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PHILIPPINE PUBLIC DEBT MANAGEMENT

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PREFACE

This study was completed through the assistance of the United States Agency for International Development (A.I.D.). The views, expressions and opinions contained in this report are the authors' and are not intended as statements of policy of either A.I.D. or the authors' parent institution.

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ABBREVIATIONS

APT	Asset Privitization Trust
BIR	Bureau of Internal Revenue
CB	Central Bank
CPA	Certified Public Accountant
CPSD	Consolidated Public Sector Deficit
DBP	Development Bank of the Philippines
DOF	Department of Finance
EO	Executive Order
EPZA	Export Processing Zone Authority
ESAA	Exchange Stabilization Adjustment Account
FRTNs	Floating Rate Treasure Notes
GFIs	Government financial institutions
GNP	Gross National Product
GOCCs	Government Owned and Controlled Corporations
IMF	International Monetary Fund
LGUs	Local Government Units
LRTA	Light Rail Transit Authority
LWUA	Local Water Utilities Administration
MAA	Monetary Adjustment Account
MIS	Management Information System
MMTA	Metro Manila Transit Authority
MRR	Manila Reference Rate
MWSS	Metropolitan Waterworks and Sewerage System
NDC	National Development Company
NEA	National Electrification Administration
NEDA	National Economic and Development Authority
NFA	National Food Authority
NHA	National Housing Authority
NIA	National Irrigation Administration
NPC	National Power Corporation
OPSF	Oil Price Stabilization Fund
PCCI	Philippine Chamber of Commerce and Industry
PCGG	Presidential Commission on Good Government
PCIB	Philippine Commercial International Bank
PIDS	Philippine Institute for Development Studies
PNB	Philippine National Bank
PNOC	Philippine National Oil Company
PNPP	Philippine Nuclear Power Plant
PNR	Philippine National Railways

PPA	Philippine Ports Authority
RCBC	Rizal Commercial Banking Corporation
RIR	Revaluation of International Reserve
SDP	Support Development Program
UCPB	United Coconut Planters Bank
VAT	Value added taxation
WB	World Bank

Chapter I

EXECUTIVE SUMMARY

There are two ways to judge the fiscal situation in the Philippines. Judged by the balance between revenues and outlays, the situation is not now alarming, but it contains certain severe risks that make it important to continue reducing the budget deficit. However, the deficit has been held down only by engaging in considerable fiscal austerity on the spending side, and recent fiscal policy can also be judged by the wisdom of those cuts. This report does not attempt to do that in detail, but many complain that the cuts have come at the expense of growth inducing expenditures. To the extent that this is true, there may be strong arguments for an additional tax effort, both to continue lowering the deficit and to add to high rate of return investments on the spending side of the budget.

The National Government's deficit remained below 3 percent of GNP in the 1987-89 period before rising to 3.6 percent in 1990. The ratio is expected to improve in 1991 and 1992. The consolidated public sector deficit, which includes local government units, the Central Bank, and other off-budget public institutions, has been somewhat less satisfactory, rising from 2.2 percent of GNP in 1987 to 5.0 percent in 1990. However, it too is expected to improve in 1991 and 1992.

The ratio of the National Government's debt to GNP was slightly above 50 percent in 1990, a level not unlike that prevailing in the United States. Roughly, one-half of that debt is domestic and the remainder is external.

The Philippines' satisfactory performance has been much aided by the Tax Reform Act of 1986. Before the reform, the revenues implied by constant tax law grew less rapidly than GNP. Now, revenue growth exceeds GNP growth. The reform also significantly simplified tax law and made it more equitable.

Simulations of current policy suggest a steadily improving fiscal situation through the end of this century.

Although the fiscal situation now appears to be under control, the risks lurking in the background justify considerable concern. High and unstable inflation rates have caused nominal interest rates to soar, and the interest bill on the debt is now approaching 40 percent of total outlays. As a result, the Philippines is highly vulnerable to any event that raises interest rates. Because of the risks caused by high inflation, the government has been unable to sell significant amounts of longer-term debt and much of the existing debt has to be refinanced weekly. Consequently, higher interest rates are reflected quickly in the interest bill, both because of the higher rates themselves and the additional debt that must be issued to finance those higher rates.

Even worse, the average interest rate paid on the debt is likely to rise significantly in the near future because the increased difficulty in attracting low-interest loans from abroad implies that a higher portion of future deficits must be financed by issuing high-interest domestic debt.

Because large amounts of Treasury securities must be issued each week, monetary management is difficult, and any spurt in inflation is self-reenforcing as the interest bill rises and adds to the financing burden.

The situation is complicated by the large losses of the Central Bank, which constituted 53 percent of the consolidated public sector deficit in 1989 and 34 percent in 1990. The National Government issues securities and makes deposits in the Central Bank to mop up the reserves that would otherwise be created by these huge losses. Consequently, the National Government is intimately involved in monetary management while the losses of the Central Bank stem from fiscal activities. This confusion of roles complicates the conduct of economic policy and adds to the danger of accelerating inflation. The situation should be clarified by having the National Government assume sufficient assets and liabilities of the Central Bank to leave it with a clean balance sheet. The Central Bank could then be put on a profitable basis and be given more independence in the conduct of monetary policy.

Simulation analysis was performed to examine various risks to the otherwise rosy outlook. Relatively small changes in economic variables can convert an improving situation into one that continually deteriorates.

The risks inherent in the current fiscal situation would obviously be ameliorated greatly by lowering the consolidated public sector deficit further and by controlling the inflation rate. Options that would achieve this end were also simulated. The current favorable fiscal outlook has been achieved to some degree by restricting public investment, which has had a negative impact on the Philippines' capacity to grow in the future. Economic growth could be aided further by reducing the extent to which the current deficit reduces national saving. Ideally, the public sector would add to national saving by running a moderate surplus in its deficit as measured by the national income accounts.

Improvement in the management of the public debt could make a significant contribution to improving the overall fiscal situation by lowering debt servicing costs.

The Philippines has been engaged in a series of negotiations with external creditors to reduce the burden of the external debt, largely acquired during the early 1980s. These negotiations involve both private and public debt, and ultimately hope to restore a net inflow of credit that could be used to finance a net inflow of real resources from abroad. As a by-product, these negotiations should also reduce the burden of servicing the public portion of the external debt.

The government should consider reforms that have the potential for reducing the difficulty of managing the domestic debt. Somewhat more generous terms might be offered on long-term debt in order to lengthen the debt's average maturity and to reduce the amounts that have to be refinanced each week. Secondary markets for debt can also be improved and it may be worth experimenting with new auction procedures that would reduce the possibility of collusion among buyers and reduce the extent to which buyers can strategize against the government. The possibility of tapping the latent demand of small savers for government securities may also be considered, although it is important first to analyze the increase in administrative costs that might be involved in such an initiative.

In conclusion, it is important to note that the very elements that create risks for the fiscal situation of the Philippines also create the opportunity for substantial improvements. Any policy that reduces the rate of growth of the public debt immediately reduces the relative burden imposed by the interest bill and enhances the ease of further deficit improvement. Any policy that reduces the inflation rate also reduces the interest bill substantially and reduces the flow of government securities to the market, thus reducing the difficulty of monetary management and facilitating further improvements in inflation.

Chapter II

RECENT FISCAL TRENDS

A. TRENDS IN AGGREGATES

Budgetary deficits do not automatically imply macroeconomic problems. If public resources are used productively, future income can be generated to cover the servicing costs of any new debt. The extent to which any given deficit level can be reconciled with broader economic goals depends largely on the way it arises. A review of the budget deficits in the two halves of the decade suggests that they arose for different reasons. The budget deficits during the early 1980's can be attributed to the rapid implementation of large public projects while government revenue performance was weakening. In addition, there was extensive government intervention in areas which were previously the domain of the private sector -- activities such as sugar and coconut trading, land transportation, hotels, airlines, rubber and coffee production, etc. The huge fiscal deficits which materialized were largely financed by foreign commercial banks. Foreign borrowings comprised roughly half of total financing in 1980 and 1981. In subsequent years, external financing became increasingly less important as foreign loans became scarce. Thus, the ratio of net external financing to the fiscal deficit declined from an average of 40.4% in 1980-85 to an average of 24.6% in 1986-90.

In contrast, the budget deficits in the second half of the decade emerged principally due to the huge debt overhang, including the debt servicing of the liabilities of the Philippine National Bank (PNB), the Development Bank of the Philippines (DBP) and other public institutions, the debts of which were assumed by the National Government. Due to the slower inflow of foreign loans, there was a marked shift from foreign to domestic sources in the financing of the deficit. The sale of short-term government securities emerged as the preferred way of financing the fiscal gap.

To counteract the negative effects of a global economic slowdown, the government pursued an expansionary fiscal program in 1980-82 in an attempt to encourage production and growth by increasing government expenditures. However, little attention was paid to the slowly deteriorating revenue mobilization. While revenues grew by an average of 4.9% from ₱34.7 billion in 1980 to ₱38.2 billion in 1982, expenditures increased by an average of 17.5% from ₱38.1 billion to ₱52.6 billion in the same period. Consequently, the fiscal deficit ballooned from ₱3.4 billion to ₱14.4 billion or from 1.3% of GNP in 1980 to 4.3% in 1982 (**Table 1**).

The tightening of foreign capital inflows combined with low revenue generation forced the former regime to adopt austerity measures that cut deeply into public capital expenditures and resulted in a decline of economic activity in 1982-83. But renewed expenditure excesses in the ensuing years resulted in persistent expansion of the National Government deficit, which grew again from 2% of GNP in 1983 to 5.1% in 1986.

Table 1. **REVENUES, DISBURSEMENTS, and DEFICITS of the National Government, 1980-91 (In Billion Pesos)**

YEAR	REVENUE	AS % OF GNP	DISBURSEMENTS	AS % OF GNP	DEFICIT	AS % OF GNP
1980	34.7	13.13	38.1	14.41	3.4	1.28
1981	35.9	11.82	48.1	15.84	12.2	4.02
1982	38.2	11.39	52.6	15.68	14.4	4.29
1983	45.6	12.04	53.0	13.99	7.4	1.95
1984	56.8	10.77	66.9	12.69	10.1	1.92
1985	69.0	11.54	80.1	13.40	11.1	1.86
1986	79.2	12.88	110.5	17.98	31.3	5.09
1987	103.2	14.67	119.9	17.05	16.7	2.37
1988	112.9	13.72	136.1	16.54	23.2	2.82
1989	152.4	15.84	172.0	17.88	19.6	2.04
1990	180.9	15.97	218.9	19.33	37.2	3.29
1991	219.9	17.30	246.3	19.38	26.4	2.09

SOURCES: Department of Budget and Management
Bureau of the Treasury

The fiscal deficit ballooned to ₱31.3 billion in 1986 as a result of the carryover effects of the election spending, the assumption by the National Government of non-performing accounts of government financial institutions (GFIs) and the expansionary fiscal programs adopted to rekindle the ailing economy.

Conscious of the adverse impact of large budget deficits on economic recovery efforts, the Aquino Administration embarked on a progressive program of budget reductions. To simultaneously address the problems of reducing deficits and increasing investments, fiscal policy centered on measures designed to raise revenues and optimize the use of scarce budgetary resources.

Important adjustments were made to the tax structure, tax administration and the quality and distribution of government expenditures. The revenue program attempted to increase tax compliance and plug identified loopholes. These measures resulted in total revenue effort rising from an average of 11.1% of GNP in 1980-85 to a 14.9% average for the period 1986-89. This meant an average annual growth rate of 22.4% in the latter period as compared to the 15.0% average growth rate in the first half of the decade.

However, current expenditures were also growing rapidly from an average 9.6% of GNP in the period 1980-85 to 13.8% from 1986-89 primarily due to the increase in interest payments and personal services expenditures. Interest payments increased as the National Government assumed guaranteed liabilities of government corporations and financial institutions and mopped up liquidity for the Central Bank. The interest payments on the assumed liabilities increased from ₱659 million in 1986 to ₱13.6 billion in 1991 (**Table 2**). Personal services expenditures also increased significantly as the National Government implemented across-the-board salary increases, upgraded the salaries of soldiers, teachers and lawyers, implemented the early retirement scheme and executed the Salary Standardization Law.

Table 2. **BUDGET DEFICIT AND INTEREST PAYMENTS (IN BILLION PESOS)**

	TRADITIONAL BUDGET DEFICIT	INTEREST PAYMENTS REGULAR	ASSUMED LIABILITIES	TOTAL	PRIMARY BUDG.SURPLUS	% OF GNP
1985	(11.1)	14.6	0	14.6	3.5	0.6
1986	(31.3)	20.9	.7	21.6	(9.7)	(1.6)
1987	(16.7)	24.7	12.2	36.9	20.2	2.9
1988	(23.2)	32.7	13.2	45.9	22.7	2.8
1989	(19.6)	41.4	13.3	54.7	35.1	3.7
1990	(37.2)	57.1	14.0	71.1	33.9	3.2
1991	(26.6)	69.8	13.6	83.4	56.8	4.5

SOURCES: Department of Budget and Management
National Economic and Development Authority
Bureau of the Treasury

Despite efforts to raise the level of investments, implementation delays were numerous. A shift to maintenance spending occurred instead. Capital expenditures for the National Government, the 14 monitored corporations and local government units (LGUs) fell from 8.2% of GNP in 1980 to 3.1% in 1986 and 4.9% in 1991 (**Table 3**).

Table 3. **PUBLIC INVESTMENTS, 1980-1991 (In Billion Pesos)**

YEAR	NATIONAL GOV'T	14 MONITORED GOV'T CORP.	LGUs	TOTAL	% OF GNP
1980	8.4	11.1	0.5	20.0	8.2
1981	12.7	13.9	0.6	27.2	9.7
1982	9.3	13.3	0.7	23.3	7.4
1983	10.4	18.1	0.8	29.3	8.1
1984	9.8	12.9	0.9	23.6	4.6
1985	8.8	12.3	0.8	21.9	3.9
1986	11.7	5.9	0.6	18.2	3.1
1987	12.9	7.9	1.5	22.3	3.3
1988	15.2	9.0	1.4	25.6	3.2
1989	21.6	15.0	1.8	38.4	4.2
1990	29.1	26.8 1/	2.6	58.5	5.5
1991	37.2	21.1 2/	3.7	62.0	4.9

1/ Based on GCMCC financial report as of October 23, 1991

2/ Based on GCMCC financial report (October actual) dated November 25, 1991

Hence, despite persistent efforts to trim government expenditures the budget deficit continued to increase from an average of 1.9% of GNP in 1983-85 to an average of 3.1% in 1986-89.

If interest payments were netted out, the primary fiscal balance exhibits surpluses from 1987-1990 (**Table 2**). This indicates just how significantly the interest bill has contributed to the deteriorating fiscal finances. But the widening of the fiscal gap cannot be blamed on the interest payments alone. From 1986 onwards, the National Government budget included the following expenditures: interest cost on open market operations of the Central Bank; advances related to the debt reduction program and subsidies to the Oil Price Stabilization Fund (OPSF).

There are costs associated with debt reduction programs which inflated the budget of the National Government. To illustrate, consider the debt buyback operations in January 1990. Under the program, the National Government was able to retire US $1.3 billion of foreign debt at a 50% discount. But to complete the transaction, the National Government provided ₱2.4 billion to the National Power Corporation, Philippine Airlines, and the Philippine National Construction Corporation which were cash deficient but eligible for assistance as part of the buyback program.

The addition of these spending items to the National Government budget renders the post-1986 budgets non-comparable with the previous budgets. Although these items started moderately at ₱659 million in 1986, the financing gap attributable to them has grown larger over the years averaging about 1% of GNP.

The relative size of the National Government deficit had progressively declined from 1986 to 1989, only to increase again in 1990. However, the deficit is expected to taper off to 2.1% of GNP in 1991 and 0.6% in 1992.

It is important to explain the acceleration of the deficit in 1990. A comparison of actual vs. programmed deficit levels, shows that in 1988 and 1989 actual revenues fell short of programmed levels, but the actual deficit was more or less maintained by reducing programmed expenditures. This course of action can be accomplished with ease as long as the revenue shortfall is relatively small and there are not large surprises on the expense side. Such was not the case in 1990. The target deficit was ₱7.9 billion but the actual figure was ₱37.2 billion or an excess of ₱29.3 billion. Personal services expenditures contributed to this unplanned increase as they totalled ₱64.3 billion, or ₱3.7 billion above the target. An unanticipated rise in interest payments was the major reason for the deterioration of the fiscal position in 1990, as actual interest payments exceeded the planned level by ₱15.7 billion. What explains this unplanned increase? The first reason was the interest rate on 91-day T bills was 24.7% against a planned level of 18.6% The second reason, equally important, was the upward revision in the programmed volume of T-bills to be sold. As a result of the December 1989 coup attempt and consequent surge in the money supply, the extent of liquidity mopping up operations were increased dramatically to keep within the stabilization program targets.

While the National Government deficit simply measures the shortfall of revenues from disbursements incurred in the operation of the National Government budget, the consolidated public sector deficit (CPSD) sums up the deficits of all the organizations within the public sector. Other components of the CPSD are : deficits of the 14 major corporations, the Oil Price Stabilization Fund, government financial institutions, local government units (LGUs), social security institutions and the Central Bank.

As a percentage of GNP, the CPSD had tapered off in 1987-88 from a high of 6.1% in 1985 only to inch up again in 1989 (4.1%) and in 1990 (5.4%) (**Table 4**). This ratio is expected to stabilize at around 2.5% in 1991 and 1992.

Table 4. CONSOLIDATED PUBLIC SECTOR DEFICIT, 1985-92

	1985	1986	1987	1988	1989	1990	1991 Estimate	1992 Forecast
National Government	11.1	31.3	16.7	23.2	19.6	37.2	26.6	3.6
Major Corporations	8.1	6.8	3.2	-2	4.4	19.1	15.4	13.7
LGUs and Social Security Inst.	-0.9	-5.9	-5.3	-5.4	-4.2	-11.6	-8.9	-11.5
Gov't Financial Institutions	18.5	12	-1.3	-1.8	-3.3	-3.1	-2	-3.2
Central Bank	15.5	18.2	10.9	16.9	20.8	21.9	21.5	36.1
Oil Price Stabilization Fund	0	0	0	0	7.1	7.4	-11.5	2.5
Intersectoral Transfers	-16.1	-32.7	-8.7	-1.1	-5.3	-13.1	-9.6	-4.2
Total Public Sector Deficit	36.2	29.7	15.5	29.8	39.1	57.8	31.5	37.0
As a percent of GNP	6.1	4.8	2.2	3.6	4.1	5.4	2.5	2.6

With the assumption of the liabilities of PNB, DBP, PNPP and other corporations, the National Government deficit represented around 100% of the CPSD in 1986-88. In the following two years, as the finances of the Central Bank deteriorated, the National Government deficit amounted to more than half of the total CPSD. In 1991, it is estimated to represent 87.4% of the consolidated deficit.

As shown in **Table 4**, the two social security institutions -- the Social Security System and the Government Service Insurance System -- have consistently been generating surpluses during the period under review. From an average of approximately half a billion pesos during 1986-89, the surplus of the social security institutions has been rising. It is expected to reach ₱8.9 billion in 1991.

With the successful rehabilitation of PNB and DBP, the government financial institutions are expected to generate a surplus of ₱2 billion in 1991, after averaging surpluses of ₱2.4 billion in the period 1987-90. Their loans and non-performing assets were transferred to the National Government for disposition in 1986. At the same time, ₱106.6 billion worth of their liabilities were assumed by the National Government. Of the 399 accounts transferred, 183 have been partially or totally sold by June 1990.

Local government units (LGUs) have been generating surpluses during 1985-1991. LGUs are expected to generate a surplus of ₱200 million in 1991. With the enactment of the New Local Government Code, the surplus position of local governments can be expected to continue. In 1992, about ₱23 billion will be allocated to LGUs.

The reform program for government owned and controlled corporations (GOCCs) started in December 1986. In spite of the continuing efforts to improve corporate performance, some GOCCs continue to be in the red. For 1990, the sector deficit was a huge ₱19.1 billion. For 1991, a reduction of ₱3.7 billion to ₱15.4 billion is planned. The objective for the following year is to further reduce the deficit to ₱13.7 billion or approximately 1% of GNP. The monitored corporations are: National Power Corporation (NPC), National Food Authority (NFA), National Electrification Administration (NEA), Metropolitan Waterworks and Sewerage System (MWSS), Local Water Utilities Administration (LWUA), Philippine National Railways (PNR), Export Processing Zone Authority (EPZA), Light Rail Transit Authority (LRTA), Philippine National Oil Company (PNOC), National Irrigation Administration (NIA), National Development Company (NDC), National Housing Authority (NHA), Philippine Ports Authority (PPA), and Metro Manila Transit Authority (MMTA). The financing gap of each corporation is defined as the difference between internal cash generation and capital expenditures. Based on the October 1991 forecast, the major losing state firms are: NPC (₱9.4 billion), NFA (₱3 billion), NEA (₱1.8 billion), MWSS (₱1.3 billion), LWUA (₱794 million), PNR (₱632 million), EPZA (₱534 million) and LRTA (₱496 million).

B. TRENDS IN REVENUES OF THE NATIONAL GOVERNMENT

Throughout the pre-reform period (1981-85), the ability of the National Government to generate revenues from tax and non-tax sources proved to be discouraging. Total revenues grew at an average yearly rate of 15% against the 18% growth of GNP for the period. A slightly declining growth of tax revenues as a percentage of GNP can, therefore, be observed from 11.2% in 1981 to 11.0% in 1985. Similarly, non-tax revenues as a percentage of GNP also declined from 1.7% in 1980 to 1.4% in 1985. About 88% of total revenues came from tax sources. Of these sources, domestic-based taxes contributed a share of 53% while international trade taxes claimed a 31% contribution.

1. Tax Measures before 1986

Income Tax

Prior to the 1986 tax reform program, the income tax system is best described as schedular. Two tax schedules existed. One was for the compensation income category (Salaries and Wages) under a modified gross income scheme of nine steps from 1 percent to 35 percent. The other was for business and professional income on a net income basis of five steps from 5% to 60%. Personal exemption levels had been revised in 1981, 1983 and 1985. Passive income (interest income, royalties and dividends) was subject to 17.5% and 15% withholding. Corporate income tax was dual rate of 25% and 35% percent based on net income.

Sales Tax

Most imported and locally produced goods were levied as ad-valorem sales tax. Since 1985, a turnover of 1.5% of gross selling price had been levied on each subsequent sale of any article, except that of manufactured oils, and other fuels. The advance sales tax on imported goods was allowed as credit against the sale tax due only on the original sale on the imported good.

In October 1985, unified sales tax rate on essential and semi-essential articles was enacted. This eliminated the mark-up provision and imposed higher rates on imported goods. The base of sales tax on domestic goods was the gross selling price while that on imports was the landed cost inclusive of tariffs plus a mark-up of 25%.

Excise Taxes

Specific taxes were imposed on certain domestically produced and imported goods. Specific taxes were earlier used to discriminate against imports, but in 1983 the rates on both types of goods were harmonized. In 1984, an ad-valorem component was added to, and in most cases replaced, the unit tax.

Import Tariffs

Under a reform implemented in 1981, the ad-valorem peak rate of 100% was reduced to 50% and tariff rates on other commodities were revised to conform to a more uniform structure. In 1982, an additional duty of 3% was imposed on all imports. The additional levy was increased to 5% in 1983 and finally to 10% in 1984. There were subsequent reductions of these additional rates, until they were finally phased out in 1986.

Export Taxes

Through the years, export taxes on particular products have been alternatively lifted, reimposed, raised and decreased depending on the performance of each product in international markets. The export tax was an ad-valorem tax levied on the gross FOB value of taxable exports. Logs are taxed at 20%, copra at 15%, coconut oil at 9%, copra meal/cake and desiccated coconut at 8%, lumber, veneer, abaca and pineapple juice at 4% and bananas at 2%.

Tax Incentives

In January 1981, a law was issued to change the up-front rewards for performance-oriented incentives, such as tax credits on net value earned and net local content of exports. In 1984, all tax exemptions to all government and private corporations were eliminated. However, a considerable number of exemptions has preferences.

Non-tax Revenues

Fees and charges were collected by various agencies for services rendered. Most fees were specific and fixed. Some are ad-valorem in nature.

2. Major Features of the 1986 Tax Reform Package

The tax reform of 1986 represents an improvement over a tax system which may be characterized as unresponsive to changes in income aggregates, having an extremely low tax yield, heavily dependent on indirect taxes and difficult to administer. The reform was based on the basic objective of obtaining a tax system that is simpler, fairer and more efficient.

A tax system should be judged on the basis of fairness, allocative efficiency, responsiveness to changes in income aggregates, simplicity and administrative ease. This analysis focuses on how the Philippine tax system performed on the basis of these criteria except for its allocative efficiency. The latter criterion is much more difficult to analyze.

Specifically, the tax reform measures had the following objectives:

1) to improve the elasticity of the tax system, i.e., by enhancing the automaticity in the increase of tax revenues with increases in economic activity;

2) to promote equity by ensuring that similarly situated individuals and firms bear the same tax burden;

3) to promote growth by withdrawing or modifying taxes that impair incentives to produce;

4) to improve tax administration by simplifying the tax system; and

5) to promote tax compliance.

a. Reforms of Direct Taxation

Direct taxation was overhauled primarily to promote equity, domestic investment and simplicity.

i. <u>Partial shift to global system of personal income taxation</u>

Prior to the reform, two tax schedules existed. As a result of EO 37, the lower 0-35% tax schedule was adopted for compensation and professional incomes. To minimize the erosion of revenue that the uniform approach would likely cause and to preserve the relative tax burden on individuals, the imposition of ceilings on certain allowable business deductions was proposed. Unfortunately, due to strong lobbying of various professional groups, this complementary measure has not been instituted.

ii. Uniform 20% tax on passive income

Prior to the reform, royalties and prizes were taxed at 15% while interest income was taxed at 17.5%. As a result of Executive Order 37 a uniform rate of 20% was imposed. The establishment of a uniform rate rendered passive income taxation neutral with respect to investment decisions involving bank deposits and royalty generating ventures. The change also resulted in an increase of revenue.

iii. Withdrawal of the Income Tax Exemption of Franchise Holders

Executive Order 72 withdrew the income tax exemption of franchise grantees and applied uniform franchise taxes on similar types of utilities. The imposition of an income tax on franchise grantees put this previously favored group on an equal footing with similarly situated individuals or firms.

iv. Uniform Corporate Income Tax

The two-tiered corporate income tax of 25% and 35% was replaced with a uniform rate of 35%. The decision to adopt a uniform rate was motivated by the need to enhance the allocative efficiency of the income tax.

v. Tax Amnesty on Undeclared Income

Through Executive Order 41, tax amnesty on undeclared income from 1981 to 1985 was offered to delinquent taxpayers. Later, through Executive Order 64, the coverage of the amnesty was expanded to include other internal revenue taxes. About 70,000 taxpayers took advantage of the amnesty which yielded ₱1.4 billion.

vi. Increased Motor Vehicle Tax

Executive Order 43 increased the tax on private passenger cars and utility vehicles by an average of 50%. However, the tax on the same vehicles more than 5 years old was reduced by ₱100.

vii. Increased Personal Exemption Levels

Personal allowances were increased to adjust for inflation and to eliminate the taxation of those earning below the poverty threshold income. The objective of this change was to improve the fairness of the income tax.

