). In branches where the former is important and technology is convex, small-industry growth has been most rapid; bakeries, tailoring and dressmaking shops, furniture, structural concrete products, fabricated metal products, and rice milling. The latter, presumably because it is a weight-losing process with convex technology, appears better located nearer the source. Large industries grew fastest where scale economies outweighed higher marketing and transportation costs resulting from centralization, e.g., sugarmilling, dessicated coconut, cotton and rayon textiles, sawmills, and papermills. Finally, both small and large establishments thrived where no clear advantages from either location or scale economies existed.

The benefits from a rapid growth of the SSIs are generally held to consist of a more efficient absorption of labor, considering their greater labor intensity, the promotion of a less concentrated industrial structure, and a healthy impact on the distribution of incomes and wealth.

The quite remarkable growth of small-scale industries in the past is traceable to the growth of markets and, implicitly, the relatively high growth rates of income achieved before (although, as it would now appear, these rates of growth were not sustainable). Especially important is the growth of agricultural incomes to provide wider markets, since the majority of those employed in small-scale industries (i.e. 78 percent in 1975 [Anderson 1981, p. 98]) were to be found in the provinces. The various policy reforms towards removing the biases against agriculture thus assume wider significance. Exchange rate realism, for instance, not only shifts demand onto nontraded goods directly, where SSIs predominate, but also stimulates agricultural exports and incomes, indirectly increasing demand for SSI output. This may also encourage production by SSIs for the wider export market. The same may be said of tariff reforms which improve effective protection for agriculture and industries in which SSIs predominate (e.g., intermediate and capital goods industries). More liberal interest rate and credit policies would also go some way in increasing the flow of commercial funds to agriculture and SSIs.

In addition, specific intervention by the government would seem necessary in view of the information economies and moral hazard problems associated with SSI dealings. Government credit and extension programs now exist which seek to address these problems. In particular, the Industrial Guaranty Loan Fund (IGLF) and Small and Medium Industry (SMI) loans of the DBP provide credit facilities, while the Medium and

Small Scale Industries Coordinated Action Program (MASICAP) and the Small Business Advisory Centres (SBAC) program provide industrial extension. The theory behind these forms of intervention is that, if, through government initially bearing the risks, high information costs and moral hazard problems can be reduced as firm reputations are built up and experience in SSI lending increases, then eventually the private sector may involve itself in SSI lending in a bigger way. The government's programs have generally had a positive impact, except that the magnitude of financing effected has been small. This is chiefly because the participation of the private financial sector has been limited to that of acting as conduit for the subsidized government funds. An important reason for the lukewarm attitude of the private sector could be the ceilings on lending rates in effect before the crisis. The effect was to make the returns unattractive relative to the greater risks associated with lending to SSIs. It now remains to be seen whether the recent movements in the interest rate, once they have become less volatile, will change private lending attitudes. The availability of institutional credit would be relief to a major bottleneck in the expansion of SSIs, since they would otherwise typically have to self-finance.

The effects of the present crisis on the development of the SSIs are generally negative. Declining real incomes per capita typically mean sluggish or falling demand for most of their products; the

competitive environment in which they operate prevents them from recouping higher costs through price increases, although the fact that they are more labor-using, and real wages have not kept up with inflation, could possibly provide them an advantage relative to more capital-intensive firms. To the extent that they are net debtors, the regime of higher interest rates would be disadvantageous, although here perhaps, as a result of denial of credit in the past and obligatory self-financing, their position is not as bad as more highly-leveraged firms. One might also argue that SSIs could now enjoy additional business, since with the shrinkage of markets in areas where they compete potentially with large firms, scale economies (working the other way) could work against the latter. This should not be overemphasized, however, for ultimately what SSIs lack is the "deep purse" to weather a crisis.

2.2 Agricultural Sector[6/]

The importance of the agricultural sector in the industrialization process is well recognized. For an industrial sector to emerge from a predominantly agrarian economy, agricultural productivity must be increased at a sufficiently rapid pace so that the total food requirements of the economy can be produced by a small proportion of the labor force at reasonably low prices. As a consequence, labor will be released to the modern industrial sector.

[6/] Certain portions of this section draw from the analyses of David (1983) and World Bank (1984).

It is clear that a prior issue before undertaking an analysis of the short run effects of the adjustment measures in the agricultural sector revolves around the question of whether or not the productivity potentials of the sector were being tapped before the occurrence of the balance of payments crisis. The unemployment in the industrial sector brought about by the crisis can induce a reverse flow to the agricultural sector. If there is excess capacity in the agricultural sector, then the unemployed workers can be absorbed and contribute to an increase in output. But if all resources in the sector are already fully employed, this excess supply of workers can be absorbed only by reducing the real agricultural wage. In other words, it is important to examine the absorptive capacity of the agricultural sector. Accordingly, we start with a review of the sector's performance and the policy environment governing it, before the crisis, then move on to the likely effects of the adjustment measures.

The Price Setting

Agricultural output was growing for most of the decade of the seventies. For the palay and corn sectors, both production and yield (in kilos/hectare) have grown steadily since 1974. However, a worsening of the terms of trade against agriculture could be noticed after 1975.[7/]

[7/] The domestic agricultural terms of trade is defined here as the ratio of the domestic price index of agricultural output to that of non-agricultural output. The trend in the domestic terms of trade for food (against non-food) shows a pattern very similar to that of the agricultural terms of trade.

Figure 1

Agriculture CDP and Domestic Terms of Trade of Agriculture in Constant 1981 Prices for GDP

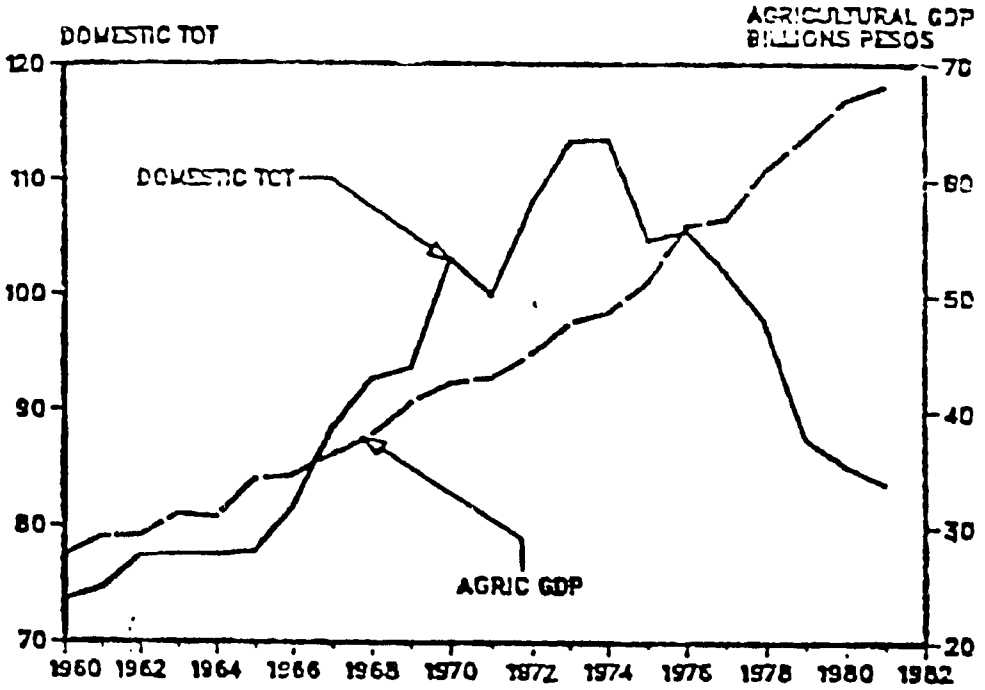
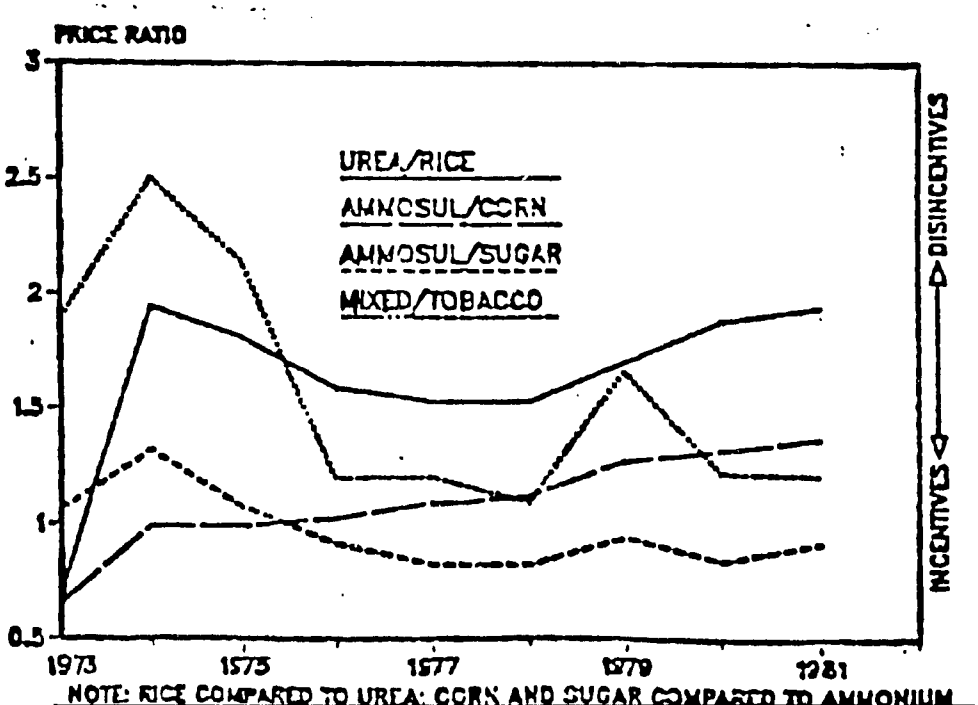


Figure 2

Fertilizer-to-Commodity Price Ratio, 1973-81



One way to appreciate the general movement of prices for agriculture is to compare ratios of fertilizer to specific commodity prices. Except for a very sharp rise in 1974, the ratios experienced a plateau between 1976 and 1978 and a gradual increase thereafter. Figures 1 and 2 show these price relationships that depict the sharp decline in domestic terms of trade and selected fertilizer-to-commodity price ratios, respectively.

Overall, it would seem that while agricultural GDP has grown alongside increases in domestic terms of trade (lagged one year), there are no discernible jumps in agricultural output responses in the late sixties or early seventies; neither could we observe a dramatic deterioration following the decline in the terms of trade after 1975.

The rise in agricultural output despite the declining terms of trade against agriculture should not of course be construed as "evidence" that Philippine farmers are insensitive to price changes. Studies on long-run supply elasticities for major Philippine agricultural products do show positive values.[8/] The introduction of HYVs beginning in the late sixties, increased use of fertilizers, and expansion in area

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[8/] Ministry of Agriculture estimates of long-run supply elasticities are as follows: rainfed rice, 0.15; irrigated rice, 0.52; copra, 0.60; sugar, 0.68; hogs, 0.90; broilers, 0.80; and yellow corn, 0.29 (World Bank 1984, Volume II, p. 9). Earlier studies by Mangahas, Recto, and Ruttan (1966) also show a generally positive supply response to price.

irrigated have all contributed to agricultural output growth in spite of the adverse price movements that started in the mid-seventies. The apparently large elasticity of supply with respect to technical change may have swamped the disincentive effects of the declining terms of trade.

Macro and Trade Policy

An examination of the policy regime for agriculture in the seventies requires a look into the general trade environment and policies for the industrial sector, as they affect such measures like interest rates, reserve levels, and credit flows. Perhaps it is understandable for agricultural research in the sixties to ignore non-agricultural policies, but it would hardly be defensible for the succeeding decades. One reason is the greater interaction between agriculture and other sectors: in the attempt to modernize agriculture, there is bound to be a greater reliance on industrial and imported inputs, the trading for which relies on modern credit markets. Another is that many agricultural goods are tradeable and trade policy can be expected to have a perceptible effect on the sector.

Since 1970, the country's exchange rate policy has been managed within a narrow band of fixed rates. Over the years and especially in the latter part of the decade the exchange rate has been overvalued. Using either a simple purchasing power parity condition or a more

complicated assumption regarding the trade regime, estimates of the peso's overvaluation put it at 20 to 30 percent above the official rate.

Real interest rates, on the other hand, have been negative in more recent times. Despite the existence of a wide network of private rural banks servicing agriculture, the major source of credit flows into the sector (channeled through the rural banks) has come from special agricultural credit programs rather than private financial intermediation (savings). As a result, the share of agricultural loans in total loans has decreased rapidly from 20 percent in the late sixties to less than 10 percent in the late seventies. Increases in rural bank assets have come from Central Bank rediscount facilities rather than from a more efficient way of mobilizing savings.

This does not mean that rural banks have diminished in importance as sources of agricultural credit. What this means is that private financial intermediation, i.e., from private savings to private investments, has been a relatively less important source of credit to the agricultural sector. For example, the increasing source of rural bank resources has come from Central Bank borrowings, such that the share of borrowings from the CB in rural bank portfolios increased from eight percent in 1961 to 54 percent in 1975 (David 1983).