Using NEDA estimate of a poverty threshold for families of ₱24,000, the allowance of single taxpayers was increased from ₱4,000 to ₱6,000, head of family from ₱5,500 to ₱7,500 and married taxpayers from ₱8,500 to ₱12,000.

viii. Separate Taxation of Married Taxpayers

This measure provides earning couples the option to file separate returns. Since both incomes may start from the 0% rate on the first ₱2,500 of taxable income, the effects of the progressive rates on combined income are removed and the separate taxation scheme reduces the tax burden on married couples.

ix. Elimination of Double Taxation on Dividend Income

The reform eliminated the taxation on inter-corporate dividends and provided a gradual phase out (in 3 years) of the tax on dividend income. The objective of the measure was the promotion of greater efficiency in resource allocation.

b. Reforms in Indirect Taxation

Value added taxation (VAT) was introduced to simplify the tax structure and its administration, to maintain progressivity and to introduce tax neutrality for resource allocation decisions. It included:

-Imposition of a general rate of 10% VAT on the sale of domestic and imported goods and services, 0% on exports and foreign currency denominated sales.

-A 10% rate in lieu of varied rates applicable to fixed taxes (60 nominal rates), advance sale tax, tax on original sale, subsequent sales tax, compensating tax, miller's tax, contractor's tax, broker's tax, film lessors and distributor's tax, excise tax on solvents and matches, and excise tax on processed video-tapes.

-Imposition of a 2% tax on entities with annual sales or receipts of less than ₱200,000.

-Adoption of the tax credit method of calculating the tax by subtracting tax on inputs from tax on gross sales.

-Exemption of the sale of basic commodities (agricultural and marine food products in their original state, price-regulated petroleum products and fertilizers, among others).

-Imposition of an additional 20% tax on non-essential articles such as jewelry, perfumes, toilet waters, yacht and other vessels for pleasure and sports.

c. Assessment of the 1986 Tax Reform

The revenue raising capability of the Philippine tax system was improved as a result of the reform package. A National Tax Research Study estimates that the responsiveness of the tax system to changes in economic activity has increased from a low of 0.9% before the tax reform to 1.4% for the period 1986-88.

Tax revenue as a percentage of GNP (tax effort) has improved dramatically. Tax effort increased from 10.9% in 1986 to 14.2% in 1990. It is expected to increase to 15.9% in 1992.

There has been no dramatic change in the ratio of net income and profit taxes to total tax revenues. According to the National Tax Research Center, income taxes as a percentage of total taxes increased from 21.1% in 1983 to 26.7% in 1987. The combined effects of increasing the personal deduction allowances and the separate taxation of married couples may account for the relative constant contribution of income taxes. Furthermore, the failure to put in place ceilings on allowable business deductions for income taxation has contributed to the lack of growth of income tax revenues. A new law expanding the personal deduction allowances may further reduce the yield of the personal income tax. The revenue loss, however, could be offset by the proposed modification of the individual income tax system through the disallowance of frequently abused deductions such as bad debts, representation and travelling expenses. Income taxes could provide significant additional resources to the National Treasury, if administrative problems that allow tax evasion were solved.

Tax revenues continue to account for the bulk of the National Government income. Tax revenue rose from 87.9% of total revenues in 1980 to 88.8% in 1985 but suddenly declined to 82.6% in 1986. It further declined to 80.4% in 1989 because of rapid increases in non-tax revenues, including increases of Economic Support Fund collections, sale of PCGG and APT assets and interest income on Central Bank deposits.

In the first half of the decade, tax revenue grew by an average of 15.3%. In 1986, however, tax revenues only grew by 6.9% but abruptly accelerated again to 31.2% in 1987 mostly due to tax reforms already in place. In 1988-90, tax revenues continued to fluctuate at a rate of 5.2%, 35.5% and 23.9%, respectively.

To improve administration and increase tax yield, the government has implemented a number of administrative reforms. The Bureau of Internal Revenue now requires CPAs to register with BIR and to certify the accuracy of tax returns. The affixing of strip stamps to cigarette packages and liquor bottles has been resumed.

The Bureau of Customs has been authorized to enter into compromise settlements for payment of delinquent duties and the scope of SGS operations has been expanded.

d. Further Tax Reforms

The improvement in revenue raising capability has provided the present administration the luxury of considering other reforms that would enhance the fairness and efficiency of the tax system. Since the tax system continues to rely heavily on indirect taxes, the improvement of income tax collection must be a major policy goal.

The imposition of ceilings on allowable deductions has long been overdue. This measure is embedded in the proposed Simplified Net Income Taxation. Other measures which could increase the share of direct taxes to total revenues should be seriously considered: imposition of a progressive net worth tax and additional real property tax. The latter will also discourage speculation on real property.

The planned gradual phase-out of the gross receipt tax on banks has to be pursued with renewed vigor. The reduction in intermediation costs and consequently, interest rates could result in higher investment and lower debt servicing for government. In turn, higher output and smaller interest bill may mean lower budget deficit or higher surplus.

A bill now pending in Congress which seeks to broaden the VAT base and improve its administration should be supported. The bill proposes to include the coverage of VAT to those services and other activities previously outside its domain. Administrative reforms designed to improve the implementation of VAT include the following: a mechanism for sharing VAT proceeds with local governments; withholding of VAT on purchase made by the government; requirement for the registration of VAT invoices; and the provision for advance tax credit certificates on zero-rated articles such as exports.

C. TRENDS IN OUTLAYS OF NATIONAL GOVERNMENT

The Medium Term Philippine Development Plan, 1987-92 states that the government spending shall give priority to employment generating activities, provision of social services and attachment of cost effectiveness by streamlining of government operations. Focus is to be given to programs that support redistributive objectives such as education, rural infrastructure, health, social welfare and agrarian reform.

1. Size and Composition of Government Expenditures

During the present administration, expenditures started to dramatically increase from ₱76.5 billion in 1985 to ₱114.6 billion in 1986 and ₱289.9 billion in 1991. This drastic change represents an annual average growth of 21.7% compared to about 15% growth experienced between 1980-85.

As a percentage of GNP, government expenditures averaged 14.3% in the first half of the decade. Within this period, however, a downturn was experienced in 1983-85 when total expenditures slowed down to an average of 13.4% of GNP from an average of 15.3% in 1980-82. This was mainly due to the budget cutbacks imposed as a consequence of the 1983-84 crisis. This downtrend was reversed during the Aquino Administration, when total expenditures averaged 22.0% of GNP between 1986-90.

These figures accurately reflect the trend in the size and growth of the government debt during the same period. The aggressive investment program pursued in the early 1980s, when revenues were dwindling, led to large budget deficits which were financed mostly by foreign loans. This led to the ballooning of the debt burden in 1986-90 when the foreign loans became due and to heavy reliance on short-term financing through the sale of securities in the domestic market. During these years, debt burden, (including net lending), averaged 43.6% of total annual budget, with a peak of 49.7% in 1987.

2. Distribution of Expenditures Among Economic Categories

Capital outlays were at their peak in 1981 when they represented 6.2% of GNP. They experienced a decline during the economic crisis of 1983-85 when capital projects suffered the most significant spending cuts. In nominal terms, they represented 2.6% of GNP in 1985.

Transfers to GOCCs in the form of equity contributions, subsidies and net lending were highest in 1980-86 when total transfers averaged annual growth rates of 25%. Lower growth rates were registered in 1987-89 when capital outlays represented only 2.6% of GNP. This was mainly due to the reduction in assistance to government corporations, which in fact resulted in negative growth in capital outlays in 1986-88.

Current operating expenditures, on the other hand, increased significantly in nominal terms during the 1986-90 period which witnessed an average annual increase of 26.2% against an average of 18.4% in 1980-85. This rapid increase can be attributed primarily to increases in interest payments which grew at an even faster rate. As a percentage of GNP, interest payments grew from 1.5% in the first half of the decade to 5.3% in the second half.

Interest payments dramatically increased from ₱2.3 billion in 1980 to ₱71.1 billion in 1990. Domestic interest payments increased from ₱10.3 billion in 1985 to ₱53.3 billion in 1990 or an average annual increase of 31.5% due to a combination of larger domestic debt and higher nominal interest payments. Interest payments to foreign lenders, on the other hand, increased from ₱4.4 billion in 1985 to ₱17.8 billion in 1990 due to the assumed liabilities owed by the state banks and other government corporations.

Although the share of personal services to total government expenditures remained stable during the 1980s, it grew considerably during the Aquino Administration both in real and nominal terms. By 1990, personal service expenditures more than tripled from ₱22 billion in 1985 to ₱64.3 billion last year. This phenomenal growth is due to a series of salary adjustments, which culminated in the implementation of the Salary Standardization Law in July 1989.

Studies of the Department of Budget and Management indicate that the increases in personal services expenditures can also be attributed to the expansion of the size of the bureaucracy. In education, 48,000 positions were created in 1988. In defense, 30,000 positions were added. The agrarian reform needed the creation of 6,000 positions and so on. All in all, from a level of 1 million in 1987, the bureaucracy is estimated to have grown to about 1.2 million in 1990.

3. Sectoral Distribution of Government Expenditures

An examination of the expenditures in the last thirteen years indicate that there has been a major reallocation from the economic sector to the social services sector, if the debt burden is netted out from total expenditures (**Tables 5 and 6**). In 1991, the social sector led by education and health posted the highest share at 37.1% (gross of the agrarian reform fund). This is 3.4 percentage points higher than the economic sector's share of 33.7%.

If the debt burden is included, the figures show that the economic sector suffered deeper cuts than the social sectors.

Expenditures for education consistently grew over the past thirteen years, both in nominal and real terms, with an annual average rate of 15.7% in 1980-85 and 22.4% in 1986-92. In nominal terms, the education budget more than tripled from ₱10.8 billion in 1985 to ₱41.3 billion in 1992. As a percentage of GNP, it increased from 2.0% in 1980-85 to 2.8% in 1986-90. The education system is intended to accommodate an estimated enrollment of 9.1 million elementary students, 2.7 million secondary students, 241,000 tertiary students and 3 million out-of-school youths.

Much of the increase in the education budget initiated in 1988 was used to improve and expand the education system. Elementary and secondary teacher salaries have increased by as much as 40% making them better paid than many of their counterparts in the private sector. In particular, the weakest link in the system --secondary education -- was upgraded and expanded through two major programs. The Secondary Education Development Program upgraded the curriculum by placing more emphasis on the sciences, mathematics, language and values education. Elementary education received the biggest share of the education budget to improve the textbook/pupil ratio; to maintain the teacher/student ratio at 1:30, a total number of 14,600 new teaching positions were created and 33,545 classrooms were built.

Although the share of the health budget has remained stable during the past ten years, nominal expenditures have significantly increased. The health budget more than tripled from ₱3.1 billion in 1985 to ₱11.5 billion in 1992. Consequently, nominal increases in per-capita health spending grew impressively from ₱29.4 in 1980 to ₱56.9 in 1985 and to ₱178.60 in 1992. In real terms, however, the gain is much lower.

Health policy shifted from an emphasis on operational coverage to an improvement in the quality of services. Thus, expenditures were focused on the improvement of primary health care, the upgrading of the quality of hospitals and health centers, the provision of more drugs and intensified training of medical personnel.

Table 5a. SECTORAL ALLOCATION OF NATIONAL GOVERNMENT EXPENDITURES, 1980-1992
(In Million pesos)

PARTICULARS	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Economic Services	15,496	21,525	18,592	18,032	21,162	20,143	28,086	24,999	25,041	39,523	51,891	59,032	60,038
Agriculture, Agrarian Reform and Natural Resources	2,326	3,362	4,035	3,730	3,577	4,709	5,114	7,439	8,389	12,964	15,067	17,955	18,794
Trade and Industry	965	2,397	1,726	1,322	731	980	612	1,010	908	1,205	1,456	1,228	1,330
Tourism	135	189	230	154	113	152	136	156	256	269	225	184	361
Power and Energy	2,571	3,110	1,798	1,144	897	1,345	1,368	1,778	211	990	6,826	1,863	2,012
Water Resource Development and Flood Control	1,387	1,684	1,755	956	688	1,468	1,594	1,395	1,413	1,989	3,833	3,994	5,036
Communications, Roads and Other Transportation	6,667	7,787	7,114	7,931	6,926	8,324	7,992	9,025	11,756	16,917	17,064	22,293	22,505
Other Economic Services	1,445	2,996	1,934	2,795	8,230	3,165	11,270	4,196	2,108	5,189	7,420	11,515	10,000
Social Services	7,932	10,143	10,700	11,411	11,996	15,156	21,017	27,336	31,025	38,512	49,127	65,034	69,531
Education, Culture and Manpower Development	4,883	6,279	6,737	6,613	8,014	10,752	14,871	17,040	22,055	27,378	33,528	38,853	41,285
Health	1,421	1,842	2,142	2,492	2,295	3,113	3,570	4,089	5,564	6,488	7,962	9,472	11,475
Social Security and Labor Welfare	450	575	453	446	480	593	795	848	1,078	1,574	2,163	5,886	5,881
Land Distribution (CARP)	0	0	0	0	0	0	220	369	0	93	1,504	2,591	2,505
Housing and Community Development	901	1,254	1,337	1,829	1,177	671	1,550	443	595	625	679	825	830
Other Social Services	277	193	31	31	30	27	11	4,547	1,733	2,354	3,291	7,407	7,555
Defense	5,764	6,693	7,116	7,897	7,799	10,067	11,587	12,549	18,928	19,766	22,688	25,171	26,594
Domestic Security	4,153	4,861	5,179	5,575	5,391	7,132	7,611	8,437	12,356	13,051	14,544	15,891	17,436
Peace and Order	1,611	1,832	1,937	2,322	2,408	2,935	3,976	4,112	5,942	6,715	8,144	9,280	9,158
General Public Services	4,629	5,896	7,624	7,630	8,248	10,738	10,688	12,756	16,817	17,453	23,567	26,092	37,700
General Administration	2,467	3,221	4,376	3,841	3,937	5,476	5,574	6,462	7,699	10,225	13,091	14,433	17,125
Public Order and Safety	417	545	554	697	877	1,122	1,302	1,568	1,956	2,678	3,968	4,567	4,975
Other General Public Services	1,745	2,130	2,694	3,092	3,434	4,140	3,812	4,726	7,162	4,550	6,508	7,092	15,600
Net Lending	675	929	2,218	2,393	4,423	1,678	15,148	7,077	5,415	3,666	2,156	833	1,472
Debt Service	3,583	3,897	4,892	8,448	14,997	18,751	28,061	69,964	71,320	82,393	106,346	122,783	113,033
Interest Payments	2,296	2,429	3,560	4,997	10,409	14,652	21,612	36,905	45,864	54,593	71,114	83,426	80,348
Debt Amortization	1,287	1,468	1,332	3,451	4,558	4,099	6,449	32,789	25,456	27,800	35,232	39,357	32,685
Total	38,079	49,083	51,142	55,811	68,625	76,533	114,587	154,411	167,916	201,313	255,775	298,945	308,368

Table 5b. PERCENT DISTRIBUTION OF THE SECTORAL ALLOCATION OF NATIONAL GOVERNMENT EXPENDITURES, 1980-1992 (In percent)

PARTICULARS	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Economic Services	40.7	43.9	36.4	32.3	30.8	26.3	24.5	16.2	14.9	19.6	20.3	19.7	19.5
Agriculture, Agrarian Reform and Natural Resources	6.1	6.8	7.9	6.7	5.2	6.2	4.5	4.8	5.0	6.4	5.9	6.0	6.1
Trade and Industry	2.5	4.9	3.4	2.4	1.1	1.3	0.5	0.7	0.5	0.6	0.6	0.4	0.4
Tourism	0.4	0.4	0.4	0.3	0.2	0.2	0.1	0.1	0.2	0.1	0.1	0.1	0.1
Power and Energy	6.8	6.3	3.5	2.0	1.3	1.8	1.2	1.2	0.1	0.5	2.7	0.6	0.7
Water Resource Development and Flood Control	3.6	3.4	3.4	1.7	1.0	1.9	1.4	0.9	0.8	1.0	1.5	1.3	1.6
Communications, Roads and Other Transportation	17.5	15.9	13.9	14.2	10.1	10.9	7.0	5.8	7.0	8.4	6.7	7.5	7.3
Other Economic Services	3.8	6.1	3.8	5.0	12.0	4.1	9.8	2.7	1.3	2.6	2.9	3.9	3.2
Social Services	20.8	20.7	20.9	20.4	17.5	19.8	18.3	17.7	18.5	19.1	19.2	21.8	22.5
Education, Culture and Manpower Development	12.8	12.8	13.2	11.8	11.7	14.0	13.0	11.0	13.1	13.6	13.1	13.0	13.4
Health	3.7	3.8	4.2	4.5	3.3	4.1	3.1	2.6	3.3	3.2	3.1	3.2	3.7
Social Security and Labor Welfare	1.2	1.2	0.9	0.8	0.7	0.8	0.7	0.5	0.6	0.8	0.8	2.0	1.9
Land Distribution (CARP)	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.0	0.0	0.6	0.9	0.8
Housing and Community Development	2.4	2.6	2.6	3.3	1.7	0.9	1.4	0.3	0.4	0.3	0.3	0.3	0.3
Other Social Services	0.7	0.4	0.1	0.1	0.0	0.0	0.0	2.9	1.0	1.2	1.3	2.5	2.4
Defense	15.1	13.6	13.9	14.1	11.4	13.2	10.1	8.1	10.9	9.8	8.9	8.4	8.6
Domestic Security	10.9	9.9	10.1	10.0	7.9	9.3	6.6	5.5	7.4	6.5	5.7	5.3	5.7
Peace and Order	4.2	3.7	3.8	4.2	3.5	3.8	3.5	2.7	3.5	3.3	3.2	3.1	3.0
General Public Services	12.2	12.0	14.9	13.7	12.0	14.0	9.3	8.3	10.0	8.7	9.2	8.7	12.2
General Administration	6.5	6.6	8.6	6.9	5.7	7.2	4.9	4.2	4.6	5.1	5.1	4.8	5.6
Public Order and Safety	1.1	1.1	1.1	1.2	1.3	1.5	1.1	1.0	1.2	1.3	1.6	1.5	1.6
Other General Public Services	4.6	4.3	5.3	5.5	5.0	5.4	3.3	3.1	4.3	2.3	2.5	2.4	5.1
Net Lending	1.8	1.9	4.3	4.3	6.4	2.2	13.2	4.6	3.2	1.8	0.8	0.3	0.5
Debt Service	9.4	7.9	9.6	15.1	21.9	24.5	24.5	45.1	42.5	40.9	41.6	41.1	36.7
Interest Payments	6.0	4.9	7.0	9.0	15.2	19.1	18.9	23.9	27.3	27.1	27.8	27.9	26.1
Debt Amortization	3.4	3.0	2.6	6.2	6.7	5.4	5.6	21.2	15.2	13.8	13.8	13.2	10.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: Department of Budget and Management

Table 5c. SECTORAL ALLOCATION OF NATIONAL GOVERNMENT EXPENDITURES AS A PERCENTAGE OF GNP, 1980-1992 (In percent)

PARTICULARS	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Economic Services	6.4	7.7	5.9	5.0	4.2	3.6	4.7	3.7	3.1	4.3	4.9	4.7	4.2
Agriculture, Agrarian Reform and Natural Resources	1.0	1.2	1.3	1.0	0.7	0.8	0.9	1.1	1.1	1.4	1.4	1.4	1.3
Trade and Industry	0.4	0.9	0.6	0.4	0.1	0.2	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Tourism	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Power and Energy	1.1	1.1	0.6	0.3	0.2	0.2	0.2	0.3	0.0	0.1	0.6	0.1	0.1
Water Resource Development and Flood Control	0.6	0.6	0.6	0.3	0.1	0.3	0.3	0.2	0.2	0.2	0.4	0.3	0.3
Communications, Roads and Other Transportation	2.7	2.8	2.3	2.2	1.4	1.5	1.3	1.3	1.5	1.9	1.6	1.8	1.6
Other Economic Services	0.6	1.1	0.6	0.8	1.6	0.6	1.9	0.6	0.3	0.6	0.7	0.9	0.7
Social Services	3.3	3.6	3.4	3.1	2.4	2.7	3.5	4.1	3.9	4.2	4.6	5.1	4.8
Education, Culture and Manpower Development	2.0	2.2	2.1	1.8	1.6	1.9	2.5	2.5	2.8	3.0	3.1	3.1	2.9
Health	0.6	0.7	0.7	0.7	0.5	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.8
Social Security and Labor Welfare	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.5	0.4
Land Distribution (CARP)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.1	0.2	0.2
Housing and Community Development	0.4	0.4	0.4	0.5	0.2	0.1	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Other Social Services	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.7	0.2	0.3	0.3	0.6	0.5
Defense	2.4	2.4	2.3	2.2	1.5	1.8	1.9	1.9	2.3	2.2	2.1	2.0	1.8
Domestic Security	1.7	1.7	1.7	1.5	1.1	1.3	1.3	1.3	1.6	1.4	1.4	1.3	1.2
Peace and Order	0.7	0.7	0.6	0.6	0.5	0.5	0.7	0.6	0.7	0.7	0.8	0.7	0.6
General Public Services	1.9	2.1	2.4	2.1	1.6	1.9	1.8	1.9	2.1	1.9	2.2	2.1	2.6
General Administration	1.0	1.1	1.4	1.1	0.8	1.0	0.9	1.0	1.0	1.1	1.2	1.1	1.2
Public Order and Safety	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.4	0.4	0.3
Other General Public Services	0.7	0.8	0.9	0.9	0.7	0.7	0.6	0.7	0.9	0.5	0.6	0.6	1.1
Net Lending	0.3	0.3	0.7	0.7	0.9	0.3	2.5	1.1	0.7	0.4	0.2	0.1	0.1
Debt Service	1.5	1.4	1.6	2.3	2.9	3.4	4.7	10.4	9.0	9.0	10.0	9.7	7.8
Interest Payments	0.9	0.9	1.1	1.4	2.0	2.6	3.6	5.5	5.8	6.0	6.7	6.6	5.6
Debt Amortization	0.5	0.5	0.4	0.9	0.9	0.7	1.1	4.9	3.2	3.1	3.3	3.1	2.3
Total	15.7	17.5	16.3	15.4	13.5	13.8	19.2	22.9	21.1	22.1	23.9	23.6	21.4

Table 6a. SECTORAL ALLOCATION OF NATIONAL GOVERNMENT EXPENDITURES NET OF DEBT SERVICE AND NET LENDING, 1980-1992 (In Million pesos)

PARTICULARS	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Economic Services	15,496	21,525	18,592	18,032	21,162	20,143	28,086	24,999	25,041	39,523	51,891	59,032	60,038
Agriculture, Agrarian Reform and Natural Resources	2,326	3,362	4,035	3,730	3,577	4,709	5,114	7,439	8,389	12,964	15,067	17,955	18,794
Trade and Industry	965	2,397	1,726	1,322	731	980	612	1,010	908	1,205	1,456	1,228	1,330
Tourism	135	189	230	154	113	152	136	156	256	269	225	184	361
Power and Energy	2,571	3,110	1,798	1,144	897	1,345	1.368	1,778	211	990	6,826	1,863	2,012
Water Resource Development and Flood Control	1,387	1,684	1,755	956	688	1,468	1,594	1,395	1,413	1,989	3,833	3,994	5,036
Communications, Roads and Other Transportation	6,667	7,787	7,114	7,931	6,926	8,324	7,992	9,025	11,756	16,917	17,064	22,293	22,505
Other Economic Services	1,445	2,996	1,934	2,795	8,230	3,165	11,270	4,196	2,108	5,189	7,420	11,515	10,000
Social Services	7,932	10,143	10,700	11,411	11,996	15,156	21,017	27,336	31,025	38,512	49,127	65,034	69,531
Education, Culture and Manpower Development	4,883	6,279	6,737	6,613	8,014	10,752	14,871	17,040	22,055	27,378	33,528	38,853	41,285
Health	1,421	1,842	2,142	2,492	2,295	3,113	3,570	4,089	5,564	6,488	7,962	9,472	11,475
Social Security and Labor Welfare	450	575	453	446	480	593	795	848	1,078	1,574	2,163	5,886	5,881
Land Distribution (CARP)	0	0	0	0	0	0	220	369	0	93	1,504	2,591	2,505
Housing and Community Development	901	1,254	1,337	1,829	1,177	671	1,550	443	595	625	679	825	830
Other Social Services	277	193	31	31	30	27	11	4,547	1,733	2,354	3,291	7,407	7,555
Defense	5,764	6,693	7,116	7,897	7,799	10,067	11,587	12,549	18,928	19,766	22,688	25,171	26,594
Domestic Security	4,153	4,861	5,179	5,575	5,391	7,132	7,611	8,437	12,356	13,051	14,544	15,891	17,436
Peace and Order	1,611	1,832	1,937	2,322	2,408	2,935	3,976	4,112	5,942	6,715	8,144	9,280	9,158
General Public Services	4,629	5,896	7,624	7,630	8,248	10,738	10,688	12,756	16,817	17,453	23,567	26,092	37,700
General Administration	2,467	3,221	4,376	3,841	3,937	5,476	5,574	6,462	7,699	10,225	13,091	14,433	17,125
Public Order and Safety	417	545	554	697	877	1,122	1,302	1,568	1,956	2,678	3,968	4,567	4,975
Other General Public Services	1,745	2,130	2,694	3,092	3,434	4,140	3,812	4,726	7,162	4,550	6,508	7,092	15,600
Net Lending	0	0	0	0	0	0	0	0	0	0	0	0	0
Debt Service	0	0	0	0	0	0	0	0	0	0	0	0	0
Interest Payments	0	0	0	0	0	0	0	0	0	0	0	0	0
Debt Amortization	0	0	0	0	0	0	0	0	0	0	0	0	0
TOTAL	33,821	44,257	44,032	44,970	49,205	56,104	71,378	77,640	91,181	115,254	147,273	175,329	193,863