On the other hand, Masagana 99 loans have constituted 83 percent of total supervised loans between 1973 and 1980 (with an absolute amount of ₱4,554 million). The total agricultural loans granted by rural banks

for the same period were ₱16,874 million. If 50 percent of these came from CB borrowings, it becomes clear that special credit has been a major source of total credit. In fact the real agricultural loans granted by rural banks peaked in 1975 after which they diminished before marginally exceeding the 1975 peak in 1980. This means rural banks as a whole have not been increasing their real loans in agriculture.

The extent of a trade regime's influence in agriculture is depicted by the protection structure accorded the sector through various tariffs--nominal, effective, and net effective protection rates in the case of agricultural outputs, and implicit tariffs in the case of inputs. In general, the protection system seems biased against the agricultural sector in favor of manufacturing and agro-processing. Moreover there is evidence that over time the protection bias against agriculture has worsened.

Positive nominal protection rates (NPR) have been estimated for rice, corn (white and yellow), sugar, pork, chicken and aggs; but the rest of the major commodity groups and export products have suffered from negative NPRs for 1981 and 1982. The same pattern emerges when effective protection rates (EPR) are used to measure the degree of protection. When the domestic currency overvaluation is taken into account, the net EPRs (NEPRs) become more negatively pronounced.

The bias against the agricultural sector becomes more telling when NEPRs are used. In the case of manufacturing, because of the high protection rates for the sector, NEPRs remain positive. For example the average EPR for manufacturing is 44 percent with an NEPR of 21 percent. In the case of agriculture, because of low protection rates, NEPRs fall and in some cases turn negative when shadow exchange rates are used.

Table 3 presents information regarding time trends for NPR, and estimates of EPR and NEPR for major agricultural products. These results open up a number of observations. First there seem to be only slight changes in NPR between the late seventies and early eighties except for changes in the protection signs for sugar (from - 16 percent to 5 percent) and pork (from - 3 percent to 6 percent). The large number of products with negative protection in 1981-82 however contrasts with zero or positive protection during the sixties. Second, there is a wide variance in the NPR of coconut products. This reflects more of product specific policies (noted below) than of the trade regime. Third, based on EPR, only corn, chicken, and eggs enjoy positive protection (with chicken given the highest rate), with the values falling drastically as soon as exchange rates are corrected. Finally the protection given to processed agricultural products such as coconut-based derivatives is apparent from the "cascading" nature of EPRs. Indeed this nature can be fully seen when other agro-processing activitie are included (such as flour milling, bakery products, and slaughtering

Table 3

Trends in Nominal Protection Rates
of Agricultural Commodities,
1975-80 and 1981-82
(percent)

	1975-80	1981-82
Rice	1	1
Corn (yellow)	20	20
(white)	2	17
Copra	-27	-26
Coconut oil	-4	-9
Dessicated coconut	-4	-4
Sugar	-16	5
Cotton	-7	-27
Pork	-3	6
Chicken	57	n.a.
Eggs	11	n.a.

Source: C.C. David. "Economic Policies and Philippine Agriculture." Paper presented at the workshop on The Impact of Economic Policies on Agricultural Policies, Tagaytay City, Philippines, March 1983.

and poultry dressing).

If agricultural output in more recent times has had little protection, the implicit tariffs (IT) the sector pays for its inputs convey an almost opposite situation. Except for irrigation, major inputs have positive IT in 1980-81. This means that in production, domestic prices of agricultural inputs have been higher than border prices (at official exchange rates). Table 4 shows the IT for 1980-81, a number of them reflecting industrial products that enter into agricultural production.

The structure of protection engendered by the trade regime in the late seventies and early eighties appears to be a combination of low protection for agricultural outputs (thus more or less similar prices domestically and internationally) and moderate protection for (mainly industrial) inputs. This has implications for the profitability and incentive environment for the agricultural sector in general and for specific crops.

Rice Policy

Rice policy has always had among its important objectives the provision of production incentives to farmers and stabilization of consumer prices. Providing support prices and defending ceiling prices have been the traditional instruments to achieve these objectives.

Table 4

Implicit Tariffs on Agricultural Inputs, 1980-81

Inputs	Implicit tariff (%)
Irrigation (NIA gravity[a/]	-86
(NIA communal)	-92
Irrigation pumps[b/]	30
Hard tractors[b/]	33
Four-wheeled tractors[b/]	10
Animal feeds (hog grower mash)[c/]	7
(cattle feeds)	17
(layer mash)	20
(broiler mash)	23
Agricultural chemicals[d/]	23
Fertilizer[e/]	10

[a/] Includes subsidy due to low irrigation fee and low repayment rate.

[b/] Based on tariff rate.

[c/] Based on weighted average implicit tariff on feed ingredients.

[d/] Based on tariff rate and advanced sales tax.

[e/] Based on price comparison of urea, ammonium sulphate, mixed fertilizer and phosphates from 1973-81.

Source: C. David, op. cit.

Since 1974 this sector's policy environment has had these features: (a) the government has been providing irrigation (both investment and some operating costs), (b) a single government entity (currently the National Food Authority or NFA) retains monopoly of rice trade, and (c) credit flows to the industry, while small in volume and perhaps insignificant, have come from special agricultural programs.

From 1977 up to 1982 total yearly rice production exceeded consumption, but residual exports were left solely with NFA. Moreover, NFA purchases of 10 percent of rice crop to defend official pricing policies were not always successful especially during peak periods in the production cycle when private discounting was widespread. This, coupled with restrictions to private (export) trading, began to widen disparities between farmgate and support prices for palay and rice between 1977 and 1983.

On the other hand, the positive implicit tariffs for manufactured inputs for rice production (machinery, fertilizer, chemical, fuel) and the very slight, if not zero, effective protection to rice effectively penalized this industry. However this probably held more strongly for rainfed rice farms and non-irrigated areas which did not benefit from heavy irrigation subsidies implied by negative IT's.

Corn Policy

Government intervention in corn as well as in rice is sometimes justified on the basis of equity considerations. But in contrast to rice, yellow corn is also used as animal feed, making its output an input into livestock and poultry. NFA is also the sole importer of yellow corn and controls domestic prices of the product. Its intervention in corn products not only affects that industry but the animal industry as well. Though white corn comprises 75 percent of all corn output, yellow corn is growing faster than the former (at 18.4 percent per annum in 1980-82). Corn is domestically priced at around 20 percent above border prices.

Because of its potential for achieving efficiency, self-sufficiency, and reduction in prices of livestock and poultry, the government launched a yellow corn program (Maisagana) in 1981, aiming to achieve sufficiency in 1986, and to export by 1987. These targets were set back however because of drought experienced in crop year 1982-83.

For corn, it seems obvious that government policy centers on the control of domestic and foreign trade by NFA, which impinges on other agricultural products (livestock and poultry), as a result of its being an intermediate good for these sectors.

Sugar Policy

In Table 3 above sugar is shown to have received negative NPR between 1975 and 1980 and a positive protection of 5 percent in 1981-82. This is a big drop from a 36 percent NPR in 1970-74. These values depict heavy government intervention through its institution or exercise of monopoly or monopsony power.

To protect producers and consumers and to attain greater marketing position, the government (through the National Sugar Trading Corporation or NASUTRA) has been the sole buyer of sugar from sugar mills and the sole exporter since 1974.

It ir difficult to track down the policy environment for sugar in general terms because of fluctuations in world sugar prices. However, in the most recent past (as reflected in Table 3), sugar producers have been receiving less than world liquidation prices and consumers paying less as well. In the eighties domestic and export prices were on par, although on the average between 1974 and 1982 it is safe to say both producers and consumers have been faced with less than the border price.

Before the government monopoly/monopsony, new mills were built with government-guaranteed loans. The depressing effect of negative NPR's on production thereafter implied excess capacities for the mills. Apart from intervention in the commercial operations of sugar exercised

by NASUTRA, the sugar industry has been subject to export taxes, price controls, minimum wages, and low interest rates.

Coconut Policy

The policy environment for the coconut industry can be described in an analogous fashion to the sugar industry. One is the consolidation of coconut mills into a United Coconut Oil Mills (UNICOM) mandated to be the largest copra buyer and the biggest seller of coconut oil. Another is the imposition of various taxes and levies partly to support coconut industry-related activities (e.g., replanting program, insurance for workers, etc.). Differential export taxes have also been imposed in order to stimulate processing for exports.

Although interventions in the coconut industry have been significant since 1970 (with the imposition of an export tax after the peso devaluation), it was only in the middle to the later part of the decade that taxes and levies accelerated. The cocofund levy started at ₱5.50 per ton of copra in 1971; in 1979 this stood at ₱600 per ton of exported copra plus ₱400 per ton for an export clearance. In 1982 the levy was suspended when average world coconut oil prices fell below 20 cents per pound.

The differential tax rates imposed on coconut products depended on the processing involved. As shown by the NPR in Table 3, it is copra which is heavily penalized compared with coconut oil and dessicated

coconut (and even copra meal/cake). In fact export taxes for copra are close to twice the rate for processed products.

In 1983 coconut prices picked up again with copra prices gaining almost twice unit prices of 1982 and exceeding 1980 average prices. World prices for these exports however, while picking up, did not reach the peak values experienced in 1979 or 1980.

Livestock and Poultry Policy

Stabilization of consumer prices is the primary reason for interventions in the livestock and poultry markets. The exercise of this function rests with the National Food Authority (NFA) as part of a general goal of food security. The instruments used have included tariffs and quantitative restrictions for intermediate inputs and fixed outputs, and monopolization of markets.

There seems to be self-sufficiency in meat production, with beef imports less than 10 percent of consumption, and poultry and pork imports less than one percent. The grant of exclusive trading rights to Food Terminal Inc. (FTI), however, has created divergences between domestic and border prices of these products.

Except for chicken and eggs, EPRs for hogs and cattle are negative although in the case of pork this has recently turned into a positive NPR. The practice of livestock and poultry importation and

retailing by FTI or NFA has not prevented continued upward movement of these prices, and the lower import prices (f.o.b.) since 1979-82 have not been translated into lower domestic prices.

Efforts at increasing production or achieving price parities in these sectors have been constrained by prices of feeds which constitute some 70 percent of costs. Thus livestock-poultry profitabilities hinge on the implicit tariff on feeds. The control of retail prices of poultry, eggs and meat and the control likewise of their main feed ingredients (yellow corn and soybean meal) suggest a strong intervention in these industries.

In more recent years, because of price controls and the growing efficiency of the livestock and poultry industry (due in turn to a shift from traditional backyard production to vertical integration and controlled-feed production), NPRs have in fact been lower than potential protection accorded through tariffs (e.g. NPR of 57 percent for broilers compared with tariff of 70 percent and NPR of 11 percent for eggs compared with tariff of 100 percent).

Accelerated imports of yellow corn have lowered its NPR and consequently the NPR of livestock and poultry (though chicken continues to enjoy high EPRs. This has implications for improving production and supporting government programs for cattle (Bakahang Barangay) and carabao (Kalabaw ng Barangay).

Fertilizer Policy

Fertilizer is an important input for agricultural production and it would be useful to understand the policy environment in this industry. Examination of interventions in the industry will also illustrate how other input industries can be viewed.

Regulation of the fertilizer industry beginning in 1973 and as its rationale the protection of farmers from excessive fluctuations of fertilizer prices especially after the quadrupling of prices in 1973. Over the years, however, this justification seems to have been eroded as fertilizer prices have declined sharply from 1976 to the present.

Intervention in the industry comprises two forms: (a) the importation, duty free, of fertilizers and raw materials, and (b) subsidies to domestic fertilizer producers for losses incurred from sales with price controls. During 1973-75, world fertilizer prices were above domestic prices as protection was given to farmers. After the fall of prices in 1975, however, the ex-warehouse prices were not reduced and thus domestic prices have been above bo-der prices.

The implicit tariff for fertilizers of 10 percent in 1980-81 (see Table 4) hides some variations depending on the type. By 1982, urea (used in rice production) was 44 percent above import prices; ammonium sulphate (used in corn), 103 percent higher; and muriate of potash (used in sugar and other export crops), 111 percent higher.

Subsidies were abolished in 1982 but tariffs remained. Deregulation was not pursued with the result that farmers were paying higher prices for fertilizers at the same time that domestic production as a fraction of total consumption declined in importance from around 70 percent in 1970 to some 25 percent in 1980.

Impacts of Adjustment Measures

Generally speaking, a more realistic exchange rate removes the bias against traded goods relative to non-tradeables. Conversely an overvalued currency penalizes tradeables. Given the fact that the non-agricultural sector (mainly manufacturing) enjoys more protection relative to agriculture, a devaluation would not have a uniform effect. For one, agriculture comprises products that are normally tradeable unlike the non-traded sector which includes services. Thus resource flows in agriculture should improve with exchange rates that approximate their opportunity costs. Also, the generally high level of protection enjoyed by many manufacturing industries practically creates a situation where the incramental benefit received from overvaluation appears unnecessary in contrast to the undue disadvantage of agriculture. Thus the NEPRs for manufacturing remain positive while for agriculture they change from positive to negative.

To the extent that an overvalued currency was pursued in the years before the crisis, it follows that agriculture was penalized

compared to the situation when the exchange rate was in equilibrium. Thus, in addition to the balance of payments problem that it created, the intersectoral balance was unduly distorted with unwarranted flows out of agriculture.

For nontraded agricultural output, the effect of the devaluation is to switch demand towards local farm products and away from imported goods. We can expect, for example, an increase in the demand for fresh produce relative to canned manufactured foods. If the farm sector is below full employment, then the increase in demand can be accommodated without a serious inflationary consequence. If there are no price controls, the increase in demand will tend to improve the terms of trade for farm produce relative to food manufactures, given a depressed demand for the latter. The improved terms of trade, however, can be negated if the government, as it did in the past, will try to protect the industrial sector workers by artificially keeping the price of food and other farm produce low in the urban areas.[9/] It is well known that price controls created disincentives for agricultural production, and

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[9/] The government has announced a policy of deregulating food prices. However, it is not quite evident that activities of the National Food Authority (NFA) which has intervened in, among others, food trading and distribution, have been delimited. Consequently, it is not at all clear whether or not observed prices for food are the market-determined prices. There is a lot of noise, for instance, attached to the observed prices for cereals and meat and poultry products.

simply succeeded in keeping rural incomes at subsistence or near subsistence levels.

The policy of favoring industrial sector workers through low food prices, rent control, and the like reflects perhaps the thinking of some government authorities that for industrialization to proceed rapidly, it is essential that a faster capital accumulation in the industrial sector be accomplished by worsening the terms of trade against agriculture. However, the adverse distributional effects of the declining terms of trade against agriculture are by now well documented.

If one looks at some indicators of income distribution over time, one can infer the adverse income distribution effects of turning the terms of trade against the agricultural or rural sector. Table 5 is quite revealing. For the rural sector, the lowest 20 percent of families showed a decline in their percentage share of total family income from, 7 percent in 1956 to 4.4 percent in 1971. Between 1965 and 1971, there was a slight improvement in the share from 3.5 to 3.8 percent for all households; however, for rural households the share of the lowest 20 percent went down from 5 to 4.4 percent. The same story emerges from a look at the Gini coefficient. Between 1965 and 1971, there was an improvement in the Gini for all households, from 51 to 49 percent, but a worsening in the Gini for rural households, from 42 to 46 percent. There are no recent estimates of income differentials

Table 5

Indicators of Income Distribution: Total, Rural and Urban
1956, 1961, 1965, and 1971

Quintile of Families (% of Total Family Income)	1956			1961			1965			1971		
	Total	Rural	Urban	Total	Rural	Urban	Total	Rural	Urban	Total	Rural	Urban
Lowest 20%	4.5	7.0	4.5	4.2	5.9	3.8	3.5	5.0	3.8	3.8	4.4	4.6
Second 20%	8.1	11.1	8.0	7.9	11.8	7.5	8.0	9.5	8.0	8.1	8.9	9.4
Third 20%	12.4	14.7	12.2	12.1	13.5	12.5	12.8	15.3	12.0	13.2	13.9	13.4
Fourth 20%	19.8	21.1	20.0	19.3	21.9	19.5	20.2	23.0	18.7	21.1	21.8	21.9
Top 20%	55.1	46.1	55.3	56.4	46.9	57.1	55.4	47.2	57.5	53.9	51.0	50.7
Top 10%	39.4	30.1	39.6	41.0	31.1	40.9	40.0	30.0	41.7	36.9	34.4	33.4
Top 5%	27.7									24.3	22.6	22.6
Gini Coefficient	.48	.38	.49	.50	.40	.52	.51	.42	.53	.49	.46	.45

Source of Basic Data: Family Income and Expenditures Survey, various issues.

Reproduced from Sharing in Development (1973, Table 3, p. 10).

between rural and urban households, but it is probably safe to infer that given the past differentials, the gap has not narrowed much, if at all. Thus, to the extent that a decline in the agricultural terms of trade would lower agricultural incomes (other things held constant), the overall effect on income distribution would be negative.

More recent analyses by Harry T. Oshima, using data obtained from the 1978 and 1979 Integrated Survey of Households, showed a deterioration in the Gini coefficient: 52 percent for 1978 and 53 percent for 1979. Oshima does not provide a breakdown of the Gini coefficient by rural and urban households. However, if past studies are of any help, one is hard-pressed looking for factors that would tend to improve the income share of rural households, given a setting of general worsening in income distribution.

It should be noted that discussion on the appropriate terms of trade between the agricultural and industrial sector can be traced to some literature which points out how capital accumulation should proceed in a socialist state. Russia, for example, took the path that sufficient capital accumulation in the industrial sector can proceed by turning the terms of trade against peasants.

More recent analyses in the context of less developed countries have shown that turning the terms of trade against peasants can also lead to a decline in the welfare of industrial workers; the decline is larger if the response of the rural surplus is larger. The intuition

behind this result follows from the fact that a decline in the surplus of the agricultural sector brought about by the poorer terms of trade must be accompanied by a reduction in the demand for the agricultural output, say food, by industrial workers, to maintain the equilibrium condition of equality in the demand and supply of the rural surplus. To effect the downward shift in the demand by industrial sectors, a decline in urban wages must be made. The urban wage reduction entails a reduction in the overall welfare of industrial workers. A theoretical example of these effects of turning the terms of trade against agriculture has been set forth by Stiglitz and Sah (1984) in a general equilibrium framework.

At least two parameters are key ingredients for establishing the above results; a positive response of the rural surplus to prices and positive income elasticities of demand for the rural output. There is econometric evidence supportive of a positive supply response by rice and corn farmers in the Philippines (see Mangahas, Recto, and Ruttan 1966). Canlas (1983) has estimated positive income elasticities of the demand for food in the urban areas. In Manila, for instance, the income elasticity of the demand for cereals is 0.362; for other urban areas it is 0.336. Other food groups (fish, meat and eggs, milk and dairy products, roots) also showed positive income elasticities for Manila and other urban areas.

A theoretical treatment of turning the terms of trade against agriculture shows that this policy cannot for long insulate industrial workers against being affected adversely. Considerations of general equilibrium dictate that the reduction in the rural surplus must be met by a reduction in urban wages to reduce demand. It is useful to note here that a decline in real wages and earnings in the urban areas has been discerned (see De Dios 1984, p. 24).

The above findings turn on the normative aspects of reforms in the terms of trade. One legacy of the present economic crisis is to draw the attention of policymakers to improved agricultural production. This action, however, is more of a response to the failures of the big industrial projects in bringing about the desired industrialization pace. It is doubtful if the stress on balanced agro-industrial development reflects a shift in the social weights given to incomes and welfare of rural and urban workers. Given the overall constraints on financing economic development in the future, and the tight domestic monetary and fiscal policies, industrial and agricultural sector plans are likely to be downsized. To the extent that the Marcos government is genuinely wedded to big industrial projects, it will be naive to think that the rural sector will now receive a greater weight in the bureaucrats' notion of a social welfare function.

2.3 Service Sector

One phenomenon that has baffled watchers of development trends in the Philippines is the high growth rate of the service sector relative to, say, the manufacturing sector. Some of the activities covered in this sector are retailing and wholesaling, banking, insurance, and personal services. Growth of the service sector is generally attributed to increasing industrialization and urbanization.

At a very broad level, the contraction of the industrial sector will induce a corresponding decline in the service sector. The decline in the volume of output that has to be retailed will mean a reduced demand for service workers. Financial and insurance markets are also expected to experience a decline in output.

The social problem created by a contraction of the service sector which in the past has shown a strong absorptive capacity relates to the workers who will be rendered unemployed. Most of these workers are in the urban areas. It is a characteristic of service firms to agglomerate in the urban areas to cut down on search and transaction costs. For one, government regulatory agencies are typically located in urban centers, and it would be economically feasible for, say, banks and insurance firms to locate also in places where these regulatory agencies are. If these unemployed workers go back to the rural areas, then there are wage and employment implications for the rural sector. If they remain in the urban area, their unemployment constitutes an unproductive use of labor resources.

The crisis brought to fore some inherent weaknesses in the financial markets. Most of the small banks became victims of speculative attacks. As private investors shifted cash balances from pesos to dollars, to be reinvested elsewhere, say, in foreign banks, the liquidity position of several small savings banks reached critical minimum level: and eventually led to their closures. These bank failures induced some output effects by raising the cost of credit intermediation. Uncertainty about credit availability can create production lags and output uncertainty.

The underlying inefficiencies in the financial market might be traced to its overall structure. The macroeconomic adjustments can lead to mergers or takeover of small banks by bigger banks, and hopefully to some institutional reforms which would make the Central Bank less dependent on the ruling political power.

There is no doubt that the financial-market crisis can be traced to inappropriate fiscal and monetary policies. These policies are traceable to some incentives created by existing institutional arrangements. When the monetary board had as members the heads of PNB and DBP, incentives for expansionary monetary policies were strong. PNB and DBP, through the rediscount facilities of the Central Bank, stood to gain from expansionary monetary policies. The presence of government bureaucrats in the current monetary board (e.g., industry and finance ministers, the NEDA director-general) also raises some incentive compatibility problems. The director-general of NEDA and the industry minister are in charge of initiating projects and their choice of

projects affects the size of the government budget deficit. The finance minister is responsible for seeking financing for government-approved projects. When government expenditures on projects and other items exceed current tax revenues, the resulting deficit can be financed by issuing interest-bearing debt instruments like bonds, here or abroad, or by creating high-powered money. This turns on the issue of whether or not the bureaucrats as members of the monetary board and given their objectives as bureaucrats are indifferent between these types of government financial policies. In view of a limited bond market, the transaction cost of bond financing is likely to be higher than money creation, which tends to make money creation a more attractive policy. Money creation, if dictated by lower transaction cost would appeal to bureaucrats and non-bureaucrats alike, rendering the issue of which set of experts should be on the monetary board less important. The more important issue then, it seems, is the setting up of rules that will impose effective limits on the chief executive's influence over monetary matters and economic activities in general, with the institutional arrangements that will make those limits binding.

The macroeconomic adjustments are also likely to reduce the activities of insurance firms. There will likely be a thinning of insurance markets. Insurable risks, instead of expanding, will probably be reduced, as insurance firms tend to be more risk averse. It is well known that a very thin insurance market can lead to an inefficient allocation of risk. This can have adverse output effects: if investors

and entrepreneurs feel that they are carrying an unduly large share of the risks involved in any business undertaking, then a less than optimal investment in productive resources will be made.

There is no presumption, however, that imperfections in insurance markets should trigger government intervention. It may well be that firms and workers will privately arrive at some contractual arrangements that will tend to minimize the risks of a productive undertaking. Outright intervention by the government will not necessarily alleviate the informational problems that lead to market failures in insurance or risk-bearing. These information problems, e.g., moral hazard and adverse selection, are indicated in some of the guarantees extended by the government to some private firms that were driven to bankruptcy by the recent balance of payments crisis.

The foregoing discussion has referred mainly to the formal service sector. Employment in the informal or unorganized service sector is actually much bigger, comprising about 60 percent of total service sector employment.[10] The informal sector, especially in the urban areas, is

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[10] This estimate is yet for 1971, from the ILO Employment Mission Report (ILO 1974). Employment in the unorganized subsector was calculated as a residual, "by subtracting employment in licensed establishments (as given by the economic census) from total employment (based on the mission's adjustments to the figures in the Bureau of the Census and Statistics labor force survey" (ILO 1974, p. 179). There are no recent estimates of the unorganized service subsector, but the ILO study shows the share to have been stable at about 60 percent over the 1961-1971 decade, and has probably remained at that level in the seventies.

often seen as providing "safety-valve" employment for new migrants and for those laid off from formal sector employment during times of recession, because of relatively free entry and small capital requirements. However, one should not overlook the possibility that many activities falling under this sector may well be among the major causes of social costs in urban economies. Small enterprises, partly because of their smallness, often easily manage to evade governmental regulatory practices so that illegality has become a characteristic commonly applied to discriminate between formal and informal sector participation (Sethuraman 1974). The very presence of government controls may indicate the desire to limit or ban such activities because their "products" are almost universally deemed to be "socially undesirable" (although they may be privately remunerative).

Aside from those pursuits which are felt to have negative social value, there are those informal sector activities where marginal social costs tend to be higher than marginal private costs because of the failure of the participants to impute economic value on otherwise scarce resources. For example, hawkers and vendors often consider sidewalks and busy streets as costless inputs to their trade, although the entrance of an additional worker reduces the average product not only of the hawkers and vendors already plying the given area but probably also of the pedestrians and other road users. To the extent that the workers are able to escape from government regulation almost costlessly, the level of employment in such itinerant trades is pushed beyond the point

where the marginal product of the workers just equals the opportunity cost of the same workers in other pursuits. This is basically the behavioral circumstance underlying the presence of disguised unemployment in urban centers.

These instances are pointed out here not as a prejudgment on the efficiency or inefficiency of the urban informal sector but merely as an appeal for a more objective and balanced view of the problems and prospects facing this sector. The growing interest in the informal sector has probably been kindled mainly by equity considerations: informal sector activities are the means of livelihood of the urban poor and therefore deserve the planners' attention. However, without due concern for the allocative dimensions, the designed equity-oriented programs may fail to deliver their expected outcomes or may not be able to realize their stated objectives without incurring substantial resource costs.