Table 6b. PERCENT DISTRIBUTION OF THE SECTORAL ALLOCATION OF NATIONAL GOVERNMENT EXPENDITURES NET OF DEBT SERVICE AND NET LENDING, 1980-1992 (In percent)

PARTICULARS	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Economic Services	45.8	48.6	42.2	40.1	43.0	35.9	39.3	32.2	27.5	34.3	35.2	33.7	31.0
Agriculture, Agrarian Reform and Natural Resources	6.9	7.6	9.2	8.3	7.3	8.4	7.2	9.6	9.2	11.2	10.2	10.2	9.7
Trade and Industry	2.9	5.4	3.9	2.9	1.5	1.7	0.9	1.3	1.0	1.0	1.0	0.7	0.7
Tourism	0.4	0.4	0.5	0.3	0.2	0.3	0.2	0.2	0.3	0.2	0.2	0.1	0.2
Power and Energy	7.6	7.0	4.1	2.5	1.8	2.4	1.9	2.3	0.2	0.9	4.6	1.1	1.0
Water Resource Development and Flood Control	4.1	3.8	4.0	2.1	1.4	2.6	2.2	1.8	1.5	1.7	2.6	2.3	2.6
Communications, Roads and Other Transportation	19.7	17.6	16.2	17.6	14.1	14.8	11.2	11.6	12.9	14.7	11.6	12.7	11.6
Other Economic Services	4.3	6.8	4.4	6.2	16.7	5.6	15.8	5.4	2.3	4.5	5.0	6.6	5.2
Social Services	23.5	22.9	24.3	25.4	24.4	27.0	29.4	35.2	34.0	33.4	33.4	37.1	35.9
Education, Culture and Manpower Development	14.4	14.2	15.3	14.7	16.3	19.2	20.8	21.9	24.2	23.8	22.8	22.2	21.3
Health	4.2	4.2	4.9	5.5	4.7	5.5	5.0	5.3	6.1	5.6	5.4	5.4	5.9
Social Security and Labor Welfare	1.3	1.3	1.0	1.0	1.0	1.1	1.1	1.1	1.2	1.4	1.5	3.4	3.0
Land Distribution (CARP)	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.5	0.0	0.1	1.0	1.5	1.3
Housing and Community Development	2.7	2.8	3.0	4.1	2.4	1.2	2.2	0.6	0.7	0.5	0.5	0.5	0.4
Other Social Services	0.8	0.4	0.1	0.1	0.1	0.0	0.0	5.9	1.9	2.0	2.2	4.2	3.9
Defense	17.0	15.1	16.2	17.6	15.9	17.9	16.2	16.2	20.1	17.1	15.4	14.4	13.7
Domestic Security	12.3	11.0	11.8	12.4	11.0	12.7	10.7	10.9	13.6	11.3	9.9	9.1	9.0
Peace and Order	4.8	4.1	4.4	5.2	4.9	5.2	5.6	5.3	6.5	5.8	5.5	5.3	4.7
General Public Services	13.7	13.3	17.3	17.0	16.8	19.1	15.0	16.4	18.4	15.1	16.0	14.9	19.4
General Administration	7.3	7.3	9.9	8.5	8.0	9.8	7.8	8.3	8.4	8.9	8.9	8.2	8.8
Public Order and Safety	1.2	1.2	1.3	1.5	1.8	2.0	1.8	2.0	2.1	2.3	2.7	2.6	2.6
Other General Public Services	5.2	4.8	6.1	6.9	7.0	7.4	5.3	6.1	7.9	3.9	4.4	4.0	8.0
Net Lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt Service	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest Payments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt Amortization	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Office of Budget and Management

Table 6c. SECTORAL ALLOCATION OF NATIONAL GOV'T EXPENDITURES AS A PERCENTAGE OF GNP, NET OF DEBT SERVICE AND NET LENDING, 1980-1992

(In percent)

PARTICULARS	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Economic Services	6.4	7.7	5.9	5.0	4.2	3.6	4.7	3.7	3.1	4.3	4.9	4.7	4.2
Agriculture, Agrarian Reform and Natural Resources	1.0	1.2	1.3	1.0	0.7	0.8	0.9	1.1	1.1	1.4	1.4	1.4	1.3
Trade and Industry	0.4	0.9	0.6	0.4	0.1	0.2	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Tourism	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Power and Energy	1.1	1.1	0.6	0.3	0.2	0.2	0.2	0.3	0.0	0.1	0.6	0.1	0.1
Water Resource Development and Flood Control	0.6	0.6	0.6	0.3	0.1	0.3	0.3	0.2	0.2	0.2	0.4	0.3	0.3
Communications, Roads and Other Transportation	2.7	2.8	2.3	2.2	1.4	1.5	1.3	1.3	1.5	1.9	1.6	1.8	1.6
Other Economic Services	0.6	1.1	0.6	0.8	1.6	0.6	1.9	0.6	0.3	0.6	0.7	0.9	0.7
Social Services	3.3	3.6	3.4	3.1	2.4	2.7	3.5	4.1	3.9	4.2	4.6	5.1	4.8
Education, Culture and Manpower Development	2.0	2.2	2.1	1.8	1.6	1.9	2.5	2.5	2.8	3.0	3.1	3.1	2.9
Health	0.6	0.7	0.7	0.7	0.5	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.8
Social Security and Labor Welfare	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.5	0.4
Land Distribution (CARP)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.1	0.2	0.2
Housing and Community Development	0.4	0.4	0.4	0.5	0.2	0.1	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Other Social Services	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.7	0.2	0.3	0.3	0.6	0.5
Defense	2.4	2.4	2.3	2.2	1.5	1.8	1.9	1.9	2.3	2.2	2.1	2.0	1.8
Domestic Security	1.7	1.7	1.7	1.5	1.1	1.3	1.3	1.3	1.6	1.4	1.4	1.3	1.2
Peace and Order	0.7	0.7	0.6	0.6	0.5	0.5	0.7	0.6	0.7	0.7	0.8	0.7	0.6
General Public Services	1.9	2.1	2.4	2.1	1.6	1.9	1.8	1.9	2.1	1.9	2.2	2.1	2.6
General Administration	1.0	1.1	1.4	1.1	0.8	1.0	0.9	1.0	1.0	1.1	1.2	1.1	1.2
Public Order and Safety	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.4	0.4	0.3
Other General Public Services	0.7	0.8	0.9	0.9	0.7	0.7	0.6	0.7	0.9	0.5	0.6	0.6	1.1
Net Lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt Service	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest Payments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt Amortization	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL	13.9	15.8	14.0	12.4	9.7	10.1	12.0	11.5	11.5	12.6	13.8	13.8	13.5
GNP (in million pesos)	243270	280543	313544	363268	508485	556074	596276	673130	795159	911251	1068486	1267600	1440600

Social welfare expenditures remained fairly stagnant in the period 1980-85, fluctuating between 450 million in 1980 to ₱593 million in 1985. Because the Aquino Administration assigned a high priority to such activities, expenditures for social welfare multiplied four times to ₱2.2 billion in 1990.

Among the economic sectors, the Agriculture, Agrarian and Natural Resources sub-sectors received the highest nominal share of the budget, with Agriculture receiving the largest share. The Agrarian Reform received the largest increases, from ₱314 million in 1985 to ₱3.9 billion in 1990. Natural Resources sub-sector expenditure levels remained flat during the Marcos years. However, increases in 1986-90 were impressive as the sub-sector budget increased 7 times from ₱778 million in 1985 to ₱5.5 billion in 1990. This increase is due mainly to the intensified reforestation and environmental improvement program of the Aquino Administration.

Defense expenditures have declined as a percentage of the budget, from 17.0% in 1980, to 13.7% in 1992. As a percentage of GNP, the defense budget has been fairly stable during the past ten years, fluctuating from 2.4% in 1980 to 1.8% in 1985 and 1.8% in 1992.

The major difference between the budgets of the Marcos Administration and those of the Aquino Administration is the remarkable shift from investments in physical capital to investments in human capital. During the period, 1980-85, expenditures on infrastructure sub-sectors (power and energy, water and flood control, communications, roads and other transportation) averaged 3.1% of GNP while the education, health and social welfare subsectors averaged 2.7%. From 1986 to 1992, the trend was reversed as the infrastructure sub-sectors averaged 2.0% of GNP while the education, health and social welfare averaged 3.7%.

Under the Aquino Administration, a substantial reordering of public investment also took place. The new program emphasized agricultural and rural infrastructure investments in line with the policy of balanced agro-industrial development. Even in the face of limited resources, the administration pushed programs with long-term redistributive effects: free secondary education, low cost housing, agrarian reform, and other social welfare services.

D. CENTRAL BANK LOSSES

Table 4 indicates the important contribution of Central Bank losses to the consolidated public sector deficit.

It is indeed very difficult to do an analysis of the financial performance of the Central Bank due to the unavailability of published data on Central Bank income statement. Fortunately, however, multilateral institutions, specifically the IMF and the WB, had gained access to such data which had been incorporated in their reports (i.e., IMF 1989 and WB 1990). This study relies mainly on the data reported in these studies.

The cumulative losses incurred by the CB during the period 1983-1990 already amounted to ₱143.7 billion. There seems to be no indication of a decline in the annual CB losses in the immediate future. The CB is expected to incur a loss of ₱22 billion in 1991 and between ₱32 billion and ₱34 billion in 1992. The question is how did the Central Bank incur such huge losses?[1] **Table 7** shows three major sources of losses, namely interest income, forward cover losses and swap arrangement losses/profits. They are discussed in detail in an annex to this chapter.

The largest source of Central Bank losses, by far, is associated with the excess of interest outlays over interest income. This is the result of the Central Bank's bad loans heavy interest subsidies. Much of the lending of the Central Bank would, more appropriately, be performed as a fiscal activity under the management of the Department of Finance or other government agencies. It is probable that such lending activity was originally undertaken by the Central Bank to keep it off budget and so, to make the National Government's deficit appear to be lower than it really was.

Given the large losses of the Central Bank, its true net worth is now negative. This fact is, however, obscured by the bank's balance sheet, which appears to show positive capital. This legerdemain is accomplished by the creation of special accounts on the asset side of the balance sheet that have no true value. The accounting practices of the Central Bank are described in detail in the annex to this chapter.

In later chapters, it is strongly advocated that the National Government take over the assets and liabilities of the Central Bank that arose from fiscal-type activities. Various options for accomplishing that feat are discussed in detail.

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[1] An excellent discussion of this can be found in Dohner and Power (1990).

Table 7. Central Bank Net Income Position, 1983 - 1990 , In Billion Pesos (Year-end Figures)

	1983	1984	1985	1986	1987	1988	1989	1990
I. Net Interest Income/Expense	-2.0	-8.3	-15.6	-18.5	-10.2	-16.2	-20.3	
A. Interest Income				8.8	8.1	7.0	6.6	
1. Domestic Assets				7.8	6.2	5.7	5.3	
Loans and Advances				6.8	5.1	4.9	4.5	
Overdrafts				0.1	0.3	0.03	0.03	
Domestic Securities				0.9	0.8	0.8	0.7	
2. Foreign Assets				1.0	1.9	1.3	1.3	
B. Interest Expenses				27.2	18.3	23.2	26.9	
1. Domestic Liabilities				11.2	4.8	8.5	10.7	
Legal Reserves				0.5	0.7	0.9	1.2	
Blocked Peso Differential				2.0	0.9	1.2	1.6	
NG Deposits					1.8	5.1	6.3	
Open Market Instruments				8.7	1.4	1.3	1.6	
2. Foreign Liabilities				16.0	13.5	14.7	16.2	
II. Forward Cover Losses	-5.0	-5.3	-7.6	-0.7	-0.1	-0.02	-0.02	
III. Swap Cover Profits / Losses	-6.8	-14.0	7.0	1.0	-0.5	-0.7	-0.8	
OVERALL CB SURPLUS (+) / DEFICIT (-)	-13.8	-27.6	-16.2	-18.2	-10.9	-16.9	-21.1	-19.0

Sources: (a) 1983 to 1985 Figures were taken from IMF (1989).
(b) 1986 to 1989 Figures were taken from World Bank (1990).

Annex to Chapter II

THE SOURCES OF CENTRAL BANK LOSSES AND THE BANK'S BALANCE SHEET

A. Sources of Central Bank Losses

1. Losses from Swap Facility

The swap facility is an arrangement whereby the exchange risk which should have been borne by banks and end-user non-financial corporations is absorbed by the Central Bank. There are three types of swaps, namely liquidity swap, end-user swap and interbank swap. Under the liquidity swap arrangement, a domestic bank borrows from a foreign bank in foreign currency and exchanges it for pesos with the Central Bank with the provision that at maturity date, the domestic bank will get back the foreign currency at pre-agreed exchange rate (which is the forward contract exchange rate). In the end-user swap arrangement, a local corporation borrows from a foreign bank through a domestic bank, which in turn exchanges the borrowed funds denominated in foreign currency for pesos with the Central Bank and lends them to the local corporation, which is the end-user. The settlement arrangement between the domestic bank and the Central Bank is the same as that of the liquidity swap. The local corporation is supposed to benefit from the low interest rate in the international capital market. This was resorted to by local corporations at a time when interest rate in the international capital market was much lower than that in the local capital market. Under the interbank swap arrangement, a domestic bank purchases foreign exchange from the interbank market and exchanges it for pesos with the Central Bank. Again, the settlement arrangement between the domestic bank and the Central Bank is the same as that of the liquidity swap.

In all these cases, the Central Bank is able to increase its foreign exchange reserves, while the domestic bank is able to expand its domestic credit. The CB normally pays a dollar interest rate based on LIBOR, while the bank pays the Manila Reference Rate (MRR) plus 1/8 percent on the peso loan.

At maturity date, the CB may pay off the swap contract or roll it over. In the case of the roll-over, however, the bank may demand the original amount plus the differential arising from exchange rate depreciation, i.e., the differential due to the deviation of the spot rate at the time of maturity of the contract and the forward contract rate. In effect, the Central Bank is forced to deliver to the bank additional pesos equivalent to the swap differential. This is additional high-powered money which could exert more pressure on domestic inflation. With the series of devaluations in 1983 and 1984, the Central Bank booked the differential as "due to banks" and blocked almost the entire amount (that is, banks were not allowed to withdraw it) to prevent a sudden increase in liquidity. In effect, the Central Bank borrowed the blocked peso differential and paid interest on it. Thus, the losses incurred by the Central Bank from the swap facility consists of the additional peso that it owes to the bank resulting from the unexpected depreciation of the peso and the interest it has to pay for blocking such account. As **Annex Table 1** shows, the outstanding swap arrangement differential rose from ₱1.2 billion in 1982 to ₱18.6 billion in 1990, while the outstanding blocked account differential increased from ₱5.0 billion in 1983 to a staggering amount of ₱15.6 billion in 1990. Except in 1985 and 1986 when the peso appreciated, the Central Bank had been losing on its swap facility. Huge losses were incurred in 1983 and 1984 because of a series of devaluations. The losses realized by the CB from swap operations since 1987 were much lower than in the 1983 and 1984, but were by no means small. On top of this, the CB has been paying the blocked differential at a rate equivalent to the Manila Reference Rate, which had been 1 to 2 percentage points lower than the Treasury bill rate. Annual interest expenses incurred by the CB on blocked accounts had been above ₱0.9 billion. They had been increasing in the last three years as a result of rising interest rates.

Annex Table 1. Swap Arrangement Differential and Blocked Differential (In Billion Pesos)

Year	Swap Arrangement Differential	Blocked Differential
1982	1,200	---
1983	8,004	5,028
1984	22,020	16,163
1985	14,209	14,632
1986	13,168	10,419
1987	13,716	11,026
1988	14,387	11,731
1989	15,143	12,220
1990	18,561	15,625

Source: Central Bank of the Philippines.

2. Forward Cover Facility

This is another arrangement whereby the Central Bank bears the exchange risk which should have been absorbed by banks and non-bank financial institutions. According to Dohner and Power (1990), this practice was started in the 1970s when the Central Bank provided exchange cover to certain domestic corporations which obtained long-term loans from the international capital market. Under this arrangement, the Central Bank agreed to provide corporations foreign exchange at a date in the future at a guaranteed exchange rate. The CB would cover the differential in cases of depreciation. This practice was halted in 1981, but again was resumed in 1983, the start of the balance-of-payments crisis, to ensure the continuous importation of critical materials, notably oil. The amount of forward cover provided by the Central Bank surged to about US$2 billion in 1984 (Dohner and Power 1990). Since the peso rapidly depreciated between 1983 and 1985, the Central Bank had been incurring huge losses amounting to more than P5 billion a year. Forward cover provided by the Central Bank has been greatly reduced since 1986. It should however be noted that the provision of forward cover to oil firms has been continued with the Department of Finance as the covering agency.

3. Interest Rate Losses

As part of its normal function, the CB lends funds to the domestic sector consisting of the banking system and the public sector (both the National Government and government instrumentalities/corporations). The CB realizes revenues from many of these operations, although some, such as advances used to finance subscriptions for international financial institutions, provide no revenues. On the other hand, the CB borrows from the domestic sector consisting of banks, the National Government and the public. It pays interest on the reserves deposited by banks with it. Under its open market operations, it either sells its own liabilities such as the CB bills or sells existing instruments it holds under the reverse repurchase agreements. When the CB accepts deposits from the National Government, it is in effect borrowing from the National Government. As already mentioned above the blocked peso differential is a form of CB borrowing.

Under normal conditions, the Central Bank should have not incurred any losses from its lending and borrowing operations since it is supposed to lend at a rate higher that its borrowing rate. However, the Central Bank until November 1985 had been performing fiscal functions by lending at a subsidized rate to sectors considered by government as priority sectors (**Annex Table 2**). Since November 1985, the CB has aligned its rediscounting rate with the MRR. However, its rediscounting rate has been well below the MRR or the Treasury bill rate (**Annex Table 3**). In other words, the CB has still continued providing interest rate subsidy to those that have access to its rediscounting window, e.g., export sector.

In 1981, several financial institutions encountered financial problem as a result of the liquidity crisis precipitated by the Dewey Dee caper.[2] More banks collapsed since 1983 when the economy experienced its worst foreign exchange crisis. The Central Bank tried to help ailing banks by providing them with financial assistance. Between 1980 and 1989, a total of 202 banks collapsed including 6 large banks. The amount of financial assistance (which consists

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[2]Mr. Dee borrowed heavily from several banks but suddenly left the country in 1981 when he could no longer pay his debts.

Annex Table 2. Central Bank Rediscounting Policy

Year	Date	Circular Number	Central Bank Rediscount Rate High (percent p.a.)	Central Bank Rediscount Rate Low (percent p.a.)	Loan Value High (percent p.a.)	Loan Value Low (percent p.a.)
1980	09-24-80	CLR 762	9.00	1.00	100	50
1981	02-27-81	CLR 784	8.00	3.00	100	80
	03-10-81	CLR 786	8.00	3.00	100	80
	06-18-81	CLR 803	8.00	1.00	100	80
1982	05-23-82	CLR 930	8.00	1.00	100	80
1983		CLR 930	8.00	1.00	100	80
1984	01-23-84	CLR 991	LR - 6	1.00	100	80
	03-12-84	CLR 994	MRR - 6	MRR - 12	90	80
1985	05-30-85	CLR 1063	MRR - 3	MRR - 12	90	80
	11-22-85	CLR 1086	12.75	12.75	80	80
1986	09-01-86	CLR 1114	11.75	11.75	80	80
	12-15-86	CLR 1125	10.00	10.00	80	80
		(Average)	12.27	12.27		
1987		CLR 1125	10.00	10.00	80	80
1988		CLR 1125	10.00	10.00	80	80
1989	06-23-89	CLR 1203	12.00	12.00	80	80
1990	02-19-90	CLR 1229	13.00	13.00	80	80
	09-14-90	CLR 1252	14.00	14.00	80	80
	10-30-90	CLR 1260	14.00	14.00	80	80

MRR - Manila Reference Rate
LR - Lending Rate

Sources: CB Review (various issues)
CB Annual Report (various issues)

Annex Table 3. Rediscount Rate, Manila Reference Rate, and Treasury Bill Rate From 1980 to 1991, In Percent P.A. (End-of-Year Figures)

Year	Central Bank Rediscount Rate	Manila Reference Rate (90-day maturity)	Treasury Bills (91-day Rates)
1980	9.00	...	12.309
1981	8.00	...	12.797
1982	8.00	14.5000	14.027
1983	8.00	17.0625	15.382
1984	30.25	36.2500	42.169
1985	12.75	12.7500	16.561
1986	10.00	8.5500	9.547
1987	10.00	10.6750	13.589
1988	10.00	12.0000	16.740
1989	12.00	19.9625	20.452
1990	14.00	23.7500	26.517

Sources: (a) Central Bank Statistical Bulletin.
(b) Central Bank Review.
(c) Philippine Financial Statistics.

of emergency loans and overdrafts) provided by the Central Bank to ailing banks rose from P306 million in 1980 to P14.8 billion in 1990. The interest rates on those loans were very high (**Annex Table 4** and **Annex Table 5**).[3] Note, however, that most of these are claims on failed banks which the Central Bank still carries in its books. That is why the interest earnings realized by the CB from overdrafts of banks declined in 1988 and 1989 despite the rise in outstanding overdrafts and the high interest rates on such loans. Again, this is one aspect where the Central Bank is experiencing significant losses.

During the height of the 1983-1984 balance of payments crisis, the Central Bank pursued a tight monetary policy. Due to lack of government securities in its hands, the CB issued its own liabilities, the CB bills, to conduct open market operations. The rates on these bills were very high, reaching more than 40% per annum. When the CB bills were phased out starting 1987, the CB used the reverse repurchase window to maintain its tight monetary policy. Rates on those instruments were also very high. More recently, the CB increased its reliance on the CB bills to conduct open market operations. The high interest rates on open market instruments of the CB have certainly added to its burgeoning losses.

The deposits of the National Government had increased phenomenally from P1.6 billion in 1980 to P67.3 billion in 1990. This was done to help the Central Bank mop up excess liquidity. But the CB has to pay interest on these deposits at market rate. In 1989 alone, the CB paid the National Government P6.3 billion on such deposits. Recently, no interest has been paid on these deposits. But pressure from the Department of Finance (DOF) on CB to pay interest on these deposits is mounting. The latest agreement concluded between the DOF and the CB is that interest will be paid on that portion of government deposits used to mop up excess liquidity and no interest will be paid on the transaction balances of the government.

Normally the CB does not lend to foreign governments or institutions. However, it deposits its foreign exchange reserves in foreign banks to earn some interest. On the other hand, it borrows from the international capital market to finance its normal operations and/or to beef up its reserves. Ideally, the CB should fully cover its foreign exchange liabilities unless it can quickly secure foreign exchange reserves from the market at a relatively lower cost. Since 1983, however, the CB's foreign exchange liabilities greatly exceeded its foreign assets (**Annex Table 6**). Note however that an increasing proportion of the CB's liabilities were actually foreign loans incurred by government corporations and private corporations with guarantees from government-owned financial institutions, i.e., PNB and DBP, that it had assumed. As of 1990, 60 percent of the CB's total foreign exchange liabilities consisted of those that it had assumed

[3] The difference between emergency loans and overdrafts is that the former is backed up by a collateral while the latter is not.

Annex Table 4. Interest Rates Charged by the Central Bank on Emergency Loans From 1980 to 1991 (In Percent)

Year	Commercial Banks	Thrift Banks	N B Q B s
1980	9.5	*/	*/
1981	9.5 12.0 24.0	*/	24.0 26.0 28.0 30.0 32.0
1982	9.5 12.0	12.0	*/
1983	9.5 19.0	12.00 20.81 20.89 20.94	9.5 18.0 24.0
1984	9.5 12.0 35.0	12.0000 18.8125 20.8125 23.6875 28.5625 28.8125 29.8125	9.5 18.0 24.0
1985	12.00000 31.03800 35.30952	44.74	18.0
1986 */			
1987	*/	*/	14.0
1988 */			
1989 */			
1990 */			
1991 */			

*/ No loans were granted.

Source: Central Bank of the Philippines.

Annex Table 5. Interest Rates Charged by the Central Bank on Overdrafts From 1980 to 1991 (In Percent)

Year	Commercial Banks	Thrift Banks	N B Q B s
1980			
1981			
1982			
1983			
1984	21.000	21.000	21.000
	24.662	24.662	24.662
	29.239	29.239	29.239
	29.893	29.893	32.500
	32.500	32.500	52.275
	34.630		
	35.749		
	43.716		
	52.240		
1985	21.000	21.000	21.000
	24.083	27.514	27.514
	25.761	29.004	29.004
	42.966	44.143	44.143
	49.275		
	51.716		
	52.275		
1986	21.000	21.000	21.000
	23.520	31.746	22.786
			23.520
1987	21.000	21.000	21.000
	21.355	22.752	22.752
	22.752	21.335	
1988	21.000	21.000	21.000
	21.328		
1989	21.000	21.000	21.000
	21.355		
1990	21.000	21.000	21.000
	21.355		
1991	21.000	21.000	21.000
	25.761		

Source: Central Bank of the Philippines.

Annex Table 6. Foreign Assets and Liabilities of the Central Bank, 1980 - 1990 (In Billion Pesos)

Year	ASSETS	LIABILITIES
1980	23.6	20.1
1981	21.1	25.2
1982	15.7	33.8
1983	12.1	73.2
1984	17.7	105.3
1985	20.7	138.7
1986	51.4	184.7
1987	41.9	174.1
1988	45.0	166.6
1989	53.2	161.5
1990	57.6	198.2

Source: Central Bank of the Philippines.

(**Annex Table 7**). It has been servicing these obligations without corresponding revenues since most of those it had assumed were non-performing assets. The interest expenses incurred by the CB on its foreign liabilities greatly exceeded its interest revenues from foreign assets.

B. Accounting for Central Bank Losses

The losses of the Central Bank should have been charged against its capital. If this were done, then its net worth should have been negative in all the years as can be seen from **Annex Table 8**. However, the Central Bank does not immediately reflect all its losses in its balance sheet. Most of them are lodged in some "suspense accounts" which ought to be amortized over a certain number of years. The three most important suspense accounts are: the Monetary Adjustment Account (MAA); Exchange Stabilization Adjustment Account (ESAA); and Revaluation of International Reserve (RIR).[4]

The MAA is a temporary suspense account to absorb extraordinary costs of printing notes and minting coins as well as those arising from the issue and service of evidences of indebtedness of the Central Bank and interest on bank reserves which the Monetary Board may prescribe. Over the years, however, new items had been included. The most important ones are the interest on reverse repurchase operations (1985), which are part of the open market instruments of the Central Bank, and interest on all National Government peso deposits (1986). As shown in **Table 7**, both are significant expense items of the Central Bank, especially after 198[illegible]. Originally, the MAA was required to be amortized over a period of five years. However, the Central Bank charter was amended in 1984 to allow the Central Bank to amortize the MAA over a period at a rate based on the adequacy of the Bank's profit. As may be seen from **Annex Table 9**, the outstanding MAA grew from ₱4.5 billion in 1980 to ₱28.6 billion in 1987,[5] most of which could be accounted for by interest payments on CB bills, reverse repurchase agreement and government deposits. Note that the amount amortized each year had been very small.