Obviously, these issues can be settled only at the empirical level. It may turn out that the activities where one would expect disguised unemployment are really very few and may even be operating at close to optimum employment levels (because some enterprising observers such as self-appointed "organizers" may be exacting private taxes on the workers and thus be appropriating the rent due the scarce resource). It is also widely held that informal sector enterprises, although they may manage to evade taxes, are at least as economically efficient as

their larger competitors and are often faced with factor prices more closely reflective of the true social opportunity costs of the resources to the economy. These observations are simply meant to bear out the complexity of the economic relationships characterizing the urban informal sector.[11/]

[11/] The last four paragraphs have been adopted from Alonzo (1980).

Part II

GROWTH ISSUES AND ADJUSTMENT MEASURES

3. Long-term Constraints to Growth

There is an inevitable interplay between the macroeconomic adjustments the government adopts in response to short-run imperatives and the achievement of the longer-term objectives of the economy. There is tautologically no future independent of present events, and the possibility and speed of the economy's attainment of a stable and efficient path of growth cannot be independent of the measures that are put in place during the transition. The short-run economic decisions may be sufficient to dictate the long-term position of the economy.

The long-term objectives for the Philippine economy may be broadly said to include the attainment of efficiency, some minimum continuous material improvement in the standard of living, equity or justice, and a presumed value given to the preservation of free choice or self-determination on the part of the individual as well as of the whole nation insofar as choice has no large adverse effects on the society or community of nations.

These aims often overlap and the achievement of one may in practice be held to conflict with the achievement of the others. Moreover, while there may be little social disagreement over the objectives in themselves, their translation into concrete economic

measures would not result in a unique configuration of policies on which all sectors of society could agree. Nevertheless, economic theory as well as the recent historical experience of this and other countries would suggest that the following would be essential ingredients in a sound policy environment for future growth.

First, the achievement of efficiency may be accomplished through an unbiased industrialization and trade regime which does not discriminate between industry and agriculture nor between exportables and importables. The adoption of such policies is generally expected to reveal the country's comparative advantage in labor-intensive manufactures, natural resource-based industries, and agriculture, hitherto suppressed by a system of protection and an overvalued currency. The grave failures of the import-substituting industrialization regime have already been sufficiently discussed and bear no repetition. Concretely, this policy translates into a restructuring of the price and incentive system in both industry and agriculture. Reforms in the structure of tariffs, subsidies and taxes (such as the current 1980-1985 tariff reform) must be completed so as to even out the protection and/or discrimination imposed on various sectors of the economy. This also implies that a single exchange rate must be adopted and applied both to importers and to exporters.

Secondly, agents in the economy should, in general, be allowed to act independently and with a minimum of government intervention,

the latter to be resorted to only when there are demonstrated externalities---whether economic or not---or scale economies that would otherwise be disregarded by private agents. This would imply that in the attainment of efficiency in resource use, some preference should generally be attached to market solutions rather than direct allocation, price control, or rationing. Monopolies and government intervention would generally not be brooked without passing certain economic and political criteria.

Thirdly, the government's role in direct asset and income redistribution should be well-defined and recognized as a valid instance when government may intervene through its taxing and spending functions. Nevertheless, such redistributions should not be mainly mediated by interventions into the market mechanism but should be accomplished through direct taxes and transfers involving the relevant sectors of society.

Fourthly, the government should pursue prudent monetary, fiscal, and exchange rate policies which accommodate secu.ar increases in income and yet minimize inflation and avoid unsustainable external imbalances and indebtedness. The value of such a broad policy prescription stems not only from the obvious economic imperatives but also from the related concern over the value of self-determination for the country, which could potentially be compromised by an inability to service debt, as the present crisis has illustrated.

More particularly, such a prescription would encompass the following recommendations:

- Adoption of a unified and flexible exchange rate;

- A growth rule for money that would be monitored on a quarterly basis;

- A pattern of government expenditures and transfer payments that can grow secularly, but not in response to cyclical changes in economic activity;

- A pattern of tax rates, also varying secularly, but not in response to cyclical changes in economic activity, and set to balance the government budget on the average;

- A clearly announced policy that wage and price agreements privately arrived at will not trigger any government reactions.

These proposals are not really new and we do not claim them to be original to us. They call for a marked shift in the conduct of fiscal and monetary policies. Instead of regarding policy as a discretionary management of economic matters, we support the view that policy be thought of as a set of rules, involving the search for institutional arrangements that will make the rules stick over a relatively long period. We submit that these proposals are more effective in controlling undesirable fluctuations in output and prices, helping provide a more stable environment for private economic agents, namely, the workers, producers, and consumers.

The proposed adoption of a fixed money growth rule stems from our acceptance of the view expressed by some eminent macroeconomists that there are limits to what monetary policies can do. For example, monetary expansion cannot peg the interest rate at a targeted level, nor raise the level of output and employment for long, without raising the inflation rate. The Central Bank should target only the variables that it can effectively control, such as the money base.

The inferiority of adopting a countercyclical policy in the face of a recession has been demonstrated by the economic events from 1973 onwards. After the first oil-price shock in 1973-74, policymakers stepped up public spending which was accommodated by an expansion in the money supply. The results of these measures are now well-known: momentary growth and permanently high inflation rates.

The expansionary monetary policies which were pursued under a regime of fixed exchange rates resulted in capital outflows: private investors were able to exchange their excess peso cash balances for dollars at a fixed nominal rate, and proceeded to invest these in capital markets abroad. Fixed exchange rates also made the economy vulnerable to inflation abroad. If the purchasing power parity condition holds, an increase in the inflation rate abroad is readily translated into an increase in the domestic inflation rate through the fixed exchange rate. To

avoid these adverse results, a flexible exchange rate must be adopted.

On the fiscal side, we eschew tax changes that react to cyclical changes in the economy. We support a secular increase in the pattern of tax rates designed to balance the budget on the average, the increase to be determined by the expressed needs of the citizenry. The willingness of the citizenry to support this increase can be obtained through a system of elections in a democratic setting. Such a system will reveal what patterns of expenditures the citizenry will support. In the past, the pattern of expenditures has been very erratic, creating the notion that public goods like basic education, health, and social infrastructures have been undersupplied (see de Dios 1984). An aura of doubt surrounds the increased expenditure share for the military, which to some observers appears to have raised the supply not of public goods but of public bads.

Corollary to the above is the need to make the budget reflect as accurately as possible the scope and size of governmental activities. A closer study of government budgeting is needed to help integrate the budget and off-budget activities of various government units, especially those of corporations that have been exempted from government audit.

Governmental respect for wage and price agreements that are privately arrived at is essential for restoring whatever

flexibility still remains of wages and prices, and providing better guidance for efficient allocational decisions. If the agreement privately arrived at is deemed inefficient and government wants to intervene, the superiority of its proposed solution over other nongovernmental solutions must first be demonstrated.

Finally, we come to the issue of what arrangements or reforms must be instituted to make the recommendations more effective. The following might help:

(1) The Central Bank Governor as the monetary authority should announce before the Batasang Pambansa (BP) the money growth rate over a decade and should be made to account every year for any deviation from the announced rate.

(2) The Finance Minister as fiscal authority should announce before the BP at the beginning of a budget year the expected budget deficit, and account for any deviation, at the end.

(3) There should be a limit on public sector borrowing from abroad, and the Finance Minister should announce the annual expected amount of foreign loans and account for any deviation from the limit before the BP.

(4) The Chief Executive should be shorn of discretionary power such as those provided by Amendment 6.

Crucial to making these arrangements effective is the presence of coordination among the Chief Executive, the fiscal and monetary authorities. If the monetary authority decides on a tight monetary policy, it should not be subverted by either the Chief Executive or the fiscal authority by ordering a tax and expenditure plan that involves large budget deficits. Once the monetary authority relents by deciding to monetize the deficits, private economic agents will be confronted with uncertainties about inflation, interest and tax rates.

Within the framework, Amendment 6 is potentially destabilizing. When the Chief Executive decides on a tax and expenditure plan that involves large deficits, it is almost sure, given the incumbent's reputation, that those deficits will be monetized, unless there is an international body like the IMF that will make the tight monetary rule stick. The above arrangements will not remove all undesirable fluctuations in output and prices. However, considerably larger fluctuations can be expected to arise from discretionary policies than from a clearly announced set of rules.

3.1 Macroeconomic Forecasts

Without doubt the most immediate constraint to long term growth is that posed by the present requirements of debt rescheduling and stabilization. Given the present contents of the financial package as *fait accompli*, the stabilization measures required

become indispensable in the short term if the economy is to make any headway towards attaining normalcy in its operations. At the same time, the stabilization measures impose ceilings on saving and foreign exchange gaps that may be allowed during the period as being consistent with the repayment of external liabilities incurred in the past. These constraints on financing inevitably have an impact on the scenario for growth over the rest of the decade.

As Table 6 below shows, the adjustment program over the next few years (1984-1986) requires a narrowing of the investment-saving

Table 6

Macroeconomic Targets for 1983-1986

	1984	1985	1986
Current Account deficit ($b)	1.5	1.1	0.6
Trade Balance ($b)	-0.5	0.1	0.5
Gross Investment (% of GNP)	22.0	22.5	23.0
Gross National Savings (% of GNP)	16.3	18.4	20.7
Investment Gap (% of GNP)	5.2	4.1	2.3
of which: Public Sector	3.6	1.4	1.0
Private Sector	1.6	2.7	1.3
Real GNP (% increase)	-6	0	1
M3 (% increase)	10	13	12
CPI (average % increase)	45-50	20-25	10

Source: Economic Memorandum, 1984.

gap from 8.2 percent of GNP in 1983 to 2.3 percent in 1986. Both public and private sector deficits are to decline from 3.7 and 4.5 percent of GNP in 1983 to 1.0 and 1.3 percent in 1986, respectively. Using optimistic assumptions regarding export growth (10-11 percent in 1985-1986), the government projects a narrowing of the current account deficits from $2.8 billion in 1983 to $0.6 billion by 1986, with a trade surplus of $0.1 billion appearing by 1985.

The effects of such external and domestic ceilings are seen in a real income decline of six percent in 1984, zero growth in 1985, and one percent growth in 1986. Given a growth rate of population of 2.5 percent per annum, this amounts to negative growth of per capita real income of -8.5, -2.5, and -1.5 percent for 1984, 1985, and 1986, respectively.

Beyond 1986, the economy is projected by the government to grow at four percent per annum until 1990. Implicitly, therefore, the adjustment period, properly called, is expected by the government to last only up to 1986, after which the real growth rate is seen to stabilize at something like historical levels. (Cf. Economic Memorandum, Table 9, p. 33.) Nevertheless, in per capita terms, this means that given present growth rates of population, 1980 per capita incomes will not be regained until 1995.

It is against this backdrop of historically low levels of per capita income that the realism and prospects for success of

the present adjustment measures must be placed. Briefly, these adjustments call for: (a) slower monetary growth to minimize inflation and pressure on the exchange rate; (b) reduction of budget deficits through new tax measures, stricter tax administration, and also cuts in expenditures; and (c) a more flexible exchange rate.

There are indeed several places in the adjustment program where the balancing of the needs of stabilization with the needs of development can test the determination of the current (as well as any future) government to make the optimal policy choices. To gain a better perspective of these issues, it would not be otiose, perhaps, to review what may be regarded as the policy environment most likely to foster long run growth and compare the policies implied with those that are likely to be implemented under the adjustment period.

3.2 Slower Monetary Growth

The effect of slower monetary growth through the sale of CB securities and treasury bills to the nonbank public has been to increase the nominal interest rates on loans. While, with the rates of inflation that have been experienced, negative real interest rates still prevail, these high nominal interest rates cannot be said to have had no real effects on output and employment. One way to view the situation is to say that while real interest

rates are negative on average, their variability (due to the erratic behavior of both inflation rates and nominal rates) has been such as to introduce elements of risk and uncertainty, which in turn discourage real investment. The uncertainty derives from the fact that resources are in effect to be committed (at high nominal opportunity costs) for an appreciable length of time before uncertain demand prospects are finally realized. When demand conditions are highly uncertain and differential rates of inflation across sectors are hard to predict, the current difference between the cost of resources and the growth of demand (which is what the real rate of interest purportedly measures) can be hardly expected to be the decisive criterion. Other elements, e.g., the possibility of disaster, may be more important. Another tack would be to argue that the impact of such rates would depend on the market structure in which firms found themselves. One might suppose higher nominal rates to have little impact if these could be passed on to consumers, say by those firms in monopolistic markets. In the case of firms which are in competitive markets, however, there is a limit to which this can be done, and cutbacks would have to occur. Of course there is also a demand limit to higher prices in the aggregate.

In any event, the high interest rates have penalized sectors which use working capital rather heavily. Some of these sectors have been those that have managed to obtain privileged credit in the past. To a certain extent, this represents a corrective to previous policies

which subsidized credit and introduced a capital bias to the economy. However some efficient sectors, especially in agriculture, have also been penalized, and the general effect has been a decline in economic activity.