The ESAA is a temporary suspense account subject to amortization over a 3-5 year period for expenses which may be deferred so as not to overburden the Central Bank's operating income during a year of operation. The charter of the Central Bank was amended in 1984 so that interest expenses and commitment fees on foreign loans and other foreign obligations and documentation in connection and other expenses incurred in connection with the negotiations, securing and servicing of foreign obligations could be amortized over a period at a rate which shall be based on the adequacy of the Bank's profits. As may be seen from **Annex Table 10**, the outstanding ESAA increased from ₱236 million in 1981 to ₱37.6 billion in 1987. Interest on foreign borrowing and on foreign currency deposits as well as service charges on IMF loans contributed significantly to the build-up of ESAA. Annual amortization had been very minimal.

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[4]Other less important ones are the Securities Stabilization Fund and Account to Secure the Coinage.

[5]Data for recent years could not be secured from the Central Bank.

Annex Table 7. Foreign Exchange Liabilities: Total and Central Bank In Million U.S. Dollars (Year-end Figures)

Year / Item	Total	%	Central Bank	%	Loans Assumed	%
1980	17,252	100.0	2,476	14.4	---	---
1981	20,893	100.0	2,940	14.1	---	---
1982	24,677	100.0	4,335	17.6	---	---
1983	24,816	100.0	3,971	16.0	---	---
1984	25,418	100.0	4,113	16.2	264.73	6.4
1985	26,252	100.0	5,923	22.6	584.60	9.9
1986	28,256	100.0	7,161	25.3	2,437.03	34.0
1987	28,649	100.0	6,504	22.7	2,952.85	45.4
1988	27,915	100.0	6,164	22.1	3,492.48	56.7
1989	27,616	100.0	5,429	19.7	3,771.19	69.5
1990	28,549	100.0	5,481	19.2	3,298.72	60.2

Sources: (a) Treasury Department, Central Bank of the Philippines.
(b) Information Management Department, Central Bank. Annual/Quarterly Reports to the President.

Annex Table 8. Central Bank Net Worth and Losses (In Billion Pesos)

Year	Net Worth	Losses
1983	0.553	13.8
1984	0.592	27.6
1985	0.641	16.2
1986	0.677	18.2
1987	0.712	10.9
1988	0.783	16.9
1989	0.873	21.1
1990	1.916	19.0

Source: Central Bank.

Annex Table 9. Monetary Adjustment Account, 1980 to 1987 (In Pesos)

	1980	1981	1982	1983
Beginning Balance	3,712,299,691.46	4,455,369,614.89	5,912,767,486.32	6,933,068,834.93
Add: Charges during the year	1,679,494,320.84	1,457,423,423.02	1,166,381,635.01	902,920,279.31
a) Printing and minting of currency	93,591,126.61	120,650,135.84	211,978,316.56	177,061,944.15
b) Issuance and servicing of:				
1) CBCIs - Local	1,576,763,818.80	.....	.....	679,494,674.63
2) CBCIs - Foreign Currency	9,139,375.43	1,302,566,070.91	954,403,318.45	42,404,949.82
3) Central Bank Bills	.....	.....	.....	.....
c) Payment of Gold Traders' Commission	.....	.....	. ...	3,958,710.71
d) Interest on Reverse Repurchase Agreement	.....	.....	.....	.....
e) Interest on Government Deposits	.....	.....	.....	.....
f) Adjustment of prior years' charges:				
1) Printing & minting of currency	.....	33,676,418.50	.....	.....
2) Issuance & servicing of CBCIs	.....	530,797.77	.....	.....
	5,391,794,012.30	5,912,793,037.91	7,079,149,121.33	7,835,989,114.24
Less: Profit from Demonetization / Amortization / Adjustments	936,424,397.41	25,551.59	146,080,286.40	27,962,954.47
a) Minting costs recovered from sale of demonetized commemorative coins	760.44	.....	104,465.34	180,739.76
b) Adjustment of prior years' entry:				
1) Printing & minting of currency	921,449.90	.....	473,275.19	1,024,208.00
2) Issuance & servicing of CBCIs				
CBCIs - Local	.....	.....	.....	.....
CBCIs - Foreign Currency	2,688,940.46			
c) Amortization of prior years' charges:				
1) Printing & minting of currency	.....	.....	.....	.....
2) Issuance & servicing of CBCIs	895,315,542.04	.....	36,144,628.52	26,758,006.71
d) Profit from sale of demonetized commemorative coins	.....	25,551.59	.....	.....
e) Redemption of old currency coins	37,497,704.57	.....	.....	.....
f) Balance of " Reserve for Contingencies-Taxes " Account	.....	.....	109,357,917.35	.....
g) Overstatement of tax provision	.....	.....	.....	.....
h) Adjustment of Accounts Payable Commitment 1985	.....	.....	.....	.....
Ending Balance	4,455,369,614.89	5,912,767,486.32	6,933,068,834.93	7,808,026,159.77

Annex Table 9 (cont'd).

	1984	1985	1986	1987
Beginning Balance	7,808,026,159.77	10,446,639,579.04	18,855,240,340.06	25,358,129,230.10
Add: Charges during the year	2,656,833,445.30	8,541,215,841.48	8,545,580,019.72	4,897,532,532.79
a) Printing and minting of currency	320,500,991.36	343,691,960.83	157,865,829.76	316,313,933.40
b) Issuance and servicing of:				
1) CBCIs - Local	578,237,125.54	271,517,618.01	57,653,179.12	896,622.28
2) CBCIs - Foreign Currency	157,397,233.98	279,754,334.54	81,875,785.84	92,422,997.90
3) Central Bank Bills	1,594,057,726.70	6,016,307,263.15	6,042,293,003.47	59,558,550.34
c) Payment of Gold Traders' Commission	6,640,367.72	35,652,377.56	.....	.....
d) Interest on Reverse Repurchase Agreement	.....	1,594,292,287.39	2,205,892,221.53	1,292,863,739.33
e) Interest on Government Deposits	.....	.....	.....	3,135,476,689.54
f) Adjustment of prior years' charges:				
1) Printing & minting of currency	.....	.....	.....	.....
2) Issuance & servicing of CBCIs	.....	.....	.....	.....
	10,464,859,605.07	18,987,855,420.52	27,400,820,359.78	30,255,661,762.89
Less: Profit from Demonetization / Amortization / Adjustments	18,220,026.03	132,615,080.46	2,042,691,129.68	1,639,366,206.54
a) Minting costs recovered from sale of demonetized commemorative coins	47,457.83	110,137.17	77,551.79	121,374.65
b) Adjustment of prior years' entry:				
1) Printing & minting of currency	.....	.....	.....	.....
2) Issuance & servicing of CBCIs				
CBCIs - Local	.....	.....	.....	.....
CBCIs - Foreign Currency	.....	.....	.....	.....
c) Amortization of prior years' charges:				
1) Printing & minting of currency	.....	4,104,496.32	30,129,926.00	63,203,200.00
2) Issuance & servicing of CBCIs	18,172,334.61	128,400,446.97	2,012,483,651.89	1,576,037,131.89
d) Profit from sale of demonetized commemorative coins	.....	.....	.....	.....
e) Redemption of old currency coins	.....	.....	.....	.....
f) Balance of " Reserve for Contingencies-Taxes " Account	.....	.....	.....	.....
g) Overstatement of tax provision	233.59	.....	.....	.....
h) Adjustment of Accounts Payable Commitment 1985	.....	.....	.....	4,500.00
Ending Balance	10,446,639,579.04	18,855,240,340.06	25,358,129,230.10	28,616,295,556.35

Source: Central Bank of the Philippines, Manila

Annex Table 10. **Exchange Stabilization Adjustment Account 1981 to 1987 (In Pesos)**

	1981	1982	1983	1984	1985	1986	1987
Beginning Balance	.....	236,250,000.00	1,781,227,000.00	3,984,971,553.97	10,201,753,141.98	16,872,383,375.38	26,121,244,622.81
Add: Charges							
Interest on Foreign Borrowings	.....	905,498,500.00	1,199,603,684.56	6,360,122,892.82	2,520,954,134.70	5,270,433,304.06	10,813,283,965.75
Interest on Foreign Currency Deposits and other obligations	236,250,000.00	686,728,500.00	774,760,959.24	3,482,981,166.33	2,987,948,149.07	4,058,329,335.46	644,149,733.57
Service Charges - IMF	.....	.....	280,251,346.20	1,293,728,974.53	1,072,065,276.83	1,573,587,398.20	1,555,822,762.09
Management Facility Fee - Trade Facility	.....	.....	.....	.....	72,676,347.09	81,247,237.24	76,539,545.41
Management and Agency Fees - Agency Fees	.....	.....	.....	2,244,712.00	12,960,836.31	11,365,487.54	7,853,159.50
Management Fees Revolving Credit	.....	.....	.....	2,800,400.00	.....	750,680.46	1,133,917.66
Commitment Fee	.....	.....	.....	.....	1,142,776.82	58,746,325.29	13,659,154.65
Commitment Charges on Standby Credit	.....	.....	.....	214,688.32	2,859,342.58	.....	.....
Documentation Expenses	.....	.....	.....	577,792.51	23,370.00	81,328.84	.....
Insurance Expense - Loan Guarantee	.....	.....	.....	.....	.....	14,362,911.36	.....
Others	.....	.....	314,823,963.97	4,110,961.50	.....	.....	.....
	236,250,000.00	1,592,227,000.00	2,569,439,953.97	11,146,781,588.01	6,670,630,233.40	11,068,904,008.45	13,112,442,238.63
T O T A L	236,250,000.00	1,828,477,000.00	4,350,666,953.97	15,131,753,141.98	16,872,383,375.38	27,941,287,383.83	39,233,686,861.44
Less: Amortizations	.....	47,250,000.00	365,695,400.00	4,930,000,000.00	.....	1,820,042,761.02	1,679,557,000.00
Ending Balance	236,250,000.00	1,781,227,000.00	3,984,971,553.97	10,201,753,141.98	16,872,383,375.38	26,121,244,622.81	37,554,129,861.44

As shown in **Table 7,** interest expenses on foreign liabilities of the Central Bank is the largest expense item.

The RIR is a special frozen account credited or debited for losses or profits arising from revaluation of the Central Bank's net assets or liabilities in gold or foreign currencies. Losses incurred by the Central Bank in swap and forward cover operations entered into in the past are lodged in this frozen account. As of 1987, outstanding RIR was P119.7 billion.

The World Bank (1988) lamented that many assets of the Central Bank are actually accounting constructs, such as those mentioned above, which do not correspond to an equal liability to the Central Bank. A gradual write off of these assets was suggested so as to present a better picture of monetary developments.

Chapter III

RECENT TRENDS IN THE PUBLIC DEBT

A. THE TOTAL DEBT OF THE NATIONAL GOVERNMENT

The total debt of the National Government at the end of 1990 was ₱610 billion (**Table 8**). By the end of 1992, it is expected to grow further by almost 10%. It would then be more than double its level in 1986 when the National Government absorbed the debt of various governmental financial institutions. However, the growth of the debt has been constrained relative to the growth of GNP. The debt-GNP ratio was 53% in 1986 and soared to 66% in 1987. But by 1990, it was back down to 54% and with some good luck, it should fall below 50% by the end of 1992.

In 1990, the domestic debt constituted almost exactly one-half of the total. Almost 20% of this domestic debt consisted of the assumed liabilities of governmental financial institutions, which are being slowly written off.

Over the entire period 1986-90, the external debt grew very much faster than the domestic debt, rising by 128% compared to a domestic debt increase of 62%. However, the external debt grew less than 2% in 1990 because of the difficulty of obtaining new external financing which is described below. Although the government hopes for a somewhat increased volume of external financing in the near future, it is, nevertheless, clear that a much higher portion of future deficits will have to be financed domestically.

B. THE DOMESTIC DEBT OF THE NATIONAL GOVERNMENT

As the domestic debt grew in the late 1980s, a higher and higher portion took the form of short-term Treasury bills. In 1986, such instruments constituted only 29% of the total debt, but by 1990 the ratio had risen to 63%. Because the maturity of Treasury notes and bonds was also shortened over time, about three quarters of the debt must be refinanced each year. That, in turn, implies that large amounts of securities must be issued every week.

The many problems posed by this massive refinancing operation will be described in detail below. But the most important problem, by far, involves the difficulty created for the Central Bank. Although the demand for Treasury securities has been very strong recently, that is not always the case. When the demand is weak at a particular auction, the Central Bank feels obliged to support the market by buying securities. This creates reserves for the banking system which either must be painfully extracted in future weeks or be allowed to create money, thus putting upward pressure on the inflation rate. The system is highly vulnerable to any extraneous event that might suddenly reduce the demand for Treasury securities. A natural calamity, a rumored devaluation, or a rumored coup can result in a large amount of reserve creation and

Table 8. **DETAILS OF OUTSTANDING DEBT OF THE NATIONAL GOVERNMENT, 1976-1992**

PARTICULARS	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
DOMESTIC	13323	15505	20777	19387	22529	29287	36203	41830	63220	88368	189779	240551	269332	292201	307345	342117	327715
Regular	13323	15505	20777	19387	22529	29287	36203	41830	63220	88368	113513	158431	203250	230183	250384	296304	283773
Treasury Bills	1967	2559	2545	2566	2983	5470	5646	6145	19377	31164	55420	107008	142615	172543	192589	219497	212592
Treasury Notes	3508	3474	3500	3678	3751	5257	8998	5789	5621	10641	16418	19203	28743	30201	28790	47302	42716
Treasury Bonds	3735	4470	4832	4933	7129	8727	11426	12631	12924	13139	12698	12273	12193	11427	11096	11096	11096
Reconstruction Bonds	0	0	0	0	0	0	0	0	0	0	0	0	0	0	4351	7201	7201
Others	4113	5002	9900	8210	8666	9833	10133	17265	25298	33424	28977	19947	19699	16012	13558	11208	10168
Assumed	0	0	0	0	0	0	0	0	0	0	76266	82120	66082	62018	56961	45813	43942
PNB	0	0	0	0	0	0	0	0	0	0	42438	40441	35848	35140	31937	24849	23438
DBP	0	0	0	0	0	0	0	0	0	0	28731	37011	26783	25082	23420	19512	19123
PNPP	0	0	0	0	0	0	0	0	0	0	5097	3492	2009	550	550	550	550
Philguarantee	0	0	0	0	0	0	0	0	0	0	0	439	172	105	27	0	0
NDC	0	0	0	0	0	0	0	0	0	0	0	737	1270	1141	1027	902	831
FOREIGN	6160	8406	12037	20494	22354	20015	25112	42125	55257	61469	132766	222442	216794	298516	302642	312708	335058
Regular	6160	8406	12037	20494	22354	20015	25112	42125	55257	61469	73488	94989	107474	179688	195089	213045	244095
Assumed	0	0	0	0	0	0	0	0	0	0	59278	127453	109320	118828	107553	99663	90963
PNB	0	0	0	0	0	0	0	0	0	0	12554	19718	27097	31817	28746	26808	25368
DBP	0	0	0	0	0	0	0	0	0	0	22861	48033	49710	55316	50892	48384	45414
PNPP	0	0	0	0	0	0	0	0	0	0	23863	52692	25841	26173	23721	20329	16189
Philguarantee	0	0	0	0	0	0	0	0	0	0	0	3569	4953	3706	2606	2583	2553
NDC	0	0	0	0	0	0	0	0	0	0	0	3441	1719	1816	1588	1559	1439
T O T A L	19483	23911	32814	39881	44883	49302	61315	83955	118477	149837	322545	462993	486126	590717	609987	654825	662773

Source: Bureau of the Treasury.

highly unstable inflation and interest rates. This instability tends to raise real interest rates, thus worsening the government's deficit and adding to the problem of managing the debt. In other words, instability tends to breed further instability.

C. THE NATIONAL GOVERNMENT'S EXTERNAL DEBT

The external debt of the Philippines creates a number of complex issues that will have to be described in considerable detail.

1. Background

An ample supply of foreign loans in the 1970s, in excess of amounts needed to adjust to the first oil shock, allowed most of the Third World's governments to engage in large scale investment programs and the Philippines was no exception.

Abundance of finance funds is not bad per se. On the contrary, prudent and efficient use of financial leverage has contributed to the spectacular growth of many multinational companies and also the developed world. The debt service burden can be maintained within manageable levels as long as newly-financed projects' contributions to the capacity to pay more than offset the additional debt service requirements.

The private plus public foreign debt problem became severe at the end of the 1970s, when outstanding debt reached a level of US$17.3 billion equivalent to 49% of Gross National Product (GNP) and 215% of the value of exports of goods and services. During most of the 1970s, foreign debt was equivalent to about one third of GNP.

After the second oil shock, the foreign debt problem became even more severe, reaching US$28.3 billion at the beginning of the Aquino Administration, equivalent to 94% of GNP and 327% of the value of exports of goods and services. Five years later, the outstanding debt to foreign creditors was at virtually the same absolute level or US$28.6 billion. Given the growth of the economy during the same period, however, the relative size of the foreign debt problem has been significantly reduced to 65% of GNP and 219% of the export of goods and services.

Creditors have recognized the need to reduce the debt burden of the Philippines and improved terms and conditions are now being negotiated with commercial banks. The negotiations will reduce the debt service burden to a level more compatible with the Philippine Republic's ability to pay.

A small reduction of the interest rates on foreign loans can have a significant impact on the level of economic activity. A simulation run using the PIDS-NEDA model indicated that a 10% decrease in the interest bill for 1991-2000 could lead to a 2.7% increase of GNP, by the end of the period, or an increase in the annual rate of growth of 0.3 percent per year.

2. Characteristics of the External Debt

On March 31, 1991 the foreign debt totalled US$28.8 billion. As mentioned before, the level of foreign loans is practically the same as that inherited by the Aquino Administration from the previous government. However, an important change has occurred regarding the composition of creditors. In December 1987, the commercial bank debt was US$15.2 billion, or 53% of the foreign debt, but as of March 31, 1991 it was only US$11.3 billion representing 39% of the total (**Table 9**).

Table 9. Foreign Debt by Creditor (In Millions of Dollars)

Creditors	March 31, 1991	December 31, 1991
Bank and FIs	11,334	15,214
Bilaterals	8,592	5,203
Multilaterals	6,328	5,033
Suppliers	2,359	2,355
Others	187	844
TOTAL	28,800	28,649

Source: Central Bank of the Philippines.

Commercial banks continue to hold the largest portion of the Philippine foreign debt. Banks from four countries (United States, Japan, France and the United Kingdom) are owed US$7.6 billion or 67% of the commercial bank debt. By far, American banks are the largest creditors in this group, as their loans total US$4.2 billion, representing 37.6 % of the commercial bank debt.

As the country has been reducing its debt with commercial banks, the financial support from bilateral sources has been growing. As a result, friendly governments have increased their lending from US$5.2 billion, or 18% of the foreign debt, to US$8.6 billion which represents 30% of the total. In fact, bilateral lenders are the only group providing the Philippines with positive net resource transfers since 1987. In other words, the payments of principal and interest to other lenders have been larger than the disbursements on new loans in the last five years. In 1987 and 1988, the Philippines paid an annual average of US$2 billion over the withdrawals on new loans.

The terms and conditions on the bilateral debt are being negotiated with the Paris Club. The largest creditor in this group is Japan with US$5.6 billion, or 66% of the bilateral debt. The United States occupies a distant second place, with an outstanding amount of US$1.5 billion representing 18% of the group total.

Most of the borrowing activity in the past was concentrated in medium- and long-term markets. Project finance obtained from traditional sources, such as international agencies and friendly governments, was complemented by syndicated loans put together by money center banks. These syndicated loans were used to recycle so-called Petro-dollars and were very popular in the 1970s. As a consequence, long-term debt now represents 84% of the Philippine external debt.

There have been no significant changes in the relative importance of short- and long-term debt. At the end of 1987, short term debt was equivalent to US$3.8 billion or 13% of the US$28.6 billion in foreign loans. At the end of the first quarter of 1991, short term debt totaled US$4.6 billion representing 16% of the total. Self-financing and trade financing provided by international banks and off-shore subsidiaries of domestic banks now supplies adequate short-term credit. Imports have been growing at an annual rate of 20% or more in the last five years.

As mentioned before, the bulk of the foreign debt was incurred by public institutions. At the end of 1987, private sector borrowing amounted to US$5.9 billion, or 20.6% of the foreign debt. Not much had changed at the end of the first quarter of 1991, as private sector borrowings were equivalent to US$5.5 billion representing 19.7% of the total. However, important changes have occurred in the accounting for the public sector debt. The National Government has assumed most of the liabilities of major public service corporations, state owned banks and other public sector entities, which were unable to service the debts accumulated in the past. The balance sheet of the Central Bank is the only major financial statement that needs to be cleared of the problem of foreign loans, many of them contracted on behalf of the National Government. Due to the outstanding debt, the reluctance of the private commercial banks to lend more and the growing fiscal deficit, the National Government was forced to substitute domestic debt for foreign debt, and the heavy borrowing in the domestic market has increased the interest bill of the government. The increased interest bill now competes for resources with education, health and infrastructure projects, which could have increased the growth rate of the economy.

D. THE CENTRAL BANK'S LOSSES AND LIABILITIES

The data on the domestic and external debt of the National Government, provided above, do not include the liabilities of the Central Bank. As noted earlier, detailed information on the Central Bank's income statement is not readily available to the public and the bank's balance sheet obscures the effects of the large losses that the Central Bank incurs. It is crucial that this situation be corrected in the near future. It frustrates careful analysis of the Philippines' national debt, which should be defined to include the net liabilities of the Central Bank. The World Bank has complained about the Central Bank's accounting practices, and more generally, lack of readily understandable public financial information inhibits the nation's ability to attract external funds.

Published balance sheet data reveals gross Central Bank liabilities of ₱323 billion at the end of 1990. This is far in excess of ₱141 billion of earning assets also held by the Central Bank. It is this mismatch that leads to the bulk of the bank's large losses.

If no offsetting action is taken, the losses of the Central Bank create bank reserves. This process is formally described in Annex A to this Chapter. To prevent this from occurring, the Central Bank has issued Central Bank notes in the past. More recently, the reserves that would be otherwise created by Central Bank losses have been mopped up by the National Government, which issues Treasury securities to finance deposits in the Central Bank.

This implies that the government must issue securities to finance both its own deficit and the deficit of the Central Bank. This adds to the volume of securities that must be issued each week and further adds to the difficulty of managing the public debt. It also gives the National Government a role in monetary policy, because the management of its deposits in the Central Bank plays an important role in money creation. Meanwhile, the Central Bank plays an important role in fiscal policy, since its losses derive, in large part, from managing subsidized loans of one type or another.

A minor problem arises because there is a constant struggle over the interest rate paid on National Government deposits by the Central Bank. The Central Bank would like to pay zero interest because its deficit then looks smaller. The National Government's deficit is then raised by a comparable amount and so this conflict makes no difference to the consolidated public sector's deficit which should be of most interest to the Philippines. But the situation leads to a bureaucratic competition over cosmetics, and this tension has the potential for complicating monetary management. Clearly, the situation would be clarified if the Central Bank paid the National Government a market rate of interest. That would provide a more accurate accounting of the National Government's true deficit versus that of the Central Bank.

However, this would be a minor reform compared to what is required in the longer run. The National Government should absorb the liabilities of the Central Bank and begin amortizing them. Below it is suggested that this be accomplished by creating a special corporation. That would clarify the responsibilities for monetary and fiscal policy. Debt management would be simplified and the danger that the current situation could inadvertently exacerbate the inflation problem would be eliminated. The Central Bank could be put on a profitable basis, and as part of the bargain, it could also be given somewhat more independence in conducting monetary policy.

E. THE DEBT SERVICING BURDEN

Although the Philippines' ratio of total debt relative to GNP is not excessive compared to that in many developed countries, high inflation which, in turn, raises nominal interest rates will push the government's interest bill toward 40% of total spending by 1992 and to over 6% of the GNP. In 1991, the total interest bill is estimated at ₱83.4 billion of which ₱63.3 billion or about three quarters is owed on the domestic debt. The remainder or ₱20.1 billion is owed on the external debt (**Table 10**).

The average interest rate is much higher on the domestic debt than it is on the external debt. The average cost on the domestic debt is about 19%. Unless market interest rates fall significantly, this will rise in the future as new deficits must be financed at higher rates and older low-interest debt must be refinanced.

The average interest rate on the external debt is only 6%. However, the peso value of the external interest bill and the principal amount of the debt will be increased by any depreciation occurring in the future. Issues related to the servicing of the external debt are described in detail in Annex B.

Past external debts, the debts assumed from other governmental agencies, and certain other domestic debts are being amortized over time. In 1991, it is estimated that principal amortization will amount to ₱39.4 billion of which ₱19.2 billion represents the amortization of external debts. This implies that total debt service amounts to ₱122.8 billion, or an amount equivalent to over 9% of GNP.

Again, none of this includes the burden of servicing the net liabilities of the Central Bank. The losses of the Central Bank probably understate this burden, because those losses are computed after the profits that the Central Bank earns on its money creation activities. The Central Bank's explicit net interest bill totalled over ₱26 billion in 1989. Its effective interest rate on total liabilities was 9.59% compared to an effective interest rate of only 5.09% on its earning assets.

There are other costs, as well, that are not reflected in the explicit interest bill of the National Government or the Central Bank. In order to counter the creation of reserves caused by the difficulties of debt management, the Central Bank has raised reserve requirements ratio to very high levels (currently at 25%). Because such reserves do not earn market rates of interest, a tax is imposed on the banking sector a portion of which might be considered a part of the cost of servicing the public debt. The average interest currently paid by banks on interest-bearing deposits is 11 percent while reserves deposited with the Central Bank earn 4 percent. This translates into an intermediation tax of 3.5% assuming a 25% reserve requirement ratio.[6]

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[6] In other words, for banks to break even, they would have to charge 14.5% for their loans.