Exporters are doubly penalized by high interest rates. For one thing, selling to foreign markets requires a lot of working capital. The shipping alone, for example, takes a long time. Thus, exporters would probably prefer that the government deficits be financed not through the issuance of Central Bank debt certificates but through money creation, expenditure reduction, or even new taxes. The burden of the latter measures can at least be tailored to fall on a wider base, whereas the former fall disproportionately on exporters and net investors, which the export sector should be if exports are to grow rapidly.

Moreover, the peso is currently overvalued. The exchange rate could therefore be defended against speculations only by maintaining extremely high interest rates.

There are several strong indicators that the peso is overvalued. Its strengthening in spite of the high domestic inflation rates and the weakening of most currencies against the dollar is the indicator most cited by newspaper columnists. But the most telling sign is the preponderance of new restrictions on the use of foreign exchange. Central Bank Circular No. 1029 is in many ways more restrictive than its predecessors. In addition to

restricting imports of capital goods and maintaining the limitation of "no-dollar" imports to essential commodities, many imports have to be cleared with at least one government agency. The list of commodities the importation of which requires permission from the BOI or some other department of the MTI, for example, is more than sixty pages long. Furthermore, the Central Bank has required that debtors pay in pesos to service foreign debts but has not used the pesos to buy foreign exchange to actually service the foreign debts. To the extent that speculators perceive (correctly in our view) that these methods of propping up the peso are not by themselves sustainable, the current exchange rates can be maintained only by keeping interest rates high, since even a two-peso rise in the cost of the dollar within a period of less than two months is enough to make 30-day notes with yields of up to 35 percent per year unattractive.

But these are not the only costs associated with the current system of controlling the exchange rate. Exporters are being induced to understate their exports. The Central Bank or some other government agency in turn will have to monitor exports and therefore greatly slow down the processing of export papers. Thus, our exporters' reliability and ability to deliver on time could suffer greatly. Stories, for example, of exports being disapproved because the price stated in the export documents is too low are now becoming more common.

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It is also noted that, in the present context when the government must assume responsibility for repaying the greater portion of the foreign debt (since a large part of the debt is either incurred by government and its corporations or guaranteed by it), the government would be a direct beneficiary of an overvalued currency, insofar as the peso cost of servicing the debt is reduced, and a further widening of the deficit is avoided when deficit targets must be met. There would, therefore, be a great disincentive for the government to adopt a more realistic foreign exchange rate. The more evident move for it would be to continue to keep interest rates high and/or institute further restrictions on foreign exchange.

(In recent weeks the government has further deregulated the foreign exchange market and allowed more active trading and greater dollar holdings among the commercial banks. At the same time, interest rates have been kept high on treasury bill and Central Bank securities. The high interest rates, the depressed state of the economy, which dampens import demand, and the moratorium on debt repayment that continues to be in force apparently suffice, at present, to keep the exchange rate low.)

3.3 Budget-deficit Restraints

The ceilings on the budget deficits required under the adjustment program will translate into greater imperatives of tapping new revenue sources and/or cutting back on government

expenditure. Pressure to maintain and raise revenue levels will make it difficult to resist imposing taxes on international trade. For example, the effects of the ongoing tariff reform have been blunted to a great extent by the additional ad valorem taxes that have been imposed on imports and the foreign exchange controls imposed earlier. This then tends to delay, if not prevent, the required restructuring of the industrial sector. As for export taxes, or levies, these carry obvious disincentives to export production, insofar as export supply is elastic. One may argue for these, however, in the case of products with inelastic supply (e.g. coconut) in lieu of land and income taxes, and whenever a seller's market prevails. This is not an indorsement, however, of current allocation of the proceeds of such funds, for it is evident the present allocation is not guided by clear efficiency, much less equity, criteria, but is instead used to sustain a monopoly.

Some pronouncements have, of course, been made regarding the desirability of reducing the dependence of government revenues on import and export taxes, and efforts are being made to rely instead on specific taxes for selected commodities (e.g. cigarettes, coal and coke, petroleum, distilled spirits, automobiles, etc.) and sales taxes. On the other hand, tax exemptions hitherto given to public entities such as the National Power Corporation and the National Food Authority have been withdrawn. The latter moves are related to efforts to increase the ability of such public corporations to generate cash internally and reduce their reliance on borrowings

and subsidies from the national government. This should in turn imply an imperative to increase rates for services they provide (e.g. electric power). This is an improvement, insofar as the price paid for services is kept more in line with costs and these are borne by the user rather than the general taxpayer, since there are presumably no externalities involved apart from equity considerations.

Specific taxes are nevertheless inferior to a system of direct income and wealth taxes, from an efficiency viewpoint, although the reluctance of the present government to consider seriously imposing additional stiffer taxes on income and wealth would seem obvious, given its political constituency. Even the specific taxes that have been imposed have not been acceptable because of the redistribution they entail and the general lack of confidence in the present regime. It is perceived as unjust generally that any additional taxation should be levied when real incomes have been severely eroded, and when the rationale for the taxes is to compensate for foreign loans very little of whose benefits have been enjoyed by the majority of taxpayers. This partly explains the violent reaction to the recent round of petroleum price increases. There is a distinct possibility that given the level of opposition to it, the government may encounter increasing tax resistance instead. This would not augur well for the success of the adjustment plans, nor for longer term recovery.

The public entities may compensate for the loss of tax privileges in a manner other than raising rates. They may take over certain profitable lines of business from the private sector, thus expanding government's role in the economy. For example, the NFA has evidently held on to the flour trade, apart from its monopoly over wheat imports, as a means of generating cash for some of its losing operations (as well as those of other agencies). The adverse economic effects of this are obvious, and so is the second-best nature of the problem. This illustrates the point that while, as far as financial adjustment is concerned, the reduction of the budget deficit may suffice, from a development view, the real objective must be to reduce the scale of government expenditure by eliminating those activities in which government has no demonstrated advantage over private agents. As for taxation to support remaining public sector activities, it is better that these revenues be drawn mainly from a system of taxes on incomes and wealth.

At this juncture, comments are in order on how the adjustment measures have affected public expenditures. In the aggregate, the Philippine government has had to suffer severe cutbacks in public expenditures, not only because of the drying up of foreign sources of deficit financing and reduced revenues in real terms, but also because of pressure from its credit sources to reduce the budget deficit. Between 1983 and 1984, programmed government capital expenditures dropped even in nominal terms, despite an inflation rate of over 50 percent; across sectors, only social services

showed a hefty nominal increase. The national budget for 1985 proposes to raise back the share of economic services to 1983 levels (at about 31 percent of the total), with the huge cutback in the area of general public services. Within the economic sector, agriculture, water resources development, and transportation and communications are receiving higher priority.

During periods of severe capital scarcity, the opportunity cost of public funds rises and consumption spending receives priority over investment spending. Thus, the cutback in government capital outlays may be viewed as supportive of a more efficient allocation of resources over time; even otherwise "worthy" public sector projects may have to be postponed as the opportunity cost of capital rises. The principle should of course apply equally to government consumption expenditures, to the extent that such expenditures are sourced at the expense of either private or public investment. However, political realities often define the limits to which current government expenditures can be curtailed.

For the Philippines, then, assuming that current public expenditures are already being contracted to the limit (an assumption that may be questioned by some observers), how would one appraise the level and composition of proposed public investment spending? This issue cannot be addressed fully without a detailed investigation of the specific project portfolio. However, one cannot but note the present bias in favor of foreign-assisted

projects. There seems to be the presumption that these projects are necessarily the most productive for the economy because they are the ones that have undergone detailed scrutiny. In a way, this presumption may be valid, to the extent that foreign lending institutions choose, and the Philippine government offers for foreign funding, those projects that are most "bankable." However, generalizations of this kind should be avoided, and the best approach remains that of reviewing and reassessing the whole portfolio of major government projects (proposed, pipeline, and ongoing, foreign-assisted or not), and evaluating their present worth with the proper reflection of the high opportunity cost of capital that the economy is presently facing and is likely to face in the next several years.

3.4 Poverty and Income Distribution

The drastically reduced living standards of the population and worsened income distribution occasioned by the present crisis make the transition to a normal growth path and its maintenance more difficult than if prospects of higher incomes were more certain to begin with. Inequality in the distribution of income is presumably less likely to lead to social tension in the context of overall growth. Conversely, social conflict is more likely to be intense when distribution is unequal and aggregate growth is faltering, with the shares of the poorest declining. This tends to be the situation now. Unemployment over the past year has risen from

about four to six percent, while underemployment has reached over 30 percent. Real incomes have been eroded by inflation.

The Philippines has reached the status of an "adult debtor" country rather quickly and without having reached a critical level of per capita income sufficient to repay borrowed resources and invest to sustain growth as well.[1/] To achieve long-term growth, a high savings ratio will have to be maintained in the next few years, not only to repay past obligations but also to keep up investment. With the occurrence of the debt crisis, it will be increasingly difficult to obtain additional foreign resources to make up for saving gaps, at the same time that low per unit capita incomes will tend to depress the savings rate. Without extraordinary measures, therefore, it is unlikely that the country can seriously plot a high growth trajectory. Of course a high savings rate can be "forced out" through taxation, failure to adjust wages completely to inflation, better interest rates, and perhaps ironically, through a worse income distribution. But it is suggested here that in the context of what may be close to marginal conditions of existence for some sectors of the population, such measures invite serious social repercussions.

The direct efforts by the government to address the question of income and wealth distribution have been limited in scope and

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[1/] The term "adult debtor" is used here simply in the sense of a country's having reached a high level of foreign indebtedness. See Kindleberger (1963, p. 460).

slow in their effects. Most tax revenue is still in the form of impositions on trade, specific duties, and transactions, rather than on assets and incomes. The land reform programme covers only the rice and corn lands and, of those, only farms above five hectares. The threatening rice shortage has recently compelled a relaxation of the rules, insofar as land recently converted to rice and corn (i.e. predominantly from sugar) is to be exempted from land reform. It is also clear that the government cannot undertake any major initiatives at redistribution away from the propertied classes at present, considering the magnitude of social influence of those classes, the regime's precarious political position, and the fact that, because of a credibility problem on the regime's part, even the potential beneficiaries could not necessarily be counted on to side with the regime. All this is apart from the obvious disincentive effects to production which would result, at a time when the recovery of normal levels of production would be at a premium.

On the other hand, the urgency of the income and asset redistribution issue will have to be faced by any regime sooner or later, and it may be argued that an opportunity which is available to a new regime--and obviously not the current one--is an ability to address this issue precisely in the middle of difficulties, based on some mandate by the electorate. Such a new regime could be less hamstrung by political commitments and insecurities than an old one, and there are more chances that the

resistance to change by the more affluent classes can be weakened and subsumed in the interests of national survival and unification.

3.5 Sectoral Issues

3.5.1 Industrial sector

The crucial reforms in the manufacturing subsector hinge upon the reform of the structure of tariffs and other incentives towards one that is more unbiased or neutral. The accomplishment of these changes is expected to reveal and allow the utilization of the country's present comparative advantage in labor-intensive manufactures for export as well as for domestic consumption. This should in turn lead to better labor absorption and utilization. While the "new manufactured exports" have come to possess the larger share of total export values (i.e. as compared to traditional exports), their contribution to GNP is really much lower because of the high import content of the more prominent ones (e.g. 80 percent and 100 percent of raw materials for garments and electronics, respectively). The manufactured exports themselves are restricted to a few products, thus exposing the economy to risks of large fluctuations in export value as compared to a situation where exports were more diversified.

It is generally felt that the present export-oriented industries lack depth. World Bank estimates indicate they accounted for no more than 14 percent of manufacturing gross value added in

1983, while the other 86 percent came from industries oriented to the domestic market. It might be said, therefore, that no substantial shift has really occurred in the direction of manufacturing output throughout the 1970s, although policy pronouncements would indicate otherwise. This is because the industrial export sector has mainly been built up as an enclave, exempted from the protectionist policy environment that affects the rest of the economy. (The export processing zones and bonded warehouses are a prominent example.) This would explain the few links between the export sector and the rest of the economy, and the failure of the former to expand. Rather than liberalize the entire economy, the government's policy has been selective liberalization with general protection. The protection of the home-dependent sector and penalization of the export-oriented sector has been accomplished mainly through an overvalued currency and a system of tariff protection and quantitative restrictions. These kept prices in the home market higher than border prices and prevented the export industries from sourcing domestically and deepening the industrial structure. Hence, both the importables and exportables industry have remained dependent on imports for their inputs.

Rather than allow the industrial structure to deepen naturally under pressure of both domestic and foreign demand, the government has instead chosen to work from the supply side by selecting heavy industries upstream of the existing ones (e.g., copper smelter,

coco-chemical complex, etc.). Apart from the strain these projects would potentially place on existing financial resources, this would seem a much riskier manner of identifying projects that promote industrial deepening. In addition, because of its large financial and political stake in such projects, there is a danger that the government could prolong the existence of such industries, if these should eventually prove inefficient, by means of protection and subsidies.

The exigencies of the present crisis have apparently justified in the minds of policymakers, a delay in the follow-through of the structural reform thrust. In particular, the additional ad valorem taxes on imports tend to weaken the impact of the tariff reforms; the relaxation of restraints on imports subject to quantitative restrictions has been postponed. While these have been called temporary measures, the pressure to keep them over a longer period cannot be underestimated, considering the government's imperative to raise revenue and reluctance to use the exchange rate fully to control imports, as discussed above. At best, therefore, one can say that judgment on the further implementation of the structural reforms must be suspended.