Table 10. DETAILS OF NATIONAL GOVERNMENT DEBT SERVICE EXPENDITURES, 1986-1992

PARTICULARS	1986	1987	1988	1989	1990	1991	1992 BESF	1992 HB34925
INTEREST PAYMENTS	21612	36905	45865	54714	71114	83426	80348	77842
DOMESTIC	15681	24224	32183	41032	53323	63309	57738	57681
Regular	15022	18678	25710	34814	46770	58220	[illegible]4132	54132
Assumed Liabilities	659	5546	6473	6218	6553	5089	3606	3549
FOREIGN	5931	12681	13682	13682	17791	20117	22610	20161
Regular	5931	6055	6991	6550	10355	11626	14209	14209
Assumed Liabilities	0	6626	6691	7132	7436	8491	8401	5952
PRINCIPAL AMORTIZATION	6449	32789	25455	27800	35232	39357	32685	28560
DOMESTIC	1979	24150	12408	16057	14952	20196	11542	11542
Regular	1979	15626	6249	11052	9895	13754	8603	8603
Assumed Liabilities	0	8524	6159	5005	5057	6442	2939	2939
FOREIGN	4470	8639	13047	11743	20280	19161	21143	17018
Regular	4470	6253	8333	6157	9005	8970	10578	10578
Assumed Liabilities	0	2386	2360	2960	8603	7191	7565	3440
Debt Reduction Program	0	0	2354	2626	2672	3000	3000	3000
TOTAL DEBT SERVICE	28061	69694	71320	82514	106346	122783	113033	106402

Source: Bureau of the Treasury.
DS7992/062

The Central Bank has also forced certain public and private entities to lend to it by blocking their accounts in the bank. To the extent that they do not receive market interest rates, yet another implicit tax is imposed that could be considered as a means of financing the servicing of the true total debt.

Three corporations - the National Power Corporation (NPC), Light Rail Transit Authority (LRTA) and the National Food Authority (NFA) - are likely to put additional pressure on the national government's debt service requirements in future years. In 1991, some P5.6 billion was added to the expenditure program to accomodate the debt servicing needs of the National Power Corporation. If no additional measures are taken, the deficit of the 14 major corporations could easily double from P14.4 billion in 1992 to P33.5 billion in 1993, with a major chunk of the increase directly attributable to the dramatic rise in the capital expenditure program proposed by NPC and LRTA. NPC seeks to increase its capital spending from P16.4 billion in 1992 to P36.4 billion in 1993 while LRTA targets an increase from P500 million in 1992 to P3.6 billion in 1993. Total capital spending for all major corporations is proposed to increase from P29.1 billion in 1992 to P60.5 billion in 1993.

Another potential problem area is the scope and financing of NFA operations. While direct budgetary support to NFA has averaged at P1.0 billion from 1990 to 1992 (projected), government support in terms of of loan guarantees has increased in recent years. The build-up in total liabilities during the last three years is as follows: P8.9 billion in 1990, P11.1 billion in 1991, and P11.8 billion (projected) in 1992. The corresponding interest expense amounts to P0.7 billion in 1990, P1.7 billion in 1991 and P1.5 billion in 1992. Due to heavy losses from operations, NFA appears incapable of servicing its huge debt. The National Government would eventually end up answering for NFA's liabilities which cannot be covered from internal corporate funds or which have already become unrecoverable losses. Various reform measures for NFA are being discussed at the Cabinet level. One such measure is to limit the role of NFA to price monitoring.

ANNEX A TO CHAPTER III

THE ROLE OF THE CENTRAL BANK'S LIABILITIES

As already mentioned above, the deficits of the Central Bank are part of the consolidated budget deficit. We will discuss here the implications of the CB losses on the conduct of monetary policy and on the current public debt situation. It might be worthwhile to discuss some fundamental relationships in money supply creation and relate them to the deficits of the Central Bank.

As commonly known,

$$M = m * RM \qquad (1)$$

where M = money supply,
m = money multiplier, and
RM = reserve money.

Equation (1) states that given a certain value for m, money supply expands as RM increases. Let us establish the linkage between Central Bank losses and money expansion.

Annex Table A-1 and **Annex Table A-2** present simplified representation of the balance sheet and the income statement, respectively. In short, the surplus (deficit) of the Central Bank for a specified period is given by the formula:

$$S = I - E \qquad (2)$$

The balance sheet is expressed as

$$L + eFA = RM + NG + eFL + OL + NW \qquad (3)$$

Rearranging (3),

$$RM = (L + eFA) - (NG + eFL + OL + NW) \qquad (4)$$

Simplifying (4),

$$RM = -NW + NFA + NDA \qquad (5)$$

where NFA = e(FA - FL) = net foreign assets, and
NDA = L - (NG + OL) = net domestic assets.

Note that any surplus realized by the Central Bank will be added to its net worth. Hence,

$$S = \underline{\Delta} NW \qquad (6)$$

Annex Table A-1. Balance Sheet of the Central Bank

	Assets
L	Loans and discounts to banks (including overdrafts and emergency loans and loans to the national government)
eFA	Foreign assets converted into local currency at exchange rate e
	Liabilities and Net Worth
RM	Reserve money (currency in circulation + reserves of banks)
NG	National government deposits
eFL	Foreign liabilities converted into local currency at an exchange rate e
OL	Other liabilites (CB bills, reverse repurchase, blocked differential)
NW	Net Worth

Annex Table A-2. Income Statement of the Central Bank

Income (I)	
iL	Interest income on loans, where i = interest rate on loans.
ERG	Exchange rate gains on foreign assets $[(e_t - e_{t-1})\ FA]$
Expenses (E)	
rNG	Interest payments on government deposits, where r = interest rate on government deposits
ERL	Exchange rate loss on foreign liabilities $[(e_t - e_{t-1})\ FL]$
rOL	Interest expenses on other liabilities, where r = same as above
Surplus (S)	Surplus = Income - Expenses

We are now in a position to link Central Bank losses to the conduct of monetary policy. Taking the first difference of (5),

$$\Delta RM = -\Delta NW + \Delta NFA + \Delta NDA \qquad (7)$$

Substituting (6) into (7),

$$\Delta RM = -S + \Delta NFA + \Delta NDA \qquad (8)$$

Equation (8) states that any surplus realized by the Central Bank will lead to a reduction in reserve money, **ceteris paribus**. Conversely, any deficit will lead to an increase in reserve money, **ceteris paribus**. It brings out an important point that NFA and NDA could remain the same, but yet RM could change due to changes in the surplus (deficit) of the Central Bank. Going back to the income statement of the Central Bank, differences on the interest rate on loans and liabilities as well as in the level of foreign assets and foreign liabilities of the Central Bank could bring about a surplus or deficit, which, in turn, could affect RM.

Annex Table A-3 shows the interest-bearing total liabilities of the Central Bank from 1980 to 1990. Foreign liabilities of the CB comprised 61% of its total liabilities in 1990. On the other hand, its foreign assets constituted only 41% of its total earning assets (**Annex Table A-4**). In absolute number, CB's foreign liabilities are more than three times its foreign assets. This shows how vulnerable the Central Bank to exchange rate depreciation. More specifically, a depreciation increases the losses of the Central Bank in absolute terms. Although it could act to reduce RM since NFA is negative, the losses of the CB from such depreciation could partly offset it. In addition, it would increase CB's swap differential which would exert an upward pressure on RM if it decides to rollover the swap. If it decides to block the additional swap differential, then it has to pay interest on it. This again leads to an increase in CB's losses, which will eventually be reflected in higher RM levels.

The open market operations could be tapped to rein in the growth of RM. At this present situation, this could be done only if the CB offers high interest rate on its CB bills and reverse repurchase instruments. But again, this would worsen the losses of the CB, which eventually will impact on RM. The other alternative it to encourage the National Government to increase its deposits with the Central Bank as was done in the past. If interest is paid on these deposits, then CB's losses would increase. On the other hand, non-payment of interest on these deposits would result into higher deficit for the National Government, which would exert upward pressure on interest rates including interest rates of CB's liabilities. The bottomline is that whatever the CB does to rein in the growth of RM, it would be less successful because of the impact of those measures on its losses.

The CB is currently confronted with two huge problems. First, the effective interest rate it earns from its total earning assets falls well below the effective rate on its total liabilities (**Annex Table A-5**). This is because it still lends at below market rates of interest while it pays a market rate of interest on its liabilities, except on legal reserves. For instance, its rediscount rate now is only 14% per annum, whereas the MRR-90 is 18.6% per annum.

Annex Table A-3. Total Liabilities of the Central Bank, End Of Period
(In Million Pesos)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
TOTAL LIABILITIES	25447	30904	39548	89728	152697	203815	258227	254697	265439	280489	322746
EXTERNAL LIABILITIES	20103	25146	33764	73223	105344	138694	184707	174130	166622	161464	198156
SHORT-TERM FOREIGN LIABILITIES	16466	20689	28538	36274	51552	53534	67744	54129	53040	49655	55748
MEDIUM & LONG-TERM LIABILITIES	3637	4457	5226	36949	53792	85160	116963	120001	113582	111809	142408
DOMESTIC LIABILITIES	5344	5758	5784	16505	47353	65121	73520	80567	98817	119025	124590
LEGAL RESERVES	3771	3073	3342	4310	7835	10611	16413	15840	19150	32789	37792
NATIONAL GOVERNMENT DEPOSITS	1573	2685	2442	5553	11947	8272	16413	42563	58210	69556	67255
CENTRAL BANK BILLS	...	...	...	...	6850	24046	23324	582	3381	3605	1939
REVERSE REPURCHASE	...	...	...	1614	4558	7560	6951	10556	6345	855	1979
BLOCKED DIFFERENTIAL - MAAB43	...	...	...	5028	16163	14632	10419	11026	11731	12220	15625

1/ Starting 1983, data reflect the expanded coverage of deposit money banks and the transfer of selected accounts of two government banks to the national government.

Sources: (a) Department of Economic Research-Domestic, Central Bank of the Philippines.
(b) Accounting Department, Central Bank of the Philippines.

Annex Table A-4. **Earning Assets of the Central Bank, End Of Period**
(In Million Pesos)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. Domestic Assets	31,670	39,119	48,797	65,282	80,838	89,292	87,313	78,594	75,872	76,668	83,062
Loans and Advances	25,271	29,315	36,484	50,532	56,605	61,048	59,634	50,139	49,661	51,167	60,009
Assistance to Financial Institutions	306	3,366	3,139	4,957	10,921	13,748	12,730	15,405	15,011	14,980	14,781
of which: Overdrafts	54	915	2	1,170	7,189	9,752	9,899	12,769	12,903	13,039	12,973
Domestic Securities	6,093	6,438	9,174	9,793	13,312	14,496	14,949	13,040	11,200	10,521	8,272
2. Foreign Assets	23,609	21,123	15,694	12,108	17,686	20,661	51,420	41,878	45,041	53,228	57,610
TOTAL EARNING ASSETS	55,279	60,242	64,491	77,390	98,524	109,953	138,733	120,472	120,913	129,896	140,672

Sources: (a) Department of Economic Research-Domestic, Central Bank of the Philippines.
(b) Accounting Department, Central Bank of the Philippines.

Annex Table A-5. Effective Interest Rate on Earning Assets and Liabilities In Million Pesos (End-of-Period)

ITEM / YEAR	1986	1987	1988	1989
Interest Income	8,800	8,100	7,000	6,600
Total Earning Assets	138,733	120,472	120,913	129,896
Interest Expenses	27,200	18,300	23,200	26,900
Total Liabilities	258,227	254,697	265,439	280,489
Effective Interest Rate on Earning Assets	6.34	6.72	5.79	5.08
Effective Interest Rate on Total Liabilities	10.53	7.19	8.74	9.59

Source of Basic Data: Central Bank of the Philippines.

Charging a market rate of interest on these assets may be one step towards correcting its income position. Second, the volume of its earning assets are substantially below that of its interest-bearing liabilities. As already pointed out above, the transfer of foreign liabilities from government financial institutions and corporations to the Central Bank was one of major causes for this. The growing amount of blocked differential needs also to be mentioned here. Thus, raising the effective rate on its earning assets to approximate the market rates will hardly save the CB from its present predicament. What may be needed is to squarely address the CB's liabilities and the losses derived therefrom by taking them out from its books. This issue is discussed further below.

ANNEX B TO CHAPTER III

THE EXTERNAL DEBT SERVICE BURDEN

A better way to judge the impact of a large external debt is to analyze debt service needs relative to the availability of foreign exchange. The average maturity and the average interest cost of the debt are the factors that determine the debt service burden. The longer the average maturity and the smaller the interest rate, the lower is the debt service burden. During the current administration, the level of the debt service burden has been around US$3 billion, and it is estimated to slightly decrease to US$2.7 billion next year. Because of the economic growth experienced by the economy in the same period, the relative size of the debt service burden has been slowly decreasing. In 1986, it represented 37% of the value of exports of goods and services and 10% of GNP, but at the end of 1991, it is estimated to decrease to only 21.2% of the value of exports of goods and services and to 6.6% of GNP (**Annex Table B-1**).

As mentioned earlier, the commercial bank debt of the Philippines has been reduced from US$15.2 billion in 1987 to US$11.3 billion in 1991. The reduction of US$3.9 billion has been accomplished mostly by debt-to-equity swaps and the US$1.3 billion debt buy back of 1990. In return, the Philippines has received softer terms and new financing from international commercial banks.

A refined measure of the net impact of external financing is the net resource transfer. It differs from the debt service burden because it takes into account new financing received from international sources. When a country must pay more in debt service than it received in new financing, it must spend less than its current production so that some of its production can be devoted to servicing its debt. The difference between total spending and output is the net resource transfer the country receives.

The direction of the net resource transfers has changed in the last seven years. Between 1974 and 1983, the Philippines usually received a net inward resource transfer of 5% or more of GNP. Since that time, the resource transfer has been consistently outward, although it has declined sharply from its 1986 peak. It is, however, unlikely that the Philippines will soon experience the high level of inward transfers experienced in the 1970s. From a level of about US$2 billion in 1987-88, the outward resource transfers have been reduced to about US$1 billion in 1989 and 1990 (**Annex Table B-2**). Further reductions are estimated for 1991 (US$200 million) and 1992 (US$474 million).

Bilateral sources were the only ones providing an inward resource transfer to the Philippines in the period 1987-90. Friendly governments provided an average of US$2[illegible]9 million during this period. In contrast, interest payments made by the country to multilateral agencies exceeded net disbursements in the last five years. Commercial banks slowly reduced new lending after the first oil shock. After non-payments by Mexico in 1984, very few commercial banks continued providing loans to the Third World; some banks even avoided 100% cash collateralized loans. For this reason, the inward resource transfer from commercial

Annex Table B-1. THE PHILIPPINES, DEBT SERVICE BURDEN (DSB)
(In Millions of Dollars)

Year		Net Amortizations	Interest Payments	DSB	Ratio to Exports of Goods and Services	Ratio to GNP
1986		1,117	1,980	3,097	37.0	10.3
1987		1,092	1,913	3,005	32.9	8.8
1988		994	2,041	3,035	28.5	7.8
1989		915	2,224	3,139	25.3	7.1
1990	(est)	1,712	1,963	3,675	28.2	8.3
1991	(est)	1,176	1,832	3,008	21.2	6.6
1992	(est)	958	1,725	2,683	17.4	5.6

Source of basic data: Central Bank of the Philippines.

Annex Table B-2. **THE PHILIPPINES, NET RESOURCE TRANSFERS (In Millions of Dollars)**

	1987	1988	1989	1990	1991 est.	1992 est.
NET RESOURCE TRANSFERS	-1836	-1956	-1396	-1039	-200	-474
Principal, net 1/	77	85	828	924	1632	1251
Interest Payments	-1913	-2041	-2224	-1963	-1832	-1725
Banks and Financial Institutions	-1222	-1112	-1448	-1129	-836	-937
Principal, net	-37	-9	-65	-105	75	-48
Interest Payments	-1185	-1103	-1383	-1024	-911	-889
Multilaterals	-476	-542	-48	-290	174	-58
Principal, net	-10	-13	443	273	663	434
Interest Payments	-466	-529	-491	-563	-489	-492
Other Sources	-401	-393	-129	5	-28	-4
Principal, net	-252	-308	-73	72	27	53
Interest Payments	-149	-85	-56	-67	-55	-57
Bilaterals	263	91	229	375	490	525
Principal, net	376	415	523	684	867	812
Interest Payments	-113	-324	-294	-309	-377	-287

Note: 1/ Net of capital inflows and excludes principal on rescheduled debt, debt converted through various schemes and debt covered by buyback.

Source: Central Bank of the Philippines.

banks was rapidly converted into an outward resource transfer in most of the Third World. In the case of the Philippines, the outward resource transfer received by commercial banks has averaged US$1.2 billion in the last five years.

As mentioned before, multilateral agencies have been receiving outward resource transfers from the Philippines since the early 1980s. However, the amount of lending from multilateral agencies has been increasing in the last four years. Thus, the outward resource transfers to those agencies have decreased from an annual average of US$509 million in 1987-88 to an annual average of US$169 million in 1989-90. Increased lending from international agencies is expected to change the direction of foreign exchange flows in 1991. An improvement of the terms and conditions of these softer loans has also contributed to a needed change in the direction of cash flows. Increasing concessionality from the Asian Development Bank is worth mentioning. The bank increased the commitment of resources from its Asian Development Fund, which carries zero percent interest, a one percent service charge and 35 years maturity total of US$504 million was committed in the period 1988-90, while only US$200 million was originally offered.

In addition to the actions described above, the Philippines has engaged in various debt conversion schemes to reduce its external debt servicing burden. In 1990, it bought back US$1,338 million of its debt at 50% of face value using resources provided by the IMF, the World Bank, and official bilateral sources. As of March 1990, total debt reduction under other debt conversion schemes amounted to US$2,170 million. Recently, the pesos made available under debt-equity swaps have been auctioned to reduce the subsidies inherent in such programs.

New money has been made available under the multilateral Philippine Assistance Program. A total of US$3.5 billion was pledged in July 1989, including US$600 million in grants. However, the need to cut government spending in 1991 reduced the Philippine's ability to utilize official development assistance because of the difficulty of coming up with matching funds.

Chapter IV

CONCEPTUALIZING THE DEBT PROBLEM

A. THE SERIOUSNESS OF THE PROBLEM

As noted above, judged only by the balance of revenues and outlays, the fiscal situation of the Philippines does not appear to be alarming, although there are very strong arguments for reducing the deficit further. Moreover, the relatively satisfactory deficit may have been achieved, in part, by curbing expenditures that are valuable to economic growth. This report cannot do the analysis necessary to support or refute this frequently made claim, but if it is true, there is an argument for increasing tax effort, both to lower the deficit further and to restore high rate of return expenditures.

Judging the situation only on the basis of the fiscal aggregates, the total debt of the National Government at the end of 1990 was ₱610 billion or about 54% of the GNP. That ratio is very similar to that now prevailing in the United States. The National Government's deficit was held significantly below 4% of GNP for the period 1986-90 and is expected to decline to less than 3% by 1992. The total public sector deficit jumped significantly to 5.4% of GNP in 1990 from 4.1% in 1989 and 2.2% in 1987, but it too is expected to improve significantly by 1992.

Although the total debt burden does not seem to be enormous relative to that in many other countries, there are, nevertheless, reasons to be concerned. The debt-GNP ratio has been held down by double-digit inflation, which taxes away a considerable part of the real value of the domestic debt each year. Such an inflation tax might be expected to ease the fiscal burden, but in the Philippines, its effects are short lived. Because the domestic debt consists largely of short-term Treasury bills, a large portion of the total must be refinanced each month. Inflation is quickly reflected in interest rates which have recently been in the 19% to 24% range. The interest bill on the total domestic and foreign debt is, as a result, now nearing 40% of total National Government disbursements or over 6% of the GNP. In contrast, the U.S. Federal government's interest bill is only a bit above 3% of GNP, even though the debt-GNP ratio is similar to that in the Philippines.

The foregoing discussion only considers the debt of the National Government. As noted earlier, a considerable portion of the consolidated public sector deficit consists of losses by the Central Bank. As also noted earlier, the balance sheet of the Central Bank does not accurately reflect its net liabilities, but it is clear that the net worth of the Central Bank is highly negative. A more accurate accounting might show net liabilities approaching ₱200 billion or an amount equal to about a third of the National Government's debt.

Chapter V of this report extrapolates the effects of continuing what appears to be current policy and confirms the conclusion that the current fiscal situation is not worrisome. Various threats to current policy are analyzed and within the context of the macro model that is used for simulation purposes, it is shown that a deterioration of the fiscal situation can often lead to higher inflation and lower real growth. However, such macro models are not good at analyzing extreme situations, and therefore, before engaging in the simulation exercises, it may be useful to look at the fundamentals of the problem and to assess the dangers of the fiscal situation deteriorating to an even greater extent than indicated by the simulations that will follow.

The interaction of the Central Bank's debt with the National Government's debt combined with high nominal interest rates and a growing interest bill raise the specter that the Philippine budget could get out of control in the sense that the overall deficit could grow so rapidly that there would be little choice but to finance it through money creation. The inevitable result of such a situation is hyperinflation. This danger will now be explored in detail.

B. FISCAL DYNAMICS

A budget can be said to be "out of control" when the debt-GNP ratio and the interest bill-GNP ratio are rising very rapidly. The determinants of the growth in the debt-GNP ratio can be seen intuitively by way of a numerical example. Suppose that the government's deficit is exactly equal to its interest bill and that equals 10% of its debt. The deficit minus the interest bill is known as the primary deficit and in this example it is zero. When the government borrows to finance just the interest bill of 10%, the debt will grow 10%. If the nominal GNP is growing 10%, the debt-GNP ratio will remain unchanged. If the GNP is growing at a rate less than the average interest rate on the debt, the government will have to achieve a deficit less than the interest bill in order to maintain the stability of the debt-GNP ratio; that is to say, there will have to be a primary surplus If the average interest rate on the debt is lower than the rate of GNP growth, the stability of the debt-GNP ratio can be maintained while still running a limited primary deficit.

Hence, the growth of the debt-GNP ratio is crucially determined by the relationship of the primary surplus or deficit to the difference between the rate of interest on the debt and the nominal growth rate of the economy. The relationship is described formally by the following formula:

$$dk = (g - t) + (r - n)k_{-1}$$

where dk is the change in the debt-GNP ratio, g is noninterest government spending relative to GNP, t is tax revenues relative to GNP, r is the average interest rate paid on the debt, n is the rate of growth of nominal GNP, and k_{-1} is the debt-GNP at the end of the previous year.

The Philippines appears to be in good shape, because the National Government is running a substantial primary surplus, i.e., the primary deficit, (g - t) is highly negative, and a primary surplus, though one that is considerably smaller, still remains when the entire consolidated public deficit is considered. At the same time, the difference between the average interest rate on the debt and the nominal rate of growth of the economy is also negative in years of normal economic growth because of relatively low rates of interest paid on external debt.

Looking toward the future, it is, however, crucial for the Philippines to maintain a substantial primary consolidated surplus, because the average interest rate paid on the debt could rise rapidly relative to the rate of growth of the economy. Any surprising increase in the consolidated public sector deficit would likely be financed by issuing high-interest domestic debt. Moreover, the deficit increase would likely to raise domestic interest rates and increase the probability that the average interest rate on the debt exceeds the growth rate of the economy. Increased interest rates are reflected quickly in the interest bill because of the short maturity of the debt. Thus, negative surprises tend to feed on themselves. A higher budget deficit might also make it more difficult to obtain external financing, a case that is simulated below. The peso interest bill on the external debt and the peso value of that debt will also be increased by any future depreciation of the exchange rate. A significant depreciation could raise the total debt-GNP ratio and worsen the effects of the average interest rate on the debt exceeding the growth rate in the economy as shown by the above formula.

The average interest rate on the debt could also be raised as an unstable inflation rate pushes real interest rates upward. The fact that the total domestic debt is of short maturity and that a large portion must be refinanced each week makes it difficult to control inflation by controlling the rate of growth of bank reserves. The issue is further complicated by the large losses of the Central Bank that require the National Government to borrow extra amounts and to make deposits in the Central Bank in order to mop up the excess reserves that would otherwise be created by Central Bank losses.

More generally, the fiscal risk facing the Philippines depends on how various economic and other events might affect the growth of the debt-GNP ratio. Various scenarios are analyzed below using the PIDS-NEDA model, but our analysis is limited by a lack of detailed knowledge as to how the budget responds to different economic events. In plotting economic and fiscal strategy, it would be useful to know, in more detail than is now available, how government spending and tax revenues respond to changes in the real growth rate, inflation rate, interest rates, and the unemployment rate.

For example, it is highly desirable to bring down the rate of growth of inflation. But would this worsen or improve the fiscal outlook? On the surface, it appears as though the fiscal outlook would be improved. On the negative side, if tax law remains unchanged, a lowering of inflation would worsen the ratio of tax revenues to GNP, thus reducing the primary surplus, because the tax reforms of the 1980s imply that a one percent reduction in the growth of nominal GNP results in more than a one percent reduction in the growth of tax revenues. But this effect is relatively minor. It should be outweighed by a reduction in the average interest rate paid on the public debt, especially if real interest rates also fall in response to lower inflation. The interest rate effect should show up quickly because of the short maturity of the debt which becomes an advantage under these circumstances.

All of this assumes that the nominal rate of growth of spending could be quickly lowered to reflect the lower inflation rate. The model used in the simulations that follow, however, assumes a different behavioral response on the part of government. As inflation comes down, the government becomes more lenient toward spending. Unless this behavioral response is disciplined, the gains from lowering inflation could be quickly dissipated.

The high and growing interest bill on the debt which creates a fiscal risk for the Philippines also creates a fiscal opportunity. It implies that any improvement in the deficit outlook will be self-reenforcing. For example, a permanent improvement in tax collections of one billion pesos per year implies that at the end of five years, all else equal, the national debt will be five billion pesos lower. Under current conditions, that would be manifested largely by a reduction in the projected domestic debt.

With domestic interest rates in the 19% to 24% range, that implies a saving on the interest bill of ₱0.95 to ₱1.2 billion, not counting the interest that is saved on securities issued to pay interest or any reduction in interest rates that might follow deficit reduction. Hence, any reduction in the permanent deficit soon yields a bonus in interest saving of equal magnitude and that bonus will grow relatively through time.

C. THE ECONOMIC EFFECTS OF THE DEFICIT

The analysis has thus far concentrated on the danger that the Philippines fiscal situation will get out of control and lead to hyperinflation. That risk seems small at the moment, but keeping it small will require much fiscal discipline.

The danger that the fiscal situation will degenerate into hyperinflation was assessed by examining the cash primary deficit, the average interest rate on the debt, and the debt-GNP ratio. A government deficit has other negative effects that are better measured by the concepts used in the national income accounts (NIA). Spending as measured by the NIA does not include net lending or other purchases of existing financial or real assets. There are other minor differences in accounting concepts that need not be described here.

The NIA deficit is primarily important because it measures the impact of the government on national saving and therefore, on national wealth. Anything that reduces the NIA deficit will add to domestic capital formation or lead to less borrowing from abroad. The former will add to the rate of growth of productivity and add to employment, wage rates, and thus, to living standards in the long run. Less borrowing abroad implies that less of domestic production will have to be devoted to servicing the external debt. A higher portion of domestic production can then be used to enhance future domestic living standards.

To the extent that a cash deficit is used to finance public capital formation, its negative effects on national wealth are diminished and the financing of public investment, while adding to the cash deficit, does not add to net national dissaving. Therefore, in the Philippine's national accounts, public investment is not considered as part of the government's NIA deficit.

Judged according to its effects on national saving, general government, including local government units whose impact is small, appears to be quite responsible. Over the period, 1988-90, government dissaving amounted to only 0.8% of GNP. The difference between this and the National Government's deficit over the same period of 2.8% is largely accounted for by public capital investment. This measure of government saving, however, takes no account of the depreciation of public investment, nor does it include the dissaving incurred by various off-budget entities, including the Central Bank.

Although the NIA deficit of the general government appears small, it still absorbed about 10% of total net national saving in the 1988-90 period. In an ideal world, the general government would be adding to rather than subtracting from national saving in a country like the Philippines where government should be doing everything possible to enhance national wealth.

Chapter V

IMPLICATIONS OF UNCHANGED POLICIES AND STRATEGIES

This section attempts to sketch the development of the economy for the next ten years, i.e., 1991-2000. The intention is to see how the economy will perform over this period given recent developments and policy reforms. However, some fortuitous events, such as failure to manage the public debt problem, could occur in the future which would adversely affect the development of the economy. These effects need to be examined closely so that appropriate public debt management strategy could be designed to avoid those fortuitous events.

The PIDS-NEDA model was used to perform such analysis. The model has four major sectors: (1) the real sector; (2) the financial sector; (3) the fiscal sector; and (4) the external sector. It contains 114 behavioral equations and 53 identities. The model has certain limitations. The most glaring, of course, is that the exchange rate is exogenous. Also, the fiscal sector's interest payments are treated as exogenous in the model, thereby weakening the interaction between interest rate, interest payments and budget deficit. In the simulation runs, modifications were adopted to address these limitations. Note that our objective is not to give precise numbers of the key economic variables but rather to examine the directions of their changes given certain assumptions about the future movements of certain variables.

The first section of this chapter discusses the assumptions and the results of the baseline scenario. The second part analyzes the likely impact of certain unfavorable developments on the budget deficit as well as on other key macroeconomic variables.

A. BASELINE SCENARIO

The baseline scenario adopted in this study is similar in several respects to that used in the SDP II (Virata and Associates 1991). In particular, efforts were made to take into consideration recent policy reforms and those that will be implemented in the immediate future that would have a significant impact on the economy. For instance, the assumption on the tariff rates for the next ten years take into account the recently implemented Executive Order 470. The important features of the economic stabilization program being negotiated by the GOP with the IMF are also taken into consideration. It is, however, noted that the current slowdown in the economy is much more severe than was anticipated before. This is clearly reflected in private construction and investments in durable equipment in the first half of 1991. These new developments are expected to produce lower growth rate for the economy for the first few years. Thus, the results here are less optimistic than those obtained in the SDP II report.

The exchange rate is assumed to average by ₱27 per U.S. dollar for 1991. It is expected to depreciate to ₱28.5 per US$1 in 1992 as the economy starts to pick up. A 5% annual depreciation is assumed to occur up to 1995 and 3% annual depreciation thereafter. The interest rate on time deposits is assumed to decline monotonically from 19.66% in 1991 to 14% in 1997 and will remain at this level up to 2000. Reserve requirement on all deposit liabilities will remain at 25% in 1991 and 1992 as the Central Bank tries to stabilize the economy. But a relaxation of monetary policy will start in 1993; hence, the reserve requirement is assumed to decline to 23%. It will further be reduced by the Central Bank in subsequent years until a 16% level is attained in 1998, which will then be maintained until 2000. Net credit to domestic banks is programmed by the Central Bank to increase by 14.2% in 1992 and 15.5% annually thereafter. The rest of the assumptions are presented in **Annex A** to this chapter.

The results of the baseline scenario are shown in **Table 11.** The economy is expected to post a growth rate of only 0.4% in 1991. Election spending and greater investors' confidence after the presidential election will help push the economy up in 1992; thus, a 3.9% growth rate is to be expected. Although the tax effort will remain practically the same during the forecast period, the deficit of the National Government as a percent of GNP tends to decline. The improvement in the deficit exerts less pressure on the capital market. Hence, the Treasury bill rate will monotonically decline from 23.26% in 1991 to 15.87% in 2000. Since the inflation rate will decline to a single digit level beginning in 1992, which is to be expected if the stabilization program of the government succeeds, holders of Treasury bills and time deposits will realize positive returns on their investment. However, small savers who hold savings deposits will still realize a negative real return on their savings.

Imports of goods are projected to grow in 1991 by only 3% as a result of the general slowdown of the economy and the 9% levy imposed on imports to raise additional revenues for the government pending the passage in Congress of the revenue-enhancement program.[7] However, imports are projected to pick up in the subsequent years as the economy recovers. Strong export performance is to be expected starting 1992. The result is an improvement in the current account balance, which will decline from 3.8% of GNP in 1991 to 2.3% in 2000.

The decline in the government budget deficit ratio and the Treasury bill rate creates an environment conducive for investment. The growth in gross capital formation will turn positive in 1992 and will be maintained at more than 10% per year for the subsequent years.

As a whole, the results of the baseline scenario are highly favorable for the Philippine economy in the next ten years.

B. SOME THREATS

The results of the baseline scenario reflecting recent policy reforms suggest little to worry about because the deficit ratio is declining over time. However, there are threats that may undermine the budget deficit, which, in turn, would adversely affect the growth of the economy. We will discuss some of them here.

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[7]This was reduced to 5 percent in August 1991.

Table 11. Baseline Scenario for Public Debt Management

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP (% change)										
Personal Consumption	4.36	5.97	5.75	5.59	5.41	6.02	5.79	6.08	6.27	6.14
Government Consumption	1.60	2.37	5.89	5.41	5.70	6.48	6.10	5.71	5.59	5.94
Gross Domestic Capital Formation	-0.09	8.29	11.96	14.05	13.36	12.36	10.59	10.26	10.56	10.93
Durable Equipment	-1.94	7.05	12.24	14.64	13.88	12.20	10.89	10.72	10.58	10.48
Private Construction	-3.26	5.82	7.88	11.68	11.97	12.43	11.49	11.18	12.17	13.32
Public Construction	-0.11	10.71	13.07	11.87	10.61	10.29	5.24	4.48	5.65	6.76
Exports	6.36	7.09	9.37	9.07	9.52	9.27	8.65	8.61	7.90	7.91
Exports of Goods	4.73	7.96	10.43	10.12	10.69	10.51	9.00	9.10	8.42	8.36
Garments	6.38	7.23	8.96	9.74	10.54	11.13	11.21	11.26	11.69	10.96
Semiconductors	9.23	7.60	9.01	9.10	11.02	9.26	10.30	11.32	9.42	9.34
Coconut products	-1.49	3.21	3.40	3.81	4.27	3.33	2.72	3.59	3.64	3.45
Other agricultural products	1.86	2.87	-6.19	7.60	7.38	6.98	7.08	8.06	6.86	8.79
Other manufactured goods	2.56	9.69	15.30	11.32	10.78	12.00	5.54	6.66	5.97	5.93
Other goods	3.61	9.12	12.92	11.53	11.63	11.37	9.08	8.23	7.49	7.61
Exports of Non-factor Services	12.43	4.08	5.58	5.10	4.92	4.14	7.12	6.44	5.48	5.75
Imports	1.57	11.17	6.67	8.92	10.22	10.95	10.38	10.22	10.54	9.74
Imports of Goods	2.99	10.46	6.64	8.84	10.17	10.93	10.45	10.32	10.66	9.82
Fuel products	4.33	10.10	4.25	7.37	8.82	10.92	8.54	9.29	10.33	9.76
Machinery	1.93	11.53	6.66	11.32	12.70	12.58	11.42	12.06	12.11	10.00
Basic metals	2.85	7.97	6.65	8.51	11.00	11.04	8.90	10.79	10.05	10.12
Cereals	9.57	20.53	6.98	3.49	2.36	2.36	2.33	2.53	2.81	3.10
Chemicals	2.54	11.98	8.39	10.54	12.26	13.59	12.72	11.54	11.96	10.63
Textile yarns	5.35	18.03	12.13	9.85	10.92	15.58	13.42	11.95	12.73	9.79
Other imports	2.49	8.20	6.63	8.29	9.78	10.93	11.16	10.12	10.60	10.41
Imports of Non-factor Services	-25.23	29.83	7.17	10.79	11.35	11.35	8.90	8.21	7.93	8.14
Gross National Product	0.40	3.92	5.65	5.92	5.50	6.10	6.13	6.58	6.94	7.50
Gross Domestic Product	0.52	3.90	5.62	5.91	5.33	6.04	6.04	6.42	6.90	7.36
B. Production (% change)										
Value-added in Agriculture	2.24	3.68	4.32	4.61	3.92	4.05	5.07	5.67	4.92	4.31
Crops	0.62	2.59	3.88	4.53	3.47	3.47	4.54	5.03	4.63	4.55
Livestock and Poultry	5.15	6.17	4.90	4.57	4.61	6.15	7.53	8.02	6.62	5.12
Fishery	3.75	4.16	5.34	5.36	4.73	3.37	3.73	4.78	3.74	2.73
Value-added in Industry	-1.16	4.13	6.80	7.26	6.45	7.91	7.54	7.81	9.07	10.29
Manufacturing	-0.90	3.97	6.19	7.01	6.32	7.83	8.12	8.32	9.47	10.52
Food	-1.15	3.95	4.79	6.13	5.23	5.11	8.22	7.90	7.78	8.28
Semiconductors	3.25	5.28	8.45	8.40	8.90	8.90	9.49	9.71	10.15	9.27
Garments	7.13	5.70	6.41	6.12	6.36	5.28	6.22	9.83	10.59	10.80
Other manufacturing	-2.94	3.37	7.03	7.26	6.76	10.68	8.03	8.10	10.65	12.79
Construction	-3.00	6.49	12.62	11.07	9.47	12.03	7.53	7.63	9.53	11.79
Mining and Quarrying	0.51	2.29	4.32	4.28	4.78	3.66	2.91	2.96	4.16	6.09
Electricity, gas, & water	-1.25	2.03	2.35	2.76	0.88	-0.22	2.51	4.10	4.51	3.54

Value-added in Services	0.75	3.87	5.54	5.67	5.33	5.78	5.39	5.69	6.24	6.63

Table 11 (continued).

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
C. Prices, Employment										
Consumer Price Index (% change)	16.58	8.64	9.43	8.00	9.06	8.03	9.68	10.48	9.08	8.07
Wages of Unskilled Workers (% change)	13.26	7.48	2.94	2.30	3.98	2.35	5.81	6.35	7.00	5.80
Full-time unemployment rate	23.80	25.36	25.97	26.00	26.05	25.94	25.56	24.71	23.90	23.24
D. External Accounts										
Balance of Payments (mil $)	1292.74	1060.25	1887.74	1390.02	1436.94	978.90	1005.71	1089.91	557.01	564.79
Current Account (mil $)	-1745.26	-1775.75	-1648.36	-1724.38	-1747.31	-1983.80	-2070.39	-2136.64	-2762.44	-2951.61
Current Account Ratio	-3.80	-3.44	-2.92	-2.81	-2.61	-2.67	-2.47	-2.23	-2.50	-2.33
E. Monetary Accounts										
Total Liquidity (% change)	13.57	15.11	12.62	14.29	15.24	18.87	17.08	17.61	15.82	13.35
Money Supply (% change)	12.03	14.56	13.77	13.61	13.99	13.62	15.30	16.65	15.71	15.38
90 day T-Bill rate	23.26	21.03	20.01	18.24	17.25	16.58	16.11	15.76	15.78	15.87
F. Fiscal Accounts										
Budget Deficit (mil P)	41810.50	38547.57	46368.36	50424.43	47239.71	58403.13	52725.23	51053.04	34278.34	39248.67
Deficit Ratio	3.27	2.62	2.75	2.62	2.14	2.31	1.80	1.48	0.85	0.84
Revenue Effort	15.93	15.68	15.62	16.04	16.09	15.73	15.64	15.17	15.18	14.76
Tax Effort	14.01	14.05	14.17	14.68	14.82	14.59	14.60	14.23	14.29	13.93
Revenues (% change)	14.60	13.06	14.17	17.18	15.12	11.83	15.48	13.98	16.55	12.76
Taxes (% change)	20.42	16.31	16.64	19.17	16.60	13.16	16.78	14.90	17.44	13.33
G. Other Values										
Nominal GNP	1280220	1471183	1685977	1923946	2208094	2525808	2933615	3446543	4013327	4655797

1. Drop in External Financing of the Deficit

One of the assumptions of the model is that part of the budget deficit will be externally financed (see the variable **EXTFIN** in **Annex A** of this chapter). Suppose that external financing of the budget deficit is cut by 50% in 1991 from ₱23.8 billion to ₱11.9 billion and that this level of financing persisted until 2000. This implies a downward adjustment in the inflow of medium and long term loans (ILTLON). The results of this scenario are shown in **Table 12**. The level of budget deficit will be higher than the baseline scenario. Most of the additional liquidity in the system that will be brought about by the reduction in the reserve requirement will be used up by the National Government. Hence, the Treasury bill rate will be slightly higher than the baseline in most of the years included in the forecast period, negating the downward pressure of reduction of the reserve requirement on interest rate. The decline in the inflation rate relative to the baseline during the first three years will not be sustained. Starting 1993, the GNP will grow at a lower pace than the baseline.

All this suggests that a significant drop in the external financing of the budget deficit could bring instability to the economy.

2. Drop in Tax Effort

One of the major achievements of the Aquino government can be found in the improvement in tax effort from about 10% when it assumed office to about 14% in 1990.[8] It is not hard for the government to become complacent in tax administration, especially with the series of natural calamities that have recently affected the country. The worst case scenario is that tax effort drops again to 10% in 1992 and the next government will be less enthusiastic in improving tax administration and in introducing new tax measures. In reflecting this scenario in the model, tax revenues were exogenized and appropriate decreases were imputed in order to attain a 10% tax effort level beginning 1992. An iterative process was followed until the resulting tax effort approximated 10%. The results of this scenario are shown in **Table 13**.

The level of budget deficit is more than 100% above that of the baseline scenario, and this difference increases over time. The Treasury bill rate will stay at levels higher than the baseline scenario, while inflation rate will accelerate. GNP will grow at a much slower pace than that of the baseline scenario, and the deviation is seen to widen over the years. It is a situation that could ultimately degenerate into hyperinflation, even though that does not occur within the time period analyzed by the model.

[8] Although this is a significant achievement, the tax effort in this country is still much lower than those of neighboring Asian countries.

Table 12. Reduction in External Financing of the Deficit by 50 Percent
Percent deviation from baseline

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP										
Personal Consumption	0.01	0.03	0.02	0.01	0.00	-0.02	-0.04	-0.06	-0.08	-0.10
Government Consumption	0.21	0.38	0.28	0.15	0.07	0.02	-0.01	-0.02	0.02	0.04
Gross Domestic Capital Formation	-0.25	-0.60	-0.75	-0.82	-0.91	-1.04	-1.18	-1.30	-1.45	-1.61
Exports	0.25	0.32	0.04	-0.05	-0.05	-0.04	-0.04	-0.03	-0.02	-0.05
Exports of Goods	0.28	0.37	0.04	-0.06	-0.05	-0.05	-0.04	-0.04	-0.03	-0.06
Imports	-0.13	-0.16	-0.12	-0.13	-0.17	-0.21	-0.25	-0.27	-0.31	-0.35
Imports of Goods	-0.13	-0.17	-0.12	-0.14	-0.18	-0.22	-0.26	-0.28	-0.33	-0.37
Gross National Product	0.14	0.15	-0.04	-0.12	-0.14	-0.14	-0.18	-0.27	-0.25	-0.34
Gross Domestic Product	0.14	0.16	-0.04	-0.11	-0.14	-0.19	-0.24	-0.22	-0.28	-0.34
B. Production										
Value-added in Agriculture	-0.34	-0.40	-0.13	-0.03	-0.01	-0.01	-0.02	0.01	-0.04	-0.02
Value-added in Industry	0.58	0.64	-0.05	-0.24	-0.27	-0.36	-0.43	-0.38	-0.47	-0.55
Value-added in Services	0.11	0.15	0.03	-0.06	-0.12	-0.16	-0.21	-0.24	-0.28	-0.33
C. Prices, Employment										
Consumer Price Index	-0.66	-0.75	-0.02	0.17	0.13	0.10	0.09	0.07	0.03	0.11
Wages of Unskilled Workers	-0.34	-0.49	-0.16	0.04	0.09	0.09	0.09	0.08	0.05	0.10
D. External Accounts										
Balance of Payments	-29.50	3.73	0.89	-10.58	-10.08	-19.70	-24.66	-32.07	-73.26	-89.67
Current Account	2.61	3.80	1.63	1.16	1.90	2.53	3.28	4.00	4.31	4.83
E. Monetary Accounts										
Total Liquidity	-3.72	-0.45	0.62	0.19	0.11	0.01	-0.07	-0.35	-0.25	-0.14
90 day T-Bill rate	-0.34	0.10	0.28	-0.06	0.02	0.02	0.05	0.07	-0.01	0.09
F. Fiscal Accounts										
Budget Deficit	1.49	2.34	0.70	0.33	0.60	0.70	1.21	1.98	3.98	4.27
Revenue Effort	0.20	0.19	-0.07	-0.10	-0.06	-0.07	-0.04	0.01	0.00	-0.01
Tax Effort	0.18	0.17	-0.07	-0.10	-0.07	-0.07	-0.06	0.00	-0.01	-0.03

Table 13. Tax Effort Drop to 10 Percent
Percent deviation from baseline

	1[illegible]	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP										
Personal Consumption	0.00	0.28	0.55	0.82	1.03	1.15	1.18	1.10	0.92	0.61
Government Consumption	0.00	-0.35	-1.04	-1.89	-2.94	-4.11	-5.44	-6.97	-8.70	-10.58
Gross Domestic Capital Formation	0.00	-0.71	-1.09	-1.66	-2.38	-3.28	-4.35	-5.54	-6.93	-8.37
Exports	0.00	-0.43	-1.07	-1.58	-2.17	-2.75	-3.43	-4.27	-5.25	-6.27
Exports of Goods	0.00	-0.50	-1.22	-1.78	-2.43	-3.06	-3.83	-4.77	-5.88	-7.02
Imports	0.00	0.07	0.09	0.11	0.07	-0.05	-0.21	-0.46	-0.80	-1.21
Imports of Goods	0.00	0.07	0.10	0.11	0.06	-0.06	-0.23	-0.50	-0.86	-1.29
Gross National Product	0.00	-0.13	-0.33	-0.53	-0.85	-1.25	-1.88	-2.73	-3.72	-4.87
Gross Domestic Product	0.00	-0.12	-0.33	-0.50	-0.81	-1.28	-1.87	-2.66	-3.67	-4.78
B. Production										
Value-added in Agriculture	-0.01	0.70	1.73	2.88	4.32	5.87	7.59	9.51	11.56	13.52
Value-added in Industry	-0.01	-0.81	-2.01	-3.07	-4.59	-6.33	-8.37	-10.83	-13.52	-15.87
Value-added in Services	0.00	-0.12	-0.34	-0.61	-1.02	-1.57	-2.29	-3.22	-4.36	-5.67
C. Prices, Employment										
Consumer Price Index	0.00	1.15	2.69	3.96	5.44	6.99	8.65	10.67	13.03	15.67
Wages of Unskilled Workers	0.00	0.59	1.66	2.81	4.18	5.81	7.53	9.67	12.10	14.96
D. External Accounts										
Balance of Payments	0.03	-5.92	-8.65	-19.10	-27.72	-55.67	-72.75	-91.66	-237.61	-307.61
Current Account	0.02	-3.54	-9.91	-15.40	-22.79	-27.47	-35.34	-46.75	-47.91	-58.86
E. Monetary Accounts										
Total Liquidity	0.01	6.25	8.33	12.00	15.21	18.03	21.72	25.75	30.49	34.17
90 day T-Bill rate	0.00	3.95	1.10	1.10	0.53	0.09	0.80	0.74	1.91	1.97
F. Fiscal Accounts										
Budget Deficit	0.00	152.09	145.34	168.89	209.79	179.89	227.41	244.01	420.15	368.41
Revenue Effort	0.00	-26.14	-27.25	-29.91	-30.94	-30.27	-30.58	-29.09	-29.67	-28.07
Tax Effort	0.00	-29.09	-29.88	-32.52	-33.41	-32.44	-32.59	-30.87	-31.38	-29.62

3. Increase in Central Bank Losses

Central Bank losses could still increase to unexpected levels, which could be attributed to a particular source or a combination of the sources of Central Bank losses as discussed above. It is assumed here that the unexpected additional losses are fully monetized; that is, the monetary base is increased by a corresponding amount of the loss. To reflect this scenario in the model, the monetary base was exogenized. A ten (10) percent increase in the monetary base, which is the percent increase in CB losses assumed here, over the baseline was then applied. The results are shown in **Table 14.**

Total liquidity will be higher than the baseline by about 10% in all the years, exerting pressure on domestic prices. Thus, inflation rate will increasingly deviate from the baseline scenario. The Treasury bill rate will remain at levels higher than the baseline. The impact of additional CB losses on GNP is decidedly negative. The deviation of the GNP growth rate in this scenario from the baseline widens over time. Interestingly, the budget deficit will fall below the baseline, despite a reduction in tax effort. It seems that the response of the National Government to the monetization of CB losses is to reduce its consumption significantly to partly sterilize the inflationary impact of such policy actions. This may well be an optimistic assumption.

4. Central Bank Losses Offset by Reducing Credit to Domestic Money Banks

The scenario portrayed here is that the Central Bank incurs a loss of P5 billion more than the baseline starting 1992. But to keep the growth of the monetary base the same as the baseline, the impact of the CB losses on the monetary base is fully offset by reducing net credit to the domestic banking sector. The results of this scenario are shown in **Table 15.**

This policy action results in a lower GNP growth than the baseline. What is also worth noting is that the three production sectors, namely agriculture, industry and services, will be adversely affected. On the demand side, gross domestic capital formation which includes government and private construction and investment in durable equipment will also be adversely affected. This explains why GNP will grow slightly slower than in the baseline.

5. Central Bank Losses Offset by Reducing Credit to the Public Sector

The scenario depicted here is that the additional Central Bank loss of P5 billion is offset by reducing net credit to the public sector to maintain the same level of monetary base as in the baseline. The results are shown in **Table 16.**

Budget deficit of the National Government will be lower than the baseline. This seems to show that with the reduction in the financing of its budget deficit, the government will trim

Table 14. Monetary Base Increase Due to CB Losses
Percent deviation from baseline

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP										
Personal Consumption	-0.03	-0.12	-0.22	-0.34	-0.46	-0.59	-0.72	-0.85	-0.98	-1.11
Government Consumption	-0.55	-1.48	-2.21	-2.78	-3.21	-3.56	-3.85	-4.09	-4.29	-4.44
Gross Domestic Capital Formation	-0.38	-1.16	-1.89	-2.53	-3.00	-3.39	-3.67	-3.85	-3.96	-3.99
Exports	-0.66	-1.51	-1.71	-1.79	-1.81	-1.82	-1.86	-1.80	-1.92	-1.93
Exports of Goods	-0.76	-1.74	-1.94	-2.00	-2.00	-2.02	-2.06	-2.11	-2.13	-2.14
Imports	-0.10	-0.33	-0.53	-0.70	-0.82	-0.94	-1.02	-1.10	-1.16	-1.21
Imports of Goods	-0.10	-0.34	-0.56	-0.73	-0.86	-0.98	-1.08	-1.15	-1.22	-1.27
Gross National Product	-0.40	-0.98	-1.25	-1.47	-1.71	-1.90	-2.13	-2.37	-2.51	-2.65
Gross Domestic Product	-0.40	-0.97	-1.24	-1.47	-1.69	-1.94	-2.17	-2.35	-2.52	-2.63
B. Production										
Value-added in Agriculture	0.92	1.99	2.54	2.94	3.27	3.49	3.59	3.62	3.52	3.34
Value-added in Industry	-1.66	-3.68	-4.41	-4.92	-5.40	-5.85	-6.21	-6.40	-6.44	-6.23
Value-added in Services	-0.29	-0.80	-1.20	-1.54	-1.83	-2.10	-2.36	-2.59	-2.78	-2.93
C. Prices, Employment										
Consumer Price Index	1.76	3.69	4.03	4.18	4.24	4.36	4.42	4.52	4.56	4.65
Wages of Unskilled Workers	0.89	2.16	2.87	3.32	3.61	3.94	4.16	4.41	4.56	4.75
D. External Accounts										
Balance of Payments	-4.46	-12.87	-7.80	-10.56	-10.18	-14.93	-15.16	-15.90	-32.40	-34.82
Current Account	-3.30	-7.69	-8.93	-8.51	-8.37	-7.36	-7.37	-8.11	-6.53	-6.66
E. Monetary Accounts										
Total Liquidity	10.08	10.49	10.49	10.21	9.88	9.56	9.20	8.71	8.19	7.61
90 day T-Bill rate	0.67	0.75	0.25	0.54	0.64	0.60	0.60	0.60	0.48	0.49
F. Fiscal Accounts										
Budget Deficit	-3.13	-7.69	-7.59	-7.46	-8.13	-6.77	-7.58	-8.03	-12.17	-10.88
Revenue Effort	-0.66	-1.21	-1.23	-1.27	-1.23	-1.24	-1.21	-1.15	-1.15	-1.15
Tax Effort	-0.62	-1.18	-1.25	-1.31	-1.30	-1.32	-1.29	-1.24	-1.24	-1.24

Table 15. Increase in CB Losses Offset by a Decrease in NCDMB
Percent deviation from baseline