Another source of distortion in the manufacturing sector which could affect long-term growth is the process of concentration taking place in the whole economy. While this has been noted in agriculture, and is perhaps most important in that sector, it has

also happened in the industrial sector, where either government, a private corporation, or a joint government-private corporation obtains some undue economic influence or privilege over certain markets. One example is the grant of sole license to import to private or public firms producing the import-competing product (e.g., alkylbenzyl and fertilizer). This introduces a severe incentive problem, since by simply restricting imports, a firm could support an arbitrarily given amount of monopoly profits or degree of inefficiency. In effect, such measures represent a form of tax on the user combined with a subsidy on the producer of the domestic substitute.

One apparently ill-advised industrial policy has been the setting of domestic content targets for many manufacturing industries. This was done in the past for the PCMP, PTMP, and PMMP, which were all import-substituting programs, in an effort to make them all increase their backward linkages with the rest of the economy. This propensity to set quantitative targets mechanically without a proper consideration given to price and cost elements has encouraged the inefficiency of these industries, preventing them from breaking into the export markets and restricted them to operations in a limited domestic market. The same policy is now being tried with the export-oriented industries, beginning with garments. Starting with the valid point that export-led industrialization has been shallow and that its impact on the economy

has been limited by low domestic value added, the policy has been evolved to set quantitative targets on domestic value added. This is at best a piecemeal approach to the problem. If domestic sources are not internationally competitive this policy can only erode the profitability of the export industries and discourage their expansion, thus defeating the original purpose.

3.5.2 Agricultural sector

The Agenda for Action in Agriculture: 1984-88 spells out in detail the policy actions at both the macro level and the level of specific food and export crops. Technical and economic problems, as well as required institutional changes, seem to have been sufficiently identified. If one is to judge by the speed at which the deregulation of poultry and livestock was pursued, the policies spelled out in the agenda could have a critical impact on agricultural development beyond the crisis period. But the agenda is uneven in the way it approaches the sector's problems and their solutions. While it is forthright in addressing livestock and poultry, it wavers when it comes to the export crops sugar and coconut, recommending only that research studies inquire into the effects of monopoly and intervention (despite the adequacy of existing documentation). While it declares the need for more active buffer stock behavior in rice and corn as the best means for price stabilization, rather than price ceilings, it likewise only recommends studies on the removal of price controls for fertilizers. While it makes concrete policy moves for improving

institutional coordination between MAF and food-related bodies (e.g. FCA and Philsucom), it only proposes a detailed study of NFA activities and operations to determine its relationship to overall agricultural policy formation.

In short, while the agenda may be appreciated as a drastic departure from the plan for agriculture embodied in the Updated Philippine Development Plan 1984-1987 because of its thrust and specificity, what is wanting is a clearer signal of the government's thorough commitment to reforms in the sector.

The important constraints to broad and sustained agricultural growth include the low productivity performance of the sector in recent years. While depressed world prices may be partly to blame in the case of some products with low productivity, a more pervasive explanation is an adverse policy environment that discourages private initiative and efficiency. Without a more conducive situation-- whether in terms of price structure, institutional setting, or government participation-- the prospects for a stronger agriculture are bound to be limited. For instance, growth in palay output has been due mostly to investments in irrigation and not productivity. In coconut, output increases have come from area expansion. Compared with those of other countries or the growth rates of the sixties, current records of productivity and of productivity growth seem to pale.

Except for the livestock and poultry industries which were recently deregulated, the measures undertaken during the crisis have been in the form of compensating step-adjustments within the existing structure of controls. Without doubt, barring abnormal shocks, these measures could suffice to put the sector back on the tracks it followed before the crisis; however, it is doubtful whether those policies would be sufficient to break agriculture's long-term constraints or induce structural shifts which could put agriculture in the forefront of a recovery and long-run development.

If until the 1990s agriculture follows basically a growth patl similar to what existed immediately before the crisis, its growth rate is unlikely to exceed the 2.5 percent annual growth of the population. Food crops would merely keep pace with population, while livestock and poultry would be constrained by the slow pace of feeds production. The underlying assumption here is that the sector would experience broadly the same policy environment as in the late seventies and early eighties.

On the other hand, if one assumes that structural reform does occur and that the current policy milieu is part of a continuous trade and sectoral realignment, if private initiative responds quickly or real rural incomes expand, agriculture will likely grow in the medium-term at rates similar to those achieved in the early seventies (4.5-5.0 percent per annum). Major contributions to this performance would probably come from better output growth of food

crops (rice and corn), coconuts (given price recoveries), marginal improvements for sugar, and an acceleration for livestock and poultry.

The achievement of these goals depends crucially on changes in the manner of determining prices and the way the government intervenes. Increased efficiency will more likely come from better resource mix rather than new investments. This would mean a rehabilitation of irrigated areas for rice; a positive response to institutional reform from coconut farmers; more irrigation for sugar; and greater cost-effectiveness for corn.

3.5.3 Service sector

During the 1970s the share of services rose dramatically to 29 percent of total employment, on average, compared to about 22 percent in the early 1960s. This is partly attributable to the growth of urbanization and some amount of industrialization, which is usually complemented by an increase in service employment (e.g. retail and wholesale trade and finance). However, it is also recognized that the strange and premature rise in the share of services in some developing countries may also be related to the poor absorption of labor on the part of agriculture and industry. The labor shed by the agricultural sector, which cannot find a place in the industrial sector because of the sluggish growth of the latter, usually ends up in the lower-paying, lower-productivity jobs of the service sector.

The service sector, therefore, is quite heterogeneous. It is not so much the fact that the service sector is being enlarged than that much of the employment being generated is of low productivity which is the cause for concern. The occurrence of the crisis and the generally slower rates of growth expected for the industrial sector may be expected to have a two-fold effect on the service sector. On the one hand, the number of jobs in the formal service sector may be expected to decline, as retail and wholesale trade, finance, and transport may slow down together with industrial output. On the other hand, the people shed off by the industrial sector (i.e. those laid off or underemployed) may be expected to increase the number of "supply-generated" occupations, which are usually of low productivity. Therefore a further shift in the composition of jobs in the service sector may be expected, from higher- to lower-productivity ones. This would be manifested in a growth of employment faster than the growth of output in the sector. Further growth of the service sector under these circumstances, whether in terms of output or employment share, would ironically be more indicative of the economy's ill-health than well-being.

To be sure, it would be possible to recommend policies which seek to improve productivity and employment conditions in the informal service sector, taking the sectoral share as given. However, the point being made is that as a result of the structural distortions affecting industry and agriculture, the present size and composition of service sector could not be called optimal nor

in line with the requirements of future development. Hence one can only view with greater urgency the reforms being urged upon both industry and agriculture. For ultimately, an improved ability by both to absorb labor would be reflected naturally in a drying up of the pool of the underemployed in services as relative real incomes in other sectors rise, and in turn service activities supportive of expanding lines in agriculture and industry become upgraded. The vulnerability of the formal service sector to the foreign exchange crisis derived ultimately from the import dependence of the industrial sector it supported. A reduction of the import dependence of industry, therefore, would also be reflected in an improved ability of the service sector to withstand shocks similar to what has just been experienced.

3.6 Obstacles to the Removal of Market Distortions

Although most economists have long held the view that the reduction of trade restrictions, the dismantling of government-mandated monopolies, the removal of ceilings on interest rates and agricultural prices, and the deregulation of foreign exchange markets would in the long run not only promote faster growth but also improve income distribution in the Philippines. Philippine policies have in fact remained protective of many inefficient and capital-intensive industries and biased against agriculture, small savers, and labor-intensive exports. Moreover, although the

government has partly removed some price distortions (e.g., tariff reforms), it has introduced new ones which are probably even more burdensome to the economy and its poorer citizens. The government-mandated coconut monopoly is perhaps the most blatant example of the latter type of distortions.

To be sure, most of the government-mandated monopolies, which are rather unpopular, would be dismantled should a more democratic government come into power. It seems, however, that many distortions would remain or may even be magnified under a post-Marcos regime. For one thing, many of the trade and industrial policies that have made Philippine industries less competitive were already in place long before the declaration of martial law. Thus, if the Marcos years turn out to be an interruption but not an elimination of the power of traditional Philippine political elites, the Philippines would have great difficulty transforming its industrial sector. Indeed, it could be argued that the Marcos government is more likely to carry out industrial and trade reforms than traditional opposition groups since it is unpopular and is therefore in greater need of foreign support.

It should also be noted that the Marcos government, despite its policies, was rather successful in portraying itself as a supporter of freer trade, export promotion, and labor-intensive industrialization. It would therefore not be surprising that a substantial segment of the intelligentsia might associate the

economic crisis with the government's advertised (but unimplemented) policies and, as a result, favor increased protectionism and capital-intensive industrialization during the post-Marcos period.

Furthermore, the IMF restructuring program is almost certainly not going to be the panacea that the government claims it would be. The restructuring period is far too short and the confidence in the leadership too low for the IMF package to be able to bring about perceptible signs of an economic recovery. Again, there is a danger that the failure of the IMF package to bring about immediately perceptible results would be blamed on the failure of trade liberalization.

In short, many economic reforms which are favored by professional economists (see, for example, ILO 1974) would already be labelled as failures even before they are given a reasonable chance to succeed. Considering the strength of the interest group that would oppose these types of economic reforms, it is quite likely that the economy does not have enough resources or enough time to make the transition towards policies that are more efficient in the long run.

In addition, the government may not have the capability to collect more direct taxes to be able to distribute the cost of adjustment more equitably. Reducing the overvaluation of the peso, for example, is viewed by many economists as a painful but necessary step towards long-run economic recovery. The government's

fiscal position, however, would be seriously derailed by a devaluation since the government had either borrowed or guaranteed most of the foreign loans. Every time the peso is devalued, the government must collect more taxes to service its foreign debt. Thus, to the extent that tax revenues are not very elastic to changes in nominal GNP, a devaluation must be accompanied by either larger deficits or new taxes.

Due to its inability to collect more direct taxes, the government's response to the devaluation was to impose new taxes on energy consumption. It has been estimated that energy taxes will amount to more than ₱20 billion out of a total revenue of around ₱50 billion in 1984. Since energy taxes fall more heavily on the urban sector, poor people in the large urban areas suffer the brunt of the adjustment since the economic crisis hit the largest cities the hardest.

It is therefore understandable why the government has resisted devaluation and decontrol of agricultural prices and has maintained what many exporters consider an unattractive peso-dollar rate by raising interest rates and regulating foreign trade and foreign exchange transactions. Thus, even assuming that the government accepts the view that more realistic exchange rates and agricultural prices are good in the long run, it is not likely to devalue the peso and free agricultural prices as long as its fiscal position remains weak.

On this basis, one could argue that aid should make the transition towards better long-term policies less suicidal politically and that aid should be used to shore up government finances while the fiscal system is being strengthened during the transition period. On the other hand, there is also a possibility that increasing aid solely on this basis might be viewed as an attempt to prop up an unpopular government which might delay more fundamental political reforms.

Here lies the dilemma. More aid is needed to make the transition towards policies that are more efficient in the long run more feasible in the short run. Unrestricted aid, on the other hand, could strengthen the resistance of the government to political reforms. In this respect, simply reducing restrictions on labor-intensive exports of the Philippines to the U.S. may be much better than aid. Given enough time, the labor-intensive export sector may become big enough to become a sufficiently influential countervailing power. But if aid must be given, it must be less fungible and it must be used as an incentive to the Philippine policymakers to reduce market distortions.

On Acceptable Growth Paths

The average post-war growth rates of the Philippine economy prior to the declaration of martial law in 1972 was slightly lower than six percent. Economists who were familiar with the experience of Taiwan and Korea of course used to consider this growth rate to be lower than what was attainable if market distortions could be removed. The NEDA five year development plans of the early 1970's, for example, considered seven percent an attainable target. Some economists even argued that distribution was the problem since the Philippines already knew how to grow.

Unfortunately, there was little overall progress in the reduction of market distortions. It seems, for instance, that the new tariff reforms would have very little immediate effect since they came at a time when quantitative restrictions are the dominant trade distortions. Furthermore, new and perhaps more burden-some forms of market intervention have been introduced during the last five to ten years.

Given past experience, it now seems that the robustness of our growth prospects (relative to external and internal influences) has been over-estimated. In other words, a six percent growth target by 1990 now seems rather optimistic. If a long term growth rates of six percent was not sustainable then, it is probably even more difficult to achieve it now that political, balance of payments, and external conditions are much less favorable.

To illustrate the difficulty of reaching a six percent growth path (which was termed as a high scenario by a recent World Bank paper) consider the implications of growth given the following assumptions:

- merchandise exports will grow at six percent (with non-traditional exports growing at eight percent)
- imports resume growth in 1987 at rates equal to GNP growth rates
- non-merchandise trade deficit will grow at 10 percent until 1988 and taper down to by 1990.
- foreign exchange reserves have to be raised by $2 billion.