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP										
Personal Consumption	-	-	-	-	-	-	-	-	-	-
Government Consumption	0.00	0.05	0.11	0.12	0.09	0.06	0.02	-0.01	-0.04	-0.05
Gross Domestic Capital Formation	0.00	-0.25	-0.24	-0.19	-0.14	-0.13	-0.12	-0.10	-0.09	-0.08
Exports	0.00	-0.68	0.02	0.02	0.00	-0.01	-0.02	-0.03	-0.03	-0.03
Exports of Goods	0.00	-0.86	0.02	C.02	0.00	-0.01	-0.02	-0.03	-0.04	-0.03
Imports	-	-	-	-	-	-	-	-	-	-
Imports of Goods	-	-	-	-	-	-	-	-	-	-
Gross National Product	0.00	-0.15	-0.02	-0.03	-0.04	0.00	-0.02	-0.06	-0.06	-0.05
Gross Domestic Product	0.00	-0.15	-0.03	-0.03	-0.03	-0.07	-0.08	-0.06	-0.60	-0.06
B. Production										
Value-added in Agriculture	-0.01	-0.18	-0.19	-0.13	-0.09	-0.09	-0.06	-0.01	0.01	0.03
Value-added in Industry	-0.01	-0.14	0.13	0.05	-0.01	-0.10	-0.14	-0.12	-0.12	-0.11
Value-added in Services	0.00	-0.14	-0.05	-0.02	-0.02	-0.03	-0.04	-0.05	-0.0[illegible]	-0.06
C. Prices, Employment										
Consumer Price Index	0.00	-0.16	-0.25	-0.12	-0.03	0.01	0.05	0.08	0.08	0.08
Wages of Unskilled Workers	0.00	-0.08	-0.16	-0.12	-0.06	-0.01	0.03	0.06	0.08	0.08
D. External Accounts										
Balance of Payments	0.03	-7.53	0.70	0.76	0.48	0.83	0.65	0.12	0.02	0.04
Current Account	0.02	-4.50	0.80	0.61	0.40	0.41	0.32	0.06	0.00	0.01
E. Monetary Accounts										
Total Liquidity	0.01	-0.94	-0.44	-0.16	0.00	0.10	0.14	0.13	0.11	0.09
90 day T-Bill rate	0.00	0.77	-0.09	-0.11	-0.20	-0.19	-0.14	-0.10	-0.08	-0.05
F. Fiscal Accounts										
Budget Deficit	0.00	1.09	0.95	0.63	0.42	0.14	0.05	0.00	-0.05	-0.08
Revenue Effort	0.00	0.12	0.10	0.04	0.01	-0.03	-0.03	-0.02	-0.02	-0.02
Tax Effort	0.00	0.11	0.09	0.04	0.01	-0.03	-0.03	-0.02	-0.02	-0.02

Notes: OTHNDA - Other Net Domestic Assets
NCDMB - Net Credit to Domestic Money Banks

Table 16. Increase in CB Losses Offset by a Decrease in MACPS
Percent deviation from baseline

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP										
Personal Consumption	0.00	0.00	-0.01	-0.02	-0.04	-0.05	-0.07	-0.08	-0.10	-0.11
Government Consumption	0.00	0.00	0.00	-0.01	-0.02	-0.04	-0.07	-0.10	-0.12	-0.15
Gross Domestic Capital Formation	0.00	-0.32	-0.53	-0.64	-0.67	-0.67	-0.67	-0.62	-0.58	-0.53
Exports	-	-	-	-	-	-	-	-	-	-
Exports of Goods	-	-	-	-	-	-	-	-	-	-
Imports	-	-	-	-	-	-	-	-	-	-
Imports of Goods	-	-	-	-	-	-	-	-	-	-
Gross National Product	0.00	-0.06	-0.11	-0.14	-0.17	-0.20	-0.18	-0.27	-0.21	-0.25
Gross Domestic Product	0.00	-0.05	-0.09	-0.14	-0.17	-0.20	-0.24	-0.21	-0.25	-0.23
B. Production										
Value-added in Agriculture	-0.01	0.01	0.02	0.02	0.04	0.05	0.03	0.11	0.08	0.10
Value-added in Industry	-0.01	0.12	-0.21	-0.30	-0.37	-0.42	-0.50	-0.44	-0.50	-0.46
Value-added in Services	0.00	-0.03	-0.07	-0.11	-0.15	-0.17	-0.20	-0.21	-0.23	-0.24
C. Prices, Employment										
Consumer Price Index	0.00	0.01	0.02	0.04	0.06	0.09	0.10	0.16	0.16	0.20
Wages of Unskilled Workers	0.00	0.00	0.01	0.02	0.04	0.07	0.09	0.14	0.16	0.19
D. External Accounts										
Balance of Payments	0.03	0.16	0.17	0.42	0.52	0.87	1.38	0.55	2.27	1.68
Current Account	0.02	0.10	0.20	0.34	0.43	0.43	0.67	0.28	0.46	0.32
E. Monetary Accounts										
Total Liquidity	0.01	-0.03	-0.01	0.02	0.06	0.08	0.14	0.12	0.16	0.13
90 day T-Bill rate	0.00	-0.26	0.04	0.07	0.09	0.09	0.06	0.14	0.01	0.08
F. Fiscal Accounts										
Budget Deficit	0.00	-12.78	-10.46	-9.51	-10.06	-8.06	-8.92	-9.12	-13.65	-11.89
Revenue Effort	-	-	-	-	-	-	-	-	-	-
Tax Effort	-	-	-	-	-	-	-	-	-	-

Notes: OTHNDA - Other Net Domestic Assets
MACPS - Net Credit to the Public Sector

its expenditures. Thus, the budget deficit will be lower than the baseline scenario if, in fact, expenditures can be disciplined. In contrast to the result when increases in CB losses were offset by a corresponding reduction in net credit to domestic money banks, this policy action would have a different impact on the three major production sectors. In particular, the industrial and services sectors will obtain lower output than the baseline, whereas agriculture will post higher output. Its negative impact on GNP is much larger than the preceding scenario. The conclusion that can be drawn from the results is that the method of offsetting the impact of Central Bank losses has a differential effects on the economy, in general, and on the production sector, in particular.

Annex A to Chapter V: Public Debt Management Assumptions, 1991 to 2000

		1991	1992	growth rate(%)	1993	growth rate(%)	1994	growth rate(%)	1995	growth rate(%)
A.	External Variables									
	1. Balance of Payments 1/									
ALLSDR	Allocation of SDR	0	0		0		0		0	
ILTLON	Inflow of medium/long term loans	4607	4322	-6.2	4786	10.7	4411	-7.8	3736	-15.3
INCOUT	Income remittances to the rest of the world	321	357	11.2	405	13.4	456	12.6	516	13.2
INCREM	Income remittances from abroad	1380	1590	15.2	1830	15.1	2105	15.0	2420	15.0
INTINC	Investment and interest income	396	452	14.1	511	13.1	563	10.2	604	7.3
ITRANS	Inflow of transfers	745	770	3.4	757	-1.7	825	9.0	898	8.8
MINT	Interest payments	2273	2467	8.5	2634	6.8	2848	8.1	2899	1.8
MNGOLD	Monetization of gold	240	265	10.4	292	10.2	320	9.6	353	10.3
NINDF	Net direct investment	737	632	-14.2	779	23.3	722	-7.3	824	14.1
NSHTRM	Net inflows of short-term capital	172	6	-96.5	129	2050.0	166	28.7	213	28.3
OLTLON	Outflows of medium and long term loans	3027	2577	-14.9	2619	1.6	2536	-3.2	1973	-22.2
OTHINM	Other non-merchandize trade inflows	3307	3436	3.9	3576	4.1	3789	6.0	3976	4.9
OTHONM	Other non-merchandize trade outflows	1072	1187	10.7	1255	5.7	1389	10.7	1550	11.6
REVADJ	Revaluation Adjustment	309	188	-39.2	169	-10.1	31	-81.7	31	0.0
UNREM	Unremitted arrears	0	0		0		0		0	
OTRANS	Outflow of transfers	5	5	0.0	8	60.0	8	0.0	8	0.0
	2. Others									
ER	Exchange rate	27.88	28.5	2.2	29.9	4.9	31.4	5.0	32.97	5.0
GNPUS	Real US GNP 2/	3508.8	3624.6	3.3	3726.1	2.8	3837.9	3.0	3953.0	3.0
MPIF	Dollar import price index for fuel products 2/	719.71	799.6	11.1	839.58	5.0	879.88	4.8	959.95	9.1
MPINF	Dollar import price index for non-fuel products 1/	207.12	215.92	4.3	225.70	4.5	234.96	4.1	244.40	4.0
PXD	Dollar export price growth rate 1/	220.67	229.91	4.2	239.66	4.2	249.32	4.0	256.98	3.1
GNPJAP	Real GNP of Japan 2/	379624	394809	4.0	413365	4.7	432793	4.7	452269	4.5
INDJAP	Index of industrial production of Japan 2/	130.11	135.31	4.0	141.67	4.7	148.33	4.7	155.01	4.5

		1996	growth rate(%)	1997	growth rate(%)	1998	growth rate(%)	1999	growth rate(%)	2000	growth rate(%)
A.	External Variables										
	1. Balance of Payments 1/										
ALLSDR	Allocation of SDR	0		0		0		0		0	
ILTLON	Inflow of medium/long term loans	3341	-10.6	3147	-5.8	2964	-5.8	2694	-9.1	2443	-9.3
INCOUT	Income remittances to the rest of the world	587	13.8	662	12.8	749	13.1	847	13.1	959	13.2
INCREM	Income remittances from abroad	2780	14.9	3197	15.0	3677	15.0	4228	15.0	4862	15.0
INTINC	Investment and interest income	649	7.5	716	10.3	785	9.6	856	9.0	931	8.8
ITRANS	Inflow of transfers	978	8.9	1034	5.7	1097	6.1	1181	7.7	1269	7.5
MINT	Interest payments	3008	3.8	3182	5.8	3351	5.3	3519	5.0	3670	4.3
MNGOLD	Monetization of gold	390	10.5	430	10.3	474	10.2	522	10.1	-	10.2
NINDF	Net direct investment	959	16.4	1010	5.3	1103	9.2	1185	7.4	1310	10.5
NSHTRM	Net inflows of short-term capital	263	23.5	333	26.6	421	26.4	526	24.9	664	26.2
OLTLON	Outflows of medium and long term loans	2013	2.0	1866	-7.3	1758	-5.8	1630	-7.3	1498	-8.1
OTHINM	Other non-merchandize trade inflows	4028	1.3	4191	4.0	4363	4.1	4541	4.1	4728	4.1
OTHONM	Other non-merchandize trade outflows	1744	12.5	1922	10.2	2114	10.0	2347	11.0	2605	11.0
REVADJ	Revaluation Adjustment	22	-29.0	22	0.0	22	0.0	22	0.0	22	0.0
UNREM	Unremitted arrears	0		0		0		0		0	
OTRANS	Outflow of transfers	8	0.0	8	0.0	8	0.0	8	0.0	8	0.0
	2. Others										
ER	Exchange rate	33.96	3.0	34.98	3.0	36.03	3.0	36.39	1.0	36.75	1.0
GNPUS	Real US GNP 2/	4071.6	3.0	4193.8	3.0	4319.6	3.0	4449.2	3.0	4582.7	3.0
MPIF	Dollar import price index for fuel products 2/	1039.6	8.3	1081.2	4.0	1124.4	4.0	1169.4	4.0	1216.2	4.0
MPINF	Dollar import price index for non-fuel products 1/	255.55	4.6	267.3	4.6	279.6	4.6	292.46	4.6	305.92	4.6
PXD	Dollar export price growth rate 1/	266.2	3.6	276.3	3.8	286.5	3.7	296.8	3.6	307.5	3.6
GNPJAP	Real GNP of Japan 2/	472621	4.5	493889	4.5	516114	4.5	539339	4.5	563609	4.5
INDJAP	Index of industrial production of Japan 2/	161.98	4.5	169.27	4.5	176.89	4.5	184.85	4.5	193.17	4.5

Annex A to Chapter V (continued).

		1991	1992	growth rate (%)	1993	growth rate (%)	1994	growth rate (%)	1995	growth rate (%)	1996	growth rate(%)	1997	growth	1998	growth rate (%)	1999	growth rate (%)	2000	growth rate(%)
T1	Average tariff for imports of fuel products	21.8	20	-8.3	19.5	-2.5	19	-2.6	18	-5.3	15	-16.7	15	0.0	15	0.0	15	0.0	15	0.0
T2	Average tariff for imports of elect. supplies, machinery, & transport equipment	18.3	16.7[illegible]	-8.3	16.37	-2.5	15.95	-2.6	15.11	-5.3	12.59	-16.7	12.59	0.0	12.59	0.0	12.59	0.0	12.59	0.0
T3	Average tariff for basic metals	9.81	9	-8.3	8.78	-2.4	8.55	-2.6	8.1	-5.3	6.75	-16.7	6.75	0.0	6.75	0.0	6.75	0.0	6.75	0.0
T4	Average tariff for cereals	12.08	11.08	-8.3	10.8	-2.5	10.53	-2.5	9.97	-5.3	8.31	-16.6	8.31	0.0	8.31	0.0	8.31	0.0	8.31	0.0
T5	Average tariff for chemicals	10.9	10	-8.3	9.75	-2.5	9.5	-2.6	9	-5.3	7.5	-16.7	7.5	0.0	7.5	0.0	7.5	0.0	7.5	0.0
T7	Average tariff for textiles	20.71	19	-8.3	18.52	-2.5	18.05	-2.5	17.1	-5.3	14.25	-16.7	14.25	0.0	14.25	0.0	14.25	0.0	14.25	0.0
B.	Production/Expenditures																			
IINV	Change in stocks	0	200		400	100.0	600	50.0	800	33.3	1000	25.0	1200	20.0	1400	16.7	1600	14.3	1800	12.5
PFEEDS	International price of feeds (maize) 3/	2.85	2.85	0.0	2.85	0.0	2.85	0.0	2.85	0.0	2.85	0.0	2.85	0.0	2.85	0.0	2.85	0.0	2.85	0.0
PPFET	World price of fertilizer 4/	3353.9	3437	2.5	3523	2.5	3611	2.5	3702	2.5	3794	2.5	3889	2.5	3986	[illegible]	4086	2.5	4188	2.5
SFORES	Value-added in forestry	600	600	0.0	600	0.0	600	0.0	600	0.0	600	0.0	600	0.0	600	0.0	600	0.0	600	0.0
PINFO	Implicit price deflator for forestry	2362.9	2599.2	10.0	2859.1	10.0	3145.0	10.0	3459.5	10.0	3805.5	10.0	4186.1	10.0	4604.7	10.0	5065.1	10.0	5571.7	10.0
WLAGRI	Legislated wages for agriculture	77.01	84.711	10.0	88.947	5.0	93.394	5.0	9[illegible].064	5.0	102.96	5.0	108.11	5.0	113.52	5.0	119.19	5.0	125.15	5.0
EXPEGW	Expenditures on electricity, gas, water	28820	31702	10.0	34872	10.0	38359	10.0	42195	10.0	46415	10.0	48736	5.0	51173	5.0	53731	5.0	56418	5.0
XSRUS	Exports of sugar to the US	215	215	0.0	215	0.0	215	0.0	215	0.0	215	0.0	215	0.0	215	0.0	215	0.0	215	0.0
PALHAS	Palay area harvested	3319	3352.2	1.0	3385.7	1.0	3419.6	1.0	3453.7	1.0	3488.3	1.0	3506	0.5	3523	0.5	3541	0.5	3559	0.5
FERTC	Fertilizer consumption	806.74	855.15	6.0	880.8	3.0	907.23	3.0	934.45	3.0	962.48	3.0	991.35	3.0	1021.0	3.0	1051.7	3.0	1083.2	3.0
COCOTR	Number of nut bearing trees	301654	307687	2.0	310764	1.0	313872	1.0	317010	1.0	320180	1.0	321781	0.5	323389	0.5	325007	0.5	326632	0.5
SEEDS	Seed use of palay	304	315	3.6	318.15	1.0	321.33	1.0	324.54	1.0	327.79	1.0	330	0.7	331	0.3	333	0.6	335	0.6
MRR	Milling recovery rate	0.65	0.65	0.0	0.65	0.0	0.65	0.0	0.65	0.0	0.65	0.0	0.65	0.0	0.65	0.0	0.6[illegible]	0.0	0.65	0.0
MRICE	Imports of rice	220	220	0.0	220	0.0	220	0.0	220	0.0	220	0.0	220	0.0	220	0.0	220	0.0	220	0.0
FPCORY	Farm price of yellow corn	4.03	4.03	0.0	4.4	9.2	4.84	10.0	5.32	9.9	5.86	10.2	6.29	7.3	6.6	4.9	6.93	5.0	7.28	5.1
FPCORW	Farm price of white corn	4.04	4.04	0.0	4.5	11.4	4.95	10.0	5.45	10.1	5.99	9.9	62.9	950.1	6.6	-89.5	6.93	5.0	7.28	5.1
INVC	Ending inventory of corn	138.2	138.2	0.0	274	98.3	274	0.0	274	0.0	274	0.0	274	0.0	274	0.0	274	0.0	274	0.0
MCORN	Imports of corn	184.67	184.6	0.0	200	8.3	200	0.0	200	0.0	200	0.0	200	0.0	200	0.0	200	0.0	200	0.0
SUGHAS	Sugar area harvested	262	275	5.0	300	9.1	325	8.3	350	7.7	375	7.1	400	6.7	400	0.0	400	0.0	400	0.0

Annex A to Chapter V (continued).

		1991	1992		1993		1994		1995		1996		1997		1998		1999		2000	
		growth rate (%)		growth rate (%)		growth rate (%)		growth rate (%)		growth rate (%)		growth rate(%)		growth rate(%)		growth rate (%)		growth rate (%)		growth rate(%)
C.	Fiscal Assumptions																			
CAPOUT	Capital expenditures, cash	44564	48380	8.6	63913	32.1	83247	30.3	105558	26.8	131347	24.4	157616	20.0	189140	20.0	226968	20.0	272361	20.0
CAPUTO	Capital expenditures, obligation	51664	74780	44.7	90463	21.0	117231	29.6	145642	24.2	181478	24.6	217774	20.0	261328	20.0	313594	20.0	376313	20.0
NETLEN	Net lending	11110	17561	58.1	23467	33.6	32495	38.5	46370	42.7	66409	43.2	79690	20.0	95629	20.0	114755	20.0	137705	20.0
OPXPO1	Operating expenditures, obligation	91896	61812	-32.7	112093	81.3	111823	-0.2	114777	2.6	113672	-1.0	137202	20.7	145023	5.7	155174	7.0	167743	8.1
OPEXP1	Operating expenditures, cash	105196	110212	4.8	129219	17.2	140463	8.7	142694	1.6	145646	2.1	156424	7.4	164245	5.0	170815	4.0	178672	4.6
EXTFIN	External financing of the deficit	23800	12700	-46.6	11609	-8.6	17151	47.7	17776	3.6	20149	13.3	22970	14.0	27564	20.0	31064	12.7	35724	15.0
INTPAY	Interest payments	84923	93018	9.5	98075	5.4	102773	4.8	107829	4.9	112228	[illegible]	[illegible]	4.9	124908	6.1	131154	5.0	137712	5.0
D.	Others																			
POP	Population 5/	63.38	64.89	2.4	66.31	2.2	67.94	2.5	69.06	1.6	70.65	2.3	71.85	1.7	77.6	8.0	79.07	1.9	80.5	1.8
POP15	Population aged 15 & above but below 65 5/	38832	39974	2.9	41148	2.9	42357	2.9	43579	2.9	44717	2.6	45879	2.6	47027	2.5	48296	2.7	49552	2.6
E.	Financial																			
ITD	Interest on time deposit	19.66	18.8	-4.4	17.5	-6.9	17	-2.9	16	-5.9	15	-6.3	14	-6.7	14	0.0	14	0.0	14	0.0
ISD	Interest on savings deposit	5	5	0.0	5	0.0	5	0.0	5	0.0	5	0.0	5	0.0	5	0.0	5	0.0	5	0.0
RR	Reserve requirement ratio	25	25	0.0	23	-8.0	21	-8.7	20	-4.8	19	-5.0	18	-5.3	16	-11.1	16	0.0	16	0.0
IPN	Interest on promissory notes	15	15	0.0	17	13.3	17	0.0	19	11.8	19	0.0	20	5.3	20	0.0	20	0.0	20	0.0
NCDMB	Net credit to domestic money banks	27117.	30981	14.2	35784	15.5	41330	15.5	47737	15.5	55136	15.5	63682	15.5	73552	15.5	84954	15.5	98121	15.5

1/ Balance of payment projections from the Central Bank as of January 1991
2/ Source: ICSEAD
3/ Average level
4/ Same growth as non-oil price growth rate
5/ Medium assumptions

Chapter VI

ALTERNATIVE APPROACHES TO PUBLIC DEBT MANAGEMENT

A. ECONOMIC ANALYSIS OF CHANGING POLICIES

This section discusses three options for reducing the budget deficit and their impact on the economy by running some simulations. The three options are: (1) reducing the growth of capital expenditures; (2) increasing tax collections; and (3) introducing innovative schemes to reduce interest rate. These are by no means exhaustive since our purpose in this exercise is to demonstrate that some options are more desirable than others from an economic point of view. The baseline scenario was already established in Chapter V. The following discusses results of introducing individually those options as exogenous shocks to the model.

1. Moderate Increase in Capital Expenditures

To deal with the budget deficit, the government may try to improve its revenues or control its expenditures or do both simultaneously. Suppose that the government is already satisfied with its revenue performance as in the baseline, and that it decides to reduce its budget deficit by cutting its expenditures. Given the already tight government expenditure budget, it is assumed that the level of capital expenditures in 1992 will be maintained at the 1991 level, and that it is allowed to grow in nominal terms by only 10% every year thereafter. This yields capital expenditures lower than the baseline. The results of this scenario are shown in **Table 17.**

Indeed, the level of budget deficit will be pared down. It has a positive effect on the Treasury bill rate, which will decline much faster than the baseline, and on inflation rate, which will decelerate faster than that of the baseline scenario. However, GNP will increase at a much lower rate than that of the baseline scenario, except in the last two years of the forecast period. This reflects the slower growth in long-run projection capacity resulting from lower public investment.

2. Increase in Tax Collections

The government is expected to increase further its tax collections through improvement in tax administration and introduction of new tax measures. It is assumed here that such actions will lead to an increase in tax collections by 10% over the baseline.[9] The results of this scenario are shown in **Table 18.**

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[9]The 10 percent increase in tax collections may be attained without introducing new tax measures.

Table 17. Moderate Increase in Capital Expenditures
Percent deviation from baseline

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP										
Personal Consumption	0.00	0.00	0.00	-0.01	-0.04	-0.07	-0.11	-0.12	-0.09	-0.01
Government Consumption	0.00	0.02	0.12	0.33	0.70	1.26	2.05	3.19	4.77	6.93
Gross Domestic Capital Formation	0.00	-0.23	-0.90	-1.80	-2.72	-3.56	-4.11	-4.31	-4.14	-3.66
Exports	0.00	0.03	0.12	0.29	0.54	0.88	1.32	1.92	2.74	3.74
Exports of Goods	0.00	0.03	0.14	0.33	0.61	0.98	1.46	2.13	3.04	4.14
Imports	0.00	-0.01	-0.02	-0.03	-0.03	-0.01	0.04	0.16	0.35	0.63
Imports of Goods	0.00	-0.01	-0.02	-0.03	-0.03	-0.01	0.05	0.17	0.37	0.66
Gross National Product	0.00	-0.02	-0.10	-0.21	-0.29	-0.35	-0.29	-0.05	0.42	1.09
Gross Domestic Product	0.00	-0.02	-0.10	-0.19	-0.30	-0.36	-0.31	-0.08	0.37	1.03
B. Production										
Value-added in Agriculture	0.00	-0.04	-0.17	-0.43	-0.88	-1.53	-2.37	-3.48	-4.90	-6.54
Value-added in Industry	0.00	-0.03	-0.08	-0.08	0.00	0.29	0.91	2.03	3.58	5.42
Value-added in Services	0.00	-0.01	-0.06	-0.11	-0.16	-0.16	-0.05	0.24	0.78	1.59
C. Prices, Employment										
Consumer Price Index	0.00	-0.07	-0.32	-0.78	-1.46	-2.40	-3.57	-5.17	-7.33	-10.11
Wages of Unskilled Workers	0.00	-0.04	-0.18	-0.51	-1.04	-1.85	-2.92	-4.42	-6.44	-9.14
D. External Accounts										
Balance of Payments	0.00	0.40	1.12	3.86	7.64	19.66	30.49	44.34	131.97	193.94
Current Account	0.00	0.24	1.28	3.11	6.28	9.70	14.81	22.62	26.61	37.11
E. Monetary Accounts										
Total Liquidity	0.00	-0.41	-1.47	-3.03	-5.00	-7.35	-10.12	-13.91	-18.30	-23.57
90 day T-Bill rate	0.00	-0.23	-0.69	-0.82	-0.77	-0.78	-0.68	-0.99	-1.65	-2.34
F. Fiscal Accounts										
Budget Deficit	0.00	-9.61	-30.93	-55.24	-91.72	-104.51	-147.70	-192.14	-356.75	-384.99
Revenue Effort	0.00	0.04	0.19	0.50	0.90	1.44	2.11	2.94	4.15	5.71
Tax Effort	0.00	0.04	0.18	0.48	0.88	1.43	2.10	2.95	4.19	5.77

Table 18. Tax Collections Increase by 10 Percent
Percent deviation from baseline

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP										
Personal Consumption	0.00	-0.10	-0.20	-0.29	-0.36	-0.41	-0.44	-0.44	-0.39	-0.31
Government Consumption	0.00	0.12	0.38	0.69	1.08	1.54	2.11	2.82	3.73	4.84
Gross Domestic Capital Formation	0.00	0.25	0.40	0.61	0.90	1.26	1.67	2.20	2.85	3.61
Exports	0.00	0.15	0.38	0.55	0.75	0.97	1.23	1.58	2.01	2.50
Exports of Goods	0.00	0.18	0.43	0.62	0.83	1.07	1.37	1.75	2.24	2.78
Imports	0.00	-0.02	-0.03	-0.03	-0.01	0.02	0.08	0.19	0.32	0.51
Imports of Goods	0.00	-0.03	-0.03	-0.03	-0.01	0.03	0.09	0.20	0.35	0.54
Gross National Product	0.00	0.04	0.10	0.16	0.27	0.47	0.73	1.02	1.48	1.97
Gross Domestic Product	0.00	0.04	0.12	0.19	0.32	0.47	0.66	1.00	1.41	1.94
B. Production										
Value-added in Agriculture	-0.01	-0.25	-0.60	-0.97	-1.42	-1.98	-2.62	-3.28	-4.07	-4.83
Value-added in Industry	-0.01	0.28	0.71	1.09	1.62	2.19	2.87	3.85	4.91	6.01
Value-added in Services	0.00	0.04	0.12	0.22	0.37	0.57	0.84	1.21	1.70	2.30
C. Prices, Employment										
Consumer Price Index	0.00	-0.40	-0.96	-1.40	-1.91	-2.52	-3.19	-4.07	-5.21	-6.55
Wages of Unskilled Workers	0.00	-0.21	-0.59	-0.99	-1.47	-2.08	-2.76	-3.65	-4.77	6.15
D. External Accounts										
Balance of Payments	0.03	2.09	3.04	6.52	9.26	19.24	25.90	32.98	88.88	118.60
Current Account	0.02	1.25	3.48	5.26	7.62	9.50	12.58	16.82	17.92	22.69
E. Monetary Accounts										
Total Liquidity	0.01	-2.18	-2.93	-4.08	-5.15	-6.17	-7.44	-9.19	-11.07	-13.11
90 day T-Bill rate	0.00	-1.39	-0.40	-0.26	-0.24	-0.31	-0.44	-0.56	-0.98	-1.20
F. Fiscal Accounts										
Budget Deficit	0.00	-53.55	-51.38	-55.73	-68.81	-62.58	-80.42	-94.84	-164.88	-162.26
Revenue Effort	0.00	9.33	9.96	10.43	10.92	11.42	11.94	12.65	13.49	14.52
Tax Effort	0.00	10.38	10.92	11.33	11.78	12.24	12.72	13.41	14.24	15.29

Tax effort will considerably improve, resulting in a large reduction in the budget deficit. As expected, the Treasury bill rate will decelerate at a much faster pace than the baseline. Inflation rate will also post at levels below the baseline.