If the growth of GDP is zero in 1985 and gradually rising from two percent in 1986 to six percent in 1990, the country will need an average of $2 billion annually in aid and capital inflow. To be sure, the above assumptions are rather arbitrary. But there is good reason to believe that the estimates are conservative. For one thing, it assumes that the recovery can be attained without high initial start-up costs. Thus, to the extent imports were reduced to $5.8 billion by severely restricting imports of capital goods, imports would be larger unless existing capital can be utilized more fully. In the case of hotels, for example, luck and better publicity may result in greater income without the need for large additional investments. Many investments, however, would be worth a lot less than their historical costs even under the best possible circumstances (e.g., Manila Bay Reclamation,

the Nuclear Plant, PCMP, etc.). In fact, the country may be better off if some investments are simply treated as sunk costs.

If nontraditional exports, however, can grow at around 12 percent per year from their present level of $2.8 billion, a target GDP growth of six percent by 1990 seems a modest target. If the import content of nontraditional exports is 50 percent, for example, a growth rate of 12 percent of nontraditional exports would result in a $400 million improvement in the trade balance of 1990 (relative to the base case where nontraditional exports grow by only eight percent).

What the foregoing implies is that examining the attainability of aggregative targets is less important than examining the incentive structure. Aggregative targets can be scaled down or up as circumstances change. Given less distortive policies (and some luck) the "high case" scenario seems feasible. But if the government persists in over-valuing the peso, it seems that the high case scenario is feasible only with massive doses of aid and loans that will extend into the 1990's.

Part III

THE ROLE OF DEVELOPMENT ASSISTANCE

4. Some General Remarks

Purely economic criteria may be distinguished from other criteria or motivations for giving assistance. The evaluation of the efficacy of a particular assistance program depends on the aims which such a program was designed to achieve in the first place, such aims not being necessarily confined to the economic. This is obviously relevant in the present situation when the decision of the donor on whether and to what extent to give assistance cannot be called neutral with respect to certain political and military, i.e., strategic, factors. Hypothetically, suppose it had been decided on purely economic grounds that the capacity of a country to absorb further capital resources efficiently was limited. Then a case could be made for ceasing to give aid altogether. On the other hand, because of some strategic importance of the country to the aid-giver's interests (e.g., military reasons or a pure urge to be altruistic), such assistance might be continued, if not even enlarged. In that case, as far as the donor was concerned, the "cost" in terms of economic efficiency may be said to have been outweighed by the noneconomic benefits. The first important question that must be asked, therefore, is to what extent such "noneconomic" criteria for aid-giving impinge on the decision of the donor countries; to the extent that they are overriding, the whole rationale behind an "economic" analysis of the

assistance package is, after all, vitiated, since there would be other reasons for giving (or not giving) the package anyway.

To answer this question, albeit partially, it might be proper to situate the development assistance package in the context of the entire program of aid to the government. Negotiations between the two governments in the context of a review of the bases agreement produced a total aid package of $500 million over the period 1980-84, and renegotiations in 1983 elicited a "pledge" on the part of the Reagan government to exert its "best efforts" to secure an aid package of $900 million for 1985-89. This total package was to have been allocated through three programs, the Military Assistance Pact (MAP), Foreign Military Sales Credits (FMSC), and the Economic Support Fund (ESF), the latter being the immediate concern. Allocations to the different programs for the periods 1980-84 and 1985-89 are shown in Table 7 below.

Table 7

Distribution of Total Aid Package
($ million)

Period	MAP	FMSC	ESF	Total
1980-84	50.0	250.0	200.0	500.0
1985-89	125.0	300.0	475.0	900.0

Comparing the two packages, therefore, it is evident that the share of economic development in the total has grown (from 40 percent to 53 percent), although the absolute amounts given to military aid have also increased by 42 percent.

Though it was not formally written into the arguments, the negotiating parties on both sides understood that the stated amounts would be prorated over the five-year period 1985-89. Annual allocations would then total $180 million, distributed as shown in Line 1 of Table 8.

Table 8

Annual Allocations, Requested and Approved For FY 1985-89
($ million)

	MAP	FMSC	ESF	Total
Requested	25.0	60.0	95.0	180.0
Approved (FY 1985)	25.0	15.0	140.0	180.0

Eventually, however, the donor country's congress passed legislation which reduced the military component for the 1985 annual allocation by $45 million, which was then added on to the annual allocation for the ESF, which then increased from the requested $95 million to $140 million (Line 2 of Table 8). This might legitimately be attributed to the fallout of the Aquino assassination and the perceived involvement by the military in human rights violations in

general. On the other hand, the rationale for the increase in the ESF was the perception that economic assistance was more urgent, especially in the context of the economic crisis that had gripped the country. In theory, the reduction in FMSC and the increase in ESF for 1985 was not meant to alter the distribution of total amounts as given in Table 7. Rather, the $45 million changes on either side were to be viewed as a "postponement" of some FMS credits, to be made up for in subsequent years, as well as a "forward funding" or acceleration of the disbursements of the total ESF amount, with consequent reductions in later years. Evidently, the shifting of funds has been viewed by the government of the Philippines as a violation of the spirit, if not the letter, of the bases negotiation.

Viewed as a political statement, the funds-shifting within the total aid package is undoubtedly highly significant. At the same time, it is evident that the leverage of this sort that can be exercised has its limits insofar as the donor government intends to honor its commitment to come across with the total amount of the aid package and in the distribution between military and economic development assistance that it has promised. Funds-shifting affects the timing but not the magnitude of the resource flows; considering the relatively short period in which this can be done, its real resource effects are not bound to be significantly different from a situation in which the original schedule had been adhered to. Considering the fungibility of these allocations, the government may simply compensate by changing the

composition of its budget accordingly, e.g., reducing development and increasing military expenditures. Furthermore, the strategic objectives of defense thinkers in the donor country apparently constrain the extent to which military assistance can be squeezed to favor development aid. Military thinkers from the donor government evidently consider the state of the armed rebellion sufficiently developed, and the response of the armed forces sufficiently poor, that they believe a critical point in the conflict may be reached in the next few years or so unless major changes are made. It is therefore unlikely that, with this viewpoint, they will long stand for the delay of the full release of the military assistance component, although one would have no way of independently verifying their underlying assumptions.

Some sectors, on the other hand, may legitimately contend that the resolution of political (and economic) questions is prior, in the sense that a more "stable" regime may be better disposed to deal effectively with the armed rebellion and, hence, utilize military aid more "efficiently". A case could then be made for delaying military assistance--though this could conceivably lead to military setbacks in the meantime--if, by so doing, a change could be facilitated towards a regime which had better long-run prospects of dealing with the rebellion, although such an option could be regarded as too risky by those whose sole concerns are military in nature. Another complicating element in the release of military assistance is its potential externality to the moderate opposition, against whom it may be used, thus further delaying

a nonviolent transition.[1/]

As a summary, therefore, it might be said that given the donor government's pledge as to the total amount of assistance forthcoming for the coming five years--and to the extent that it does not renounce its commitment--there is really very little room in which to maneuver as regards the size of the package, which might potentially have been the most effective form of leverage. Short of abjuring the entire agreement, the most that might be done seems to have been done already; this refers to the delaying of the military component and the acceleration of the development component. On the other hand, we have also seen how the donor country's defense interests might limit the length of time it may regard as feasible to withhold military funds.

The increase in the size of the development component (at least for 1985) was motivated, no doubt, by broad humanitarian concerns raised by the severity of the present crisis. There is some question, however, whether in an economic sense such a manner of reacting to events--which is perilously close to pursuing a countercyclical aid policy--is indeed advisable.

[1/] The speech by Wolfowitz before the Congress subcommittee on foreign affairs indicated that the armed forces' procurement plans under MAP and FMSC were part of a change in emphasis from defending against external aggression to one of coping with insurgency and domestic disturbances.

The first question to be raised is that of the country's capacity to absorb such increased aid efficiently. This is often neglected in most discussions by both donor and recipient, with the implicit assumption always being made that "more is always better," and that almost all constraints are to be found on the supply side, with the demand for aid being, for all practical purposes, infinitely elastic. Such an assumption would be true only if one did not exclude the support of current consumption from the scope of the uses of aid. Obviously, however, such a prospect is ruled out from the present aid program; only investment projects are being considered.[2/] If so, then, assuming the national leadership ordered social projects according to social rates of return, the limit to the amount of capital that could be absorbed would be found in the marginal project whose rate of return equaled the cost of borrowed funds.

On the other hand, what the occurrence of the present crisis has placed in serious doubt is precisely whether the leadership and institutions presently exist which will allow for such a rational ranking of priorities in the first place and, hence, whether under present conditions, an efficient utilization of development assistance

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[2/] Nevertheless the idea of supporting consumption for well-defined sectors of society should perhaps not be ruled out entirely, considering the severity of the impact of the crisis and the adjustment. The amount of "leakages" from such assistance would also be presumably smaller than from investment projects.

funds is at all possible. Even if standard cost-benefit measures should indicate that particular projects are worthwhile undertaking, the evaluation must ultimately refer to the wider economic environment (e.g. macroeconomic policies, trade and development strategies). The use of shadow pricing is, at most, only a partial remedy because of well-known second-best problems with using Pareto-efficient criteria when large distortions exist. This is well-recognized in the literature on development aid and is reflected in the policy prescription that aid is preferably allocated according to programs rather than projects.[3/] The problem of fungibility and "leakages" is a concrete example of the need to take a more general-equilibrium approach to the question of whether and to what extent assistance should be given. Hence even prior to any cost-benefit analyses being undertaken, a decision must be made regarding the overall direction of the authorities' economic plan and their capacity to implement it. Briefly, the contention of this paper is that, while the publicized economic plans of the government are broadly if hazily in line with what is required for longer-term growth, their long-term capacity and determination to implement these plans are, at best, highly uncertain and, at worst, highly suspect because of severe

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[3/] "The efficiency of any one project is very much a function of the country's entire investment program, and the impact of aid cannot be assessed without a general analysis of resource allocation in the recipient country. When the donor country acts as if it were simply a banker or private foreign investor, concerned only with projects, then a given amount of financial assistance will not contribute as much to the objective of accelerating development as would program aid." (Meier 1968: 111).

political constraints on the behavior of the ruling group.

In the face of such uncertainty in the capacity of the ruling group in government to formulate and implement a clearcut program for recovery, it is further contended that an aid cutback is sufficiently warranted on economic grounds. The increase in the ESF component for 1985 without any corresponding steps taken towards greater economic rationality is to be viewed as an unfortunate measure motivated by misplaced humanitarian concerns unmindful of political and economic realities. At worst, one cannot help but take the view that the donor government's reluctance to alter the size of the assistance package in a clear-cut manner is motivated more by strategic considerations than by economic criteria alone. To put it differently, if the donor did not have as large a strategic stake in the country and based its aid decisions on efficiency criteria alone, then the presence of such grave political uncertainty would conceivably have induced it to mark time in aid-giving.

The other argument for marking time has to do with positive leverage. In a situation characterized by a foreign exchange bottleneck, such as what the country is experiencing at present, it is clear that foreign assistance has a higher productivity than similar amounts of domestic saving, since the former also makes a contribution to scarce international reserves, so that this might perhaps be taken as a justification for increasing the flow of aid at the present time. On

the other hand, if the foreign exchange crisis is mainly the outcome of the authorities' failure to make timely adjustments--as an analysis of the present crisis would suggest--then a surge in aid could be counter-productive insofar as it allowed the authorities to postpone making adjustments. The disincentive effect of development assistance on the authorities' decision to adjust is greater the larger is the aid package and the looser are the terms. For example, if aid financed not only the foreign but also the local cost components, and if it was allocated on a program rather than on a project basis, the likelihood would be greater that it would be tantamount to pure support to the government budget and the balance of payments. This could allow the authorities to avoid having the narrow deficits by reducing expenditures, raising the tax effort and pursuing a more realistic exchange rate policy.

Underlying all of these, of course, is a prior evaluation of the government's capacity and determination to undertake necessary adjustments, for the way for aid would seem clear, given the assumption that the present government (whichever it is) is willing to take the essential steps towards adjustment. Then the role for aid would be to ease the transition and lower the costs of adjustment. For example, providing budget and balance of payments support in the form of soft conditionality loans would be acceptable if it could be ascertained that the measures as drawn up and implemented represented some "best effort" on the part of the government which had a high probability of succeeding. It is in this sense that political criteria unavoidably impinge on economic decisions.

Given the degree of uncertainty in the economic priorities of the present leadership, and in order not to undo the pressure towards adjustment which the crisis places upon the latter, aid should not be accelerated so that it becomes "countercyclical". Given a certain size, its allocation and disbursement should be designed so that it entails the least leakages and makes fungibility least possible. This can be achieved by, among other things, disbursing aid through channels as close as possible to its intended beneficiaries, e.g. the local governments, private nongovernmental groups, etc.. Perhaps distinctions in policy can be made between loans and grants that are extended through national government mechanisms on the one hand and those that are made through local agencies, with the former carrying harder terms in general. This could partially discourage the funds-shifting that takes place in national agencies (which intuitively seems less probable in the case of local agencies) and compel the national government to apply more stringent criteria for projects. Foreign exchange allocated to projects (which should defray foreign component costs alone) should immediately be used once it is disbursed, for example, and not stashed away in some time deposit. As between localities, priority should be placed on the depressed areas which have not benefited as much from national government assistance for whatever reason in the past. This is, after all, only in line with the presumably humanitarian motives which dictated the increase in the ESF package. Besides, assistance is fungible only if the project would have been accomplished without

it anyway, and one is here referring to a type of project which the government, by itself, would not have undertaken.

Such criteria should, of course, be drastically altered if it was perceived that a regime's economic priorities were generally sensible, had a good chance of succeeding (which also implies some measure of social support), and were in line with the requirements for adjustment. Given that assessment, assistance would preferably be extended on more liberal terms, on program rather than on project basis, to include local costs financing, and generally supportive of the budget and the current account.

To summarize, the present economic crisis places serious doubt on the capacity of the leadership and institutions to pursue a rational ranking of priorities that would permit the efficient utilization of development funds. With this scenario, an aid cutback may be warranted on economic grounds. However, if the donor country's own strategic concerns render such action infeasible, the idea of aid supporting consumption of well-defined sectors of society should perhaps be given serious consideration, especially with the severity of the impact of the crisis. Of course, with an optimistic scenario where the government would show the capacity and determination to take the essential steps toward adjustment, the role of aid in easing the transition and lowering the costs of adjustment comes in better light, with budgetary and balance of payments support probably constituting the best means of

helping the recipient country.

5. The USAID Assistance Strategy

It is then in the context of the above remarks that the review of present USAID programs presented in this section should be read. A brief background on current programs, particularly those addressed to agriculture and rural development, is first presented. Some important factors that would promote a vigorous agriculture sector are then spelled out, taking off from the environment before the crisis and the subsequent policy milieu. From there, the broad implications of those factors on existing aid programs are discussed and some possible directions for the allocation of aid resources are suggested.

5.1 Background

Since the beginning of the eighties US assistance to the Philippines (through the US Agency for International Development or AID) has had a new direction in the form of a focused attention on rural employment strategies. The USAID Country Development Strategy Statement for 1982 specifically supports the Philippine government's efforts to redress poverty. Thus program assistance has targetted specific poverty areas, in terms of depressed regions and occupational groups.

Although the program portfolio contains activities in (1) agriculture, rural development, and nutrition, (2) population planning, (3) health, (4) selected development activities, and (5) economic support funds, agriculture is the pivotal area and seems to be the thrust for the country efforts.

For agriculture and rural development, three program elements have been pursued: (1) Rainfed Resources Development, (2) Rural Private Enterprise Development, and (3) Local Resources Management. In the first program element the aim is to increase agricultural productivity through better natural resources management such as agroforestry and coastal zone management. In Rural Private Enterprise Development, the assistance helps private enterprises in selected regions improve capitalization. In Local Resources Management, support is given to local governments in understanding local development problems and in planning and implementing projects to increase employment and productivity. A wide range of projects in agriculture falls within the framework of these elements: farming systems development, freshwater fisheries development, integrated production and marketing, and others. A number of new projects involving agriculture are scheduled for 1985, still complementing the basic thrust of the assistance strategy. Among these are Accelerated Agricultural Production, Rural Productivity Support Program, Balanced Rural Growth, and Local Infrastructure and Government Development Fund.

Common across program elements in the assistance strategy for agriculture are features characterizing them as direct action, local capacity development, and poverty alleviation. In terms of direct action, it is clear that beneficiaries of the programs are well-defined. Programs benefit the target groups directly, or at least would have immediate impact. On the other hand, the development support given to local institutions and governments indicates a strengthening of decentralization initiatives. The improvements in local capabilities in project development would equally have direct and long-term effects in supporting broadly based participation in decision-making. Finally, since the assistance is location-specific towards depressed areas and those with high poverty incidence, the programs have a poverty-alleviation character.

The US assistance strategy, program formulation, and project composition imply a set of underlying assumptions regarding the mechanisms by which strategies would work or projects would actualize specific thrusts. One of these assumptions is that the package is pursued within a given setting of a sectoral policy regime. Moreover, this means that an assessment of that setting is being implicitly made either as satisfactory or, if judged otherwise, not quite immediately alterable. Another implicit assumption of the assistance strategy briefly outlined above is that the existing portfolio is somehow equity-oriented from an aggregate or national viewpoint. Finally, there is also an underlying assumption that once local planning and

project development capabilities are strengthened, a continuous flow of resources will be forthcoming, with which the local expertise becomes effectively utilized; however, resources given in this assistance process are often simply single infusions.

In the context of looking into the medium term or of preparing an assistance strategy in that time frame, it might be useful to examine, at least for agriculture and rural development, the sectoral environment in the immediate past and the crisis milieu. The review of these aspects in the earlier sections should provide that perspective as well as some clues to possible changes in country strategy and programs.

5.2 Factors Affecting Agricultural Development

The earlier sections argued that the constraints affecting agriculture's long-term growth are rooted in the policy environment that has been fashioned especially since the mid-seventies. More pertinently, it has been advanced that even the sector's post-crisis milieu is not really cognizant of removing the wide range of distortions that have seriously affected agriculture.

One common feature to these constraints is of course the low productivity growth experienced by the sector which, in the last few years, only just about equalled the population growth rate. In turn,

productivity constraints reflect old "technologies" (especially for export crops) or premature shifts in land use (especially for food crops) due to declining incentives for private enterprise efficiency and profitabilities aggregatively indicated by turns in domestic terms of trade.

The current economic crisis and the policy responses to it put into more serious light the strength of agriculture to rebound and more importantly to lead in a new wave of growth. In terms of several devaluations that have taken place since October 1983, the degree of factor substitutability for imported inputs is a critical aspect in avoiding absolute declines in output and productivities assuming some lag in output price liberalization. For example, one estimate puts a production decline of eight percent to rice output arising from declines in fertilizer use of 15 percent which in turn responded to a 28 percent increase in the fertilizer price in June 1984. On the other hand, interest rate adjustments to agriculture (not to mention the absolutely high nominal values) clearly impinge on farmer ability to undertake modern production processes. This would be particularly telling for special government agricultural programs.

With respect to agricultural exports, it is not true that their prospects depend primarily on international conditions. The internal environment is likewise important. In the case of sugar, a traditional export crop, export growth in part depends on the cost structure of

the industry compared with other sugar exporters. The same is true for coconut products though perhaps to a lesser degree. For non-traditional export products, much depends on market stability and how agricultural entrepreneurship perceives cost and return considerations.

Agricultural growth similarly spurs the expansion of ancilliary nonfarm agricultural industries and nonfarm employment. This is a core element of the recovery program through balanced agro-industrial development (BAID). One constraint to an accelerated BAID, however, is the relatively weak stimulation that would come from pure productivity increases. Indeed, many of agro-industrial linkages come from income multiplier effects. Thus even with this kind of aggregate growth path, constraints to agriculture would hinder wider gains.

5.3 Possible Directions for Aid Resources

The background of US assistance strategy and programs for the Philippines and the identified factors affecting agricultural growth would seem to constitute a good basis for setting directions for additional flows of resources. A simple way of viewing the matter is that assistance needs to be given to support an adjustment process, from, say, one growth path to another. For the present agricultural sector, this means assisting various programs meant to increase output and productivity.

But clearly this is not all there is. An appropriate assessment of directions needs an appraisal of the basis for the current assistance strategy. While the program portfolio appears to respond to disparities in development incidence and the gaps in agricultural capacities and also looks supportive of the government's overall long-term plans, it seems that certain dimensions assume particular importance especially in the climate of the current economic crisis.

1. Sectoral Policy Environment and Reform - In past USAID programs and projects, policy reforms have been integral to their underlying specification. Yet a policy agenda or dialogue has not been an explicit direction or program. The recent crisis however seems to show many reasons why this dimension needs to be considered as a separate activity. In the first place the relative success of direct interventions depends in part on a constructive if not conducive policy regime. But differently action projects would yield limited impact in a situation where distortions are pervasive. For example, support to small farmer systems would have minimal positive consequences in the face of a policy environment that favors large farmers.[4/] Similarly,

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[4/] While, as pointed out earlier, the overall policy environment (particularly the exchange rate policy) discriminated against agriculture in favor of industry, several policies have had differential effects within agriculture in favor of large farmers. Not only has the share of agriculture in total loans granted declined in the seventies, but the bulk of agricultural production loans even went to large agri-business concerns (see also footnote 1, p. 13). Most subsidies to agriculture, particularly to irrigation development and to fertilizer inputs in the mid-seventies, did not reach upland farmers who were not heavy users of modern inputs.

their demonstration value is diminished. In the second place, the cost-effectiveness of aid resources is called to question in a restrictive policy regime. Indeed the deleterious effects of an environment are often used by a restrictive regime as a justification for interventions rather than the removal of distortions. Finally, in a national context, commitment to reform or its actual implementation may be a necessary condition for pursuing a program or project. For example, it is clearly not useful to build local capacities in development planning and implementation if programs and projects are nationally determined or if flexible resources are not at the disposal of local institutions. Both the Local Resources Management (LRM) Project and its close predecessor, the Provincial Development Assistance Project (PDAP), require policy reorientation in order to ensure greater sustainability of local capacities.

Thus policy reform tops a set of directions that both government and aid resources should pay attention to. Granting that this dimension becomes an explicit part of an aid portfolio in the medium term, what might be the substance and scope of it?

There are at least two ways that this could take place. One is through the institution of a clear policy dialogue as a specific program that is not simply taken as a matter of course. More pointedly, a series of dialogues may be associated with particular industries that are integral to a sector-wide structural reform. A difficulty with

this mode is a construed "interference" with an indigenous process. On the other hand, support should be given to open up policy measures to wider technical expertise.

Another is through tying the scale of supported intervention programs to the degree of policy change that is instituted during a plan period. This need not be an arbitrary notion but can be quantitatively incorporated into specific activities (e.g. support for rainfed farms would have an escalation of scale depending on the degree of fertilizer industry liberalization). Since this is somehow part of a policy reform agenda, there is all the more a necessity for serious interaction at the policy level on how measures are to be carried out and their implementation instituted.

2. Production Adjustments to Price Changes - The recent steep acceleration in the prices of material and capital inputs (e.g., fertilizer, fuel, machinery) has created apprehensions of sharp output declines especially in the more modernized areas. In the medium term, the production problem seems to be to search for alternative input combinations that would at least maintain output and productivity at historical levels. The adjustment process implied here is both technological and technical.

As the agricultural sector adjusts to price changes induced by aggregate measures instituted in response to the economic crisis, support is needed to keep production behavior from shifting to traditional

technologies or avoiding required investments, actions that may lead to sharp reductions in farm output and incomes. For example, in food crops, one type of adjustment that farmers, in the absence of knowledge of substitute inputs, may adopt is a return to traditional low-yield varieties less intensive of modern inputs. A specific program direction therefore is technological in nature, i.e., to support schemes for input substitution that minimize losses in real output and incomes, given adverse price changes. But the prospects need to be seriously experimented on and adapted to more normal production environments and patterns. Such adjustment support addresses a medium-term scenario while the government reintensifies its food production program in the short run.

The technical aspects of these adjustment processes involve the effective diffusion of the adaptive technologies throughout the sector. A component activity would therefore be information and demonstrations to farm production units. While, in theory, factor proportions adjustments are an economic problem for which farmers are in the best position to decide, the technological element requires social support.

For the export crops, the technological dimension is to induce necessary investments to obtain higher productivities. In the case of coconuts, for example, the task is to induce replanting behavior. In part this may be promoted by price and trade liberalization without a search for new input combinations. Yet the adjustment process itself

requires resources to support short-run drops in income or investment funds.

3. Agricultural Credit - The flow of credit to agriculture (and to the rural sector in general) remains as a bottleneck to the country's development efforts. If in the short run the direction is to provide credit to agriculture at market rates while the financial intermediation process is allowed to work, the medium term would seem to call for changing the distribution pattern of agricultural credit in such a way that the different subsectors are given equal access. The mechanism for this appears to fall within the broader policy reform noted in the first suggested direction.

4. Institutional Transformation - Part of the policy problems in agriculture must be attributed to the institutional setting for analysis, implementation and evaluation of development programs. Since the latter part of the seventies the sector has seen greater fragmentation of functions among a larger number of institutions, basically independent of each other. The recent reorganization of the Ministry of Agriculture and Food appears as a step in improving sectoral coordination. More institutional changes are clearly necessary and supporting the continuation of these is another avenue for aid resources.

There are at least two specific ways of enhancing institutional reforms. One is to provide resources for an independent assessment of the setting for agricultural policy. The decision on the substance and scope of such an assessment can be undertaken by the Ministry but with an understanding that it would be related to the structural change in policy for a sustainable growth.

The other is to insure that there is a single project development cycle and set of agricultural priorities imposed on programs and projects irrespective of implementing agencies. This direction can of course be tied to a policy reform project (dialogue). Needless to say the scarcity of aid resources argue that their use be subjected to uniform criteria and not left open to competing discretion. For example, agricultural activities using development assistance resources should be subjected to similar principles as those using Economic Support Funds (ESF). Indeed basic economics dictates this to be the case for the ultimate benefit of both donor and recipient.

It does appear that this last direction is not really a concrete project but rather a philosophy. But it has become a critical factor not only to recovery and long-term growth but also to the lethargic performance of the sector in recent times.

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