Increase in tax collections will have a favorable effect on the general economy. As can be seen from **Table 18**, GNP will post a higher growth rate than the baseline.

3. Interest Rate Reduction

Several means of reducing domestic interest rate have been discussed above. This has an important impact on the budget deficit since as pointed out above, interest expenses comprise a significant portion of the debt service burden. Clearly, a decline in interest rate will have a beneficial impact on the budget deficit.

This scenario is reflected in the model by exogenizing the Treasury bill rate. It was decreased by one percentage point from 1993 to 1995 and by two percentage points thereafter. To establish the linkage between interest payments and interest rate, we regressed the former on the latter. The results revealed that interest payments decrease by ₱1,440 million for every one percentage point decrease in the Treasury bill rate.[10] On the basis of this result, interest payments in the model were adjusted accordingly. The results of this scenario are shown in **Table 19**.

Although there is no improvement in tax effort, interest rate reduction will lead to a reduction in the budget deficit relative to the baseline. Note that the deviation of the budget deficit in this scenario from the baseline widens over time, suggesting an increasingly positive feedback effect of interest rate reduction on interest payments and the budget deficit. The inflation rate will slightly improve over that of the baseline. The effect of this development on GNP is positive and quantitatively similar to that of increasing tax collections.

The results discussed above strongly suggest that reducing the budget deficit by cutting government capital expenditures, has a serious negative effect on the economy. On the other hand, increasing tax collections brings beneficial effects to the economy. One option that bears directly on the budget deficit and at the same time contributes to the improvement in the economy is interest rate reduction.

B. DIRECT MANAGEMENT OF THE DOMESTIC PUBLIC DEBT

1. Background

Because interest costs are a major part of the budget problem in the Philippines, any reduction of the debt servicing costs effectively reduces the size of the public sector deficit and

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[10]This amount is very close to the rule of thumb that NEDA uses for its forecasting exercises.

Table 19. Reduce Treasury Bill by 1 Percent
Percent deviation from baseline

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP										
Personal Consumption	0.00	0.00	0.09	0.18	0.27	0.43	0.59	0.74	0.88	1.02
Government Consumption	0.00	0.00	0.03	0.09	0.16	0.29	0.47	0.68	0.93	1.18
Gross Domestic Capital Formation	0.00	0.00	0.67	1.10	1.34	1.95	2.35	2.65	2.81	2.91
Exports	0.00	0.00	0.04	0.10	0.14	0.23	0.34	0.44	0.55	0.65
Exports of Goods	0.00	0.00	0.05	0.11	0.15	0.26	0.38	0.49	0.62	0.72
Imports	0.00	0.00	0.07	0.16	0.23	0.35	0.46	0.59	0.68	0.78
Imports of Goods	0.00	0.00	0.07	0.16	0.24	0.36	0.48	0.62	0.71	0.81
Gross National Product	0.00	0.00	0.15	0.30	0.46	0.72	1.01	1.18	1.45	1.60
Gross Domestic Product	0.00	0.00	0.15	0.32	0.46	0.72	0.95	1.23	1.41	1.60
B. Production										
Value-added in Agriculture	-0.01	0.00	0.01	0.03	0.01	-0.03	-0.13	-0.15	-0.28	-0.31
Value-added in Industry	-0.01	0.00	0.30	0.61	0.85	1.35	1.79	2.29	2.59	2.85
Value-added in Services	0.00	0.00	0.13	0.28	0.42	0.67	0.92	1.18	1.41	1.61
C. Prices, Employment										
Consumer Price Index	0.00	0.00	-0.10	-0.23	-0.33	-0.57	-0.85	-1.08	-1.38	-1.62
Wages of Unskilled Workers	0.00	0.00	-0.05	-0.15	-0.24	-0.44	-0.69	-0.94	-1.24	-1.52
D. External Accounts										
Balance of Payments	0.03	0.01	-0.33	-1.06	-1.67	-3.79	-4.40	-5.83	-12.11	-13.97
Current Account	0.02	0.01	-0.38	-0.85	-1.37	-1.87	-2.14	-2.98	-2.44	-2.67
E. Monetary Accounts										
Total Liquidity	0.01	0.00	-0.46	-0.57	-0.73	-1.36	-1.55	-1.99	-2.16	-2.36
90 day T-Bill rate	0.00	0.00	-5.00	-5.48	-5.80	-12.06	-12.41	-12.69	-12.67	-12.60
F. Fiscal Accounts										
Budget Deficit	-0.01	0.00	-3.38	-3.34	-3.93	-6.04	-7.12	-7.65	-11.82	-10.54
Revenue Effort	0.00	0.00	-0.01	0.00	-0.01	0.00	0.02	0.09	0.11	0.19
Tax Effort	0.00	0.00	0.00	0.01	0.00	0.02	0.04	0.12	0.15	0.24

also reduces the required amount of new issues of internal debt as the refinancing needs are smaller. On the other hand, any success in limiting the fiscal deficit and reducing inflation, will yield a very large reward in reducing nominal interest rates and the interest bill.

Further complicating the management of the huge public internal debt is the fact that recent deficits have been largely financed by issuing short term Treasury Bills. Seventy-six percent (₱225 billion) of the internal debt represents short term instruments. The short term nature of the debt stock means that the National Government has to refinance most of the internal debt within a year, exerting strong pressures on a domestic financial market which is thin to begin with. This may also contribute to slightly higher interest rates, as this is a buyers market due to the constant and growing need to refinance.

The difficulty of managing the public debt may be mitigated by increasing the average maturity of the public sector debt, by reducing the interest rate paid to the holders of government securities and foreign loans, and by improving the efficiency of the primary and secondary markets for debt issues.

2. Change Composition of Debt

Inflationary pressures and the expectation of a sizable devaluation of the peso have contributed to the concentration of financial transactions in the short term segment of the market. There are other factors limiting the development of the capital markets in the Philippines.[11] However, inflation is by far the most pervasive factor restraining the development of capital markets. A steady reduction of the inflation rate would, inter alia, facilitate the issuance of longer term financial instruments not only by the public sector but also by private companies.

The National Government has managed to sell some securities with maturities beyond one year. Medium and long-term securities outstanding as of June 1991, totalled ₱71.8 billion or 24% of the public sector internal debt. More than half (₱37.2 billion) of these longer-term instruments were sold to the social security system and other public entities.

In the third quarter of 1991, the National Government floated a maiden issue of three-year Floating Rate Treasury Notes (FRTNs), which pay interest rates that are adjusted quarterly on the basis of the average of two preceding 91-day T-Bills. By expanding the medium-term segment of the public sector security market, it is expected that short-term rates on government securities will be lowered. Such longer-term securities have not been popular in the past, but demand has increased recently, perhaps indicating growing optimism that inflation can be kept under control.

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[11]In 1987, Terrence, Reilly Curtis, Malet-Prevost, Cole and Mosle completed a study entitled Report and Recommendations on Developing the Capital Markets in the Philippines, which identifies an extensive list of distorting and inappropriate policy and regulatory phenomena affecting the efficient allocation of resources.

The Central Bank and the Department of Finance should consider adjusting the conditions of the FRTNs and the mix of securities offered to primary dealers in order to take advantage of the changing liquidity of the security market. However, the government believes that frequent changes in the features of FRTNs are undesirable, because it takes time for buyers to become informed about and accept a given set of terms. Nevertheless, if, over time, a growing volume of longer-term issues are not accepted by the market, there may be a strong argument for experimenting with slightly more generous terms.

Currently, the Central Bank is giving high priority to developing a stable market for bonds with 3-year maturities. However, in the longer run, they should consider the issuance of bonds with various maturities to appeal to the tastes of different types of investors.

The costs of selling long-term securities in smaller denominations should be studied. Small savers and non-institutional investors may take advantage of the security offered by long-term notes. If correctly structured and marketed, small savers may prove to be a surprising source of demand.

The computerization of the auction process, which may be assisted by the World Bank, would provide the opportunity to carefully analyze market conditions and may make it easier to exploit changes in those conditions.

The issuance of "indexed" long-term securities might be considered in marketing plans as another option. However, using short-term interest rates as an indirect way of compensating inflation losses on the principal invested as in the existing 3-year FRTNs is more practical because inflation figures are not always available on a timely basis. Moreover, inflation rates are usually difficult to measure using an objective indicator. Therefore, indexed securities should not be considered until inflation is a good deal lower. With lower inflation, measurement problems are much less serious.

At the end of 1990, the Central Bank was holding 3.3% of the securities issued by the National Government while deposit money banks held 21.6%. Domestic non-bank holders held 74% while foreign non-bank holders held 1%. This demand pattern will likely continue in the future. Assuming that the bulk of the 74% held by domestic non-bank holders are related to the demands of private corporations and individuals, the success of the marketing of longer-term securities requires that they offer an adequate real interest rate. There is no other way to meet the budgeted sales targets.

Limits on the ability to borrow abroad, which in the Philippine case are likely to be present for the next few years, represent a real obstacle to any attempt to change the composition of the public sector debt in any significant way. Changes in the composition of the debt stock will be determined by the path followed by the public sector internal deficit. If the fiscal deficit continues growing, then there is no alternative but to continue selling increasing amounts of government securities. However, if the stabilization program succeeds in reducing the fiscal deficit, then the stock of internal debt will be reduced and refinancing needs will ultimately be lower.

In addition to selling larger amounts of longer term securities, there is another area that offers some potential in providing additional financial resources to the government and the financial system. According to an initial assessment of the market situation, it has been determined that small savers have limited access and inadequate incentives to hold larger amounts of financial assets. Savings accounts are one of the most popular financial assets among small savers, because transactions costs are low and the minimum opening deposit and the minimum incremental deposit required are within the saving capacity of a small saver.

Nominal interest rates on savings accounts are very low, 5%, and real interest rates are negative given the on-going inflation. Government securities offering lower credit risks than private sector securities and paying competitive interest rates should generate a strong demand by small savers. In addition to small denominations, the new securities must have transaction costs similar to a savings account. Otherwise net financial yields may not be as good as the nominal rate would indicate.

Further analysis is needed to prepare an action plan geared to improve the access of small savers to high-yielding securities. Some of the tasks to be included in the action plan are:

a. Identify and assess the pros and cons of each recommended instrument and marketing strategy. Simple instruments should be investigated. Complex marketing features that complicate the calculation of the financial yields, such as lottery schemes, are unlikely to be desirable. The initial list of instruments should include: savings bonds, trust units and "savings clubs". The latter mechanism deserves some explanation. A special savings account is established at a public sector financial institution, earning the standard interest rate on savings accounts ar the beginning. As the balance of the account increases so does the interest rate. When the balance reaches an amount equal to the smallest denomination of a government security issued for small savers, then the proceeds of the account are used to but the security. This is the financial equivalent of the lay away system widely used by small stores and itinerant sellers of clothing and jewelry in Central America. The purpose is to facilitate the saving of small savers that do not possess the resources to save using traditional methods.

b. Evaluate the costs and benefits of alternative marketing strategies. An intensive marketing program would probably be necessary.

c. Study the legal, institutional and regulatory changes required to smoothly implement each alternative instrument and marketing strategy.

In considering the possibility of selling government securities to small savers, it is, of course, important to carefully study the administrative costs of the effort. It is possible that those costs would be so high as to make the initiative impractical.

3. Reduce Cost of Debt

The second component for improving the management of the public sector debt is to reduce the size of the interest bill. A one percent reduction of the interest rate paid to foreign commercial banks, would reduce the National Government deficit by ₱3 billion or 6.5% of the 1990 deficit. The US prime rate has fallen 2.5% in the last twelve months and the Eurodollar rates have fallen almost 3% in the same period, producing significant savings on the cost of commercial bank debt. A one percent fall in the Treasury bill rate would reduce the fiscal deficit by ₱1.4 billion or 3% of the 1990 deficit[12]. The saved amount is not large enough to significantly contribute to solving the cash shortage of the National Government, but together with other positive corrective measures may contribute to changing the direction of the government's cash flows.

4. Improve Marketing of Government Securities

Weekly auctions that take place every Friday at the Central Bank provide the main marketing channel for selling government securities. The Central Bank is the financial agent of the government. It has been showing more flexibility in adapting the auction mechanism to market trends. However, some improvements are possible that would enhance the competitive nature of the auction method. The Central Bank and the Department of Finance should experiment with changes in current auctions and even try other auction methods that offer primary dealers fewer opportunities for manipulation. The combined goal of a good auction method is to achieve an optimal balance between investor protection and avoidance of market disturbance while at the same time minimizing undue increases of the interest rates paid on government securities. Continuing the fine tuning of the system, the Central Bank will increase the number of primary dealers by a small percentage in coming months.

In response to market trends, the maturity mix of the weekly ₱7.5 billion offering has been changed to ₱3 billion for 91-day Treasury bills, ₱2.5 billion for 182-day Treasury bills and ₱2 billion for 364-day Treasury bills. This is the fourth time that the offering mix was fine tuned to respond to demand shifts in 1991. The first time occurred in January when the 63-day Treasury bills were introduced. The second modification was in April with the phase-out of the 63-day Treasury bills and a new ₱2.5 billion, ₱3 billion and ₱2.5 billion mix. The third change occurred in July when the offering amount of ₱8 billion was reduced to ₱7.5 billion and the mix was changed to ₱3, ₱2.5 and ₱2 billion. The fourth modification occurred in August when the maturity mix was again changed to ₱3.5, ₱2.5 and ₱2 billion. The National Government issued a total of ₱298.5 billion securities in the first three quarters of 1991. The weighted average yield on securities issued in the third quarter dropped to 20.9% from 21.3% the previous quarter. The downward path of interest rates is expected to continue in the fourth quarter as maturing volumes remain higher than the regular offering of ₱7.5 billion.

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[12]See Section A of Chapter VI.

Gross issuances during the third quarter amounted to ₱125 billion, ₱32.3 billion short of the second quarter gross issuances of ₱157.3 billion. Redemptions of matured securities totaled ₱114.6 billion, slightly below the ₱115.1 billion redeemed in the second quarter. As a result, net sales amounted to ₱10.4 billion or ₱31.8 billion lower than the previous quarter's ₱42.2 billion. The strong demand for government securities in the third quarter lowered the interest cost on newly issued Treasury Bills.

Another interesting way to look at the strong demand enjoyed in the third quarter is to see what happened to the volumes of rejected bids. During our visit to the Philippines in October 1991, the volumes of rejected bids grew during four consecutive weeks. Unusual amounts of tenders flooded the auction office at the Central Bank building. The first significant overflow occurred during the 27 September 1991 auction, when ₱12.4 billion (65% more than the regular ₱7.5 billion offering) worth of bids were received. In the following auction (October 4, 1991) tenders reached an all-time record of ₱21.5 billion or 186% in excess bids. Breaking the previous week's record, some ₱27.5 billion worth of tenders were received during the October 11 auction, meaning that rejected bids totaled ₱20 billion or 276% of the regular ₱7.5 billion offering. The oversubscription for 182-day Treasury bills was so large, 600%, that the Central Bank sold an additional amount of ₱750 million of those maturities. This strong showing may lead to yet another change in the maturity mix, by increasing the offered amount of 182-day Treasury bills and reducing the other maturities' volumes. Final figures were not ready for the auction of 18 October 1991 which we attended, but the oversubscription was also significant.

For the third time in a row, interest rates declined at the 11 October 1991 auction. The composite weighted average rate dropped to 22.459% from the previous week level of 22.807%, or a 35 basis point slippage. Because of a stronger demand, the 182-day Treasury bills cost was reduced by 59.7 basis points to 23.262% followed by a reduction of 56.2 basis points for the 364-day Treasury bills which settled at 24.294%. The 91-day Treasury bills enjoyed the smallest cost reduction, as the average yield dropped to 21.845% or just a 14.5 basis point decrease.

Recently, when auctions are oversubscribed additional securities have been sold through a "tap facility." Dealers whose demands are not satisfied at the weekly auction are allowed to buy additional securities in the following week on Monday, Tuesday, and Thursday. They pay the highest price (receive the lowest interest rate) bid at the previous auction.

The Central Bank's current auction method first satisfies non-competitive bids. If these are not sufficient to absorb 30% of the issue the excess is sold using competitive bidding. Starting at the highest price, the Central Bank accepts the highest bids and, working down the list, the bank continues the assignment process until all of each particular maturity is sold. This method is preferred by the Department of Finance because it sells securities at the highest submitted prices and thus, provides the largest amount of cash to the National Government.

The predictability of the way prices are set is as important as the auction method used, because predictable price setting rules provide more opportunities to overbid and collude. The Central Bank should consider using different price setting systems on a regular basis. When the dispersion of tendered prices is wider than usual, say a difference of more than 4% between the highest and lowest prices, the managing committee could decide to use a "Dutch auction". This method is one price method that critics of US Treasury auctions say would promote lower interest rates and eliminate the incentive to overbid and collude. The assignment process is completely the opposite of the current one. It starts with the lowest price and works up the list until the issue is sold at the lowest price to all bidders. At a particular auction, the cash value of the auction would be lower than the one that could have resulted if the traditional auction method was used. Conversely, the composite average interest rate would be higher, which is not the outcome we are looking for. However, this is only an undesirable short-term effect. In the long run, as manipulative dealers really want to meet the demand of their customers, they will tend to bid within a narrower range of prices. Those bidders will tend to avoid extreme high and low prices, because they will not be sure which method is going to be used at the time of the auction.

When the demand is strong, the average price will tend to fall in the higher area of the possible range of prices; then, it would make more sense to use the Dutch auction method. When the demand is weak, the average price will tend to fall in the lower area of the possible range of prices; then it would make more sense to increase the non-competitive portion of the regular auction to more than the standard 30%. In the end, the changing use of the different alternatives would provide lower interest rates.

Dealers strongly object to any changes in the auction process. This may indicate that they have become too comfortable with the current approach.

Our major recommendations are listed below:

a. Increase the number of primary dealers beyond the small increase planned now. The larger number of dealers should be attained without significantly reducing the quality of the dealers. This subject will be expanded in the next section.

b. The market shares of the few largest dealers warrant a further analysis of the market, to find out if regulatory and legal measures are promoting the concentration of the market.

c. Automated bidding which has been planned for some time now and as noted previously may be assisted by the World Bank. It should be implemented as soon as possible. Computer screens would replace the current system of scrawled bids for billion of pesos of securities. Computerized trading would provide quick order-verification and make possible easier detection of violations. Moreover, it would allow the improvement of the timeliness and sophistication of reports used by the Government Securities Department of the Central Bank and the managing committee of the security auctions. An improved MIS is crucial to a more effective management of the auctions.

d. The improved MIS would allow the quick detection of bidding violations and may even help to prevent them with an improved analysis of the primary dealers' behavior. Violations, including unauthorized trades and excessive mark-ups, should be quickly dealt with and the fines and penalties should be revised. Violations should be widely exposed to the general public and the community of primary dealers.

e. Predictable price setting rules provide more opportunities to overbid and collude. The auction method in use in the Philippines produces the highest amount of cash for the National Government, and in theory should produce the lowest interest rates. Given the huge amount of securities sold every week and the volume of profits related to small price changes, it is more than likely that some overbidding and collusion takes place. The Central Bank should use different auction methods, depending upon the results of prior auctions and the strength of the demand at a specific auction session. The non-competitive portion of the auction should also be adjusted more frequently and more widely.

Eventually, the intelligent use of different auction methods, more sophisticated and better managing reports and timely changed of key elements of the offerings would provide lower interest rates.

Of course, a reduction in the inflation rate would reduce the financial costs of the National Government internal debt more than any of the initiatives discussed above. Nominal interest rates would be drastically reduced if inflation rates could be lowered to the single digit range. Real interest rates would also likely fall.

5. Improve the Efficiency of the Primary and Secondary Markets

The current domestic dealer network was established in 1985. Currently, the primary dealer network consists of 20 banks and four investment houses. The list of banks includes: Bank of the Philippine Islands, Bank of China, Citibank, Equitable, Interbank, Land Bank, Metrobank, PB Commercial, PCIB, PNB, Solidbank, Union Bank, UCPB, Urban Bank, Prudential, Banco de Oro, Standard Chartered, City Trust, RCBC and the Development Bank of the Philippines. The four investment houses are: Anscor, FEB Investment, Multinational and PCCI.

The criteria for accreditation and evaluating the performance of dealers has been changed frequently in the past.

Based on the performance criteria, dealers are awarded numerical ratings which are then converted using a rating system based on letters. In a recent evaluation, 22% of the dealers were rated VS (the highest rating), 22% obtained a AA rating and 56% were rated A. A rating lower than A calls for the cancellation of a dealership's accreditation.

The rating system does not subtract points for minor violations of the bidding process. This may be a change that should be implemented as part of on-going revision of the system.

In the previous section, we recommended some changes aimed at reducing the interest rates paid on government securities. These measures would also improve the efficiency of the primary and secondary markets for government securities.

There have been no major problems related to the government security market in the Philippines, such as those that emerged in the Solomon Brothers scandal in the United States. However, the Philippine security market might be improved by letting more dealers transact in the government security market and by strengthening the dealers that capture the smaller market shares. Any expansion must, of course, be done carefully to insure that the average quality of the dealers can be maintained.

An analysis of the regulatory and legal environment with the goal of reducing the concentration of the market should be placed high on the agenda of the National Government because of the urgent need to reduce the fiscal deficit. Computerized bidding, improved managing reports and some experimentation on the auction floor itself would effectively modernize the market. The Central Bank and the Department of Finance are already implementing some of these changes. What is recommended here is to quicken the pace of reform and to expand the number of areas to be covered.

Chapter VII

RECOMMENDATIONS

A. OBJECTIVES

Although the fiscal situation of the Philippines is not now alarming, judged solely by the balance of revenues and outlays, the country faces numerous risks that have been elaborated above. It is important to lower those risks by improving the deficit outlook further. One of the most important risks is that of accelerating inflation. An improved deficit outlook would improve this risk as would organizational changes that clarify the roles of the National Government and the Central Bank.

A reduction in the debt servicing burden could make an important contribution to improving the deficit outlook. The Philippines has been and is currently engaged in a series of negotiations that are reducing the burden of servicing its external public debt. It should also consider options that hold the promise of reducing the average interest rate paid on its domestic debt.

B. RECOMMENDATIONS

1. General

The Philippines must strive mightily to improve its deficit outlook further. In examining the spending side of the budget, it is, however, important to avoid cuts in public capital investments. Our simulation results suggest that this could significantly slow the economy's rate of growth of productive capacity.

On the tax side, efforts should concentrate on collecting the revenues due under current law. Although we have not been able to conduct a careful review of tax administration, it is clear that there is much room for improvement.

There is an intimate relationship between the rate of inflation and the fiscal outlook. The large amounts of Treasury securities that must be issued each week create a temptation to monetize a considerable portion of the debt. This temptation must be resisted at all cost. Conversely, increases in the rate of inflation are likely to worsen the fiscal outlook by increasing the interest bill unless they inspire more discipline over spending as is suggested by one of our simulations. Greater control over inflation would, however, be very likely to lower real interest rates, a phenomenon that is not picked up by our model. The high and uncertain rate of inflation also makes it more costly for the government to issue longer-term bonds and so is indirectly responsible for the very large portion of the debt that must be refinanced each week.

2. Lowering the Interest Burden on the Domestic Debt

The management of the domestic debt can be made less difficult by improving primary and secondary markets, by lengthening the maturity of the debt, and by tapping small savers.

Primary and secondary markets can be improved by:

a. increasing the number of primary dealers to a greater extent than planned currently. In increasing the number of dealers, it is, however, important to be cautious and to avoid diluting the average quality of the dealers.

b. regulations and laws should be examined carefully with the goal of finding reforms that would strengthen the position of weaker dealers and so intensify competition.

c. computerized bidding should be implemented as quickly as possible. This would have the by-product of providing valuable information to government officials that would aid in improving the management and supervision of auctions.

d. the Central Bank should experiment with different auction techniques and frequently change the rules depending on the strength of demand. This would reduce the possibility of collusion and reduce the ability of dealers to game auctions.

The maturity of the debt can be lengthened in the longer run by offering more generous terms on long-term securities and by providing a greater variety of such instruments. Longer-term securities should provide an adjustable interest rate based on rates short-term securities plus a premium. The premium can be minimized by shortening the adjustment period as much as feasible. In the first instance, this would raise the average interest rate on the debt, but in the longer run, it should make it easier to control the inflation rate by reducing the volume of refinancing. That, in turn, would lower nominal and real interest rates. In the longer run, maturities of 2, 3, 4, and 5 years should be offered in order to appeal to the differing tastes of various investors. The Central Bank should take advantage of periods of strong demand to raise the ratio of the long to short-term securities that are offered.

The issuance of smaller denomination securities should be considered to appeal to small savers. More work needs to be done in assessing the administrative costs of lowering the denomination and on other techniques for attracting small savers to government securities. The feasibility of savings bonds, savings clubs, and unit trusts should all be explored.

3. Institutional Changes

The National Government should take over the assets and liabilities of the Central Bank that arose from subsidized lending. The profitability of the Central Bank would be restored and it could be given somewhat more independence in the management of monetary policy, which would become much simpler. Greater budgetary control would also be established over subsidized lending.

There are a variety of approaches that could be followed to accomplish these goals. The liabilities could be taken over and managed by the Ministry of Finance, but we see considerable merit in establishing an independent public corporation for this purpose. It could be charged with collecting those debts that are collectible and developing a plan for writing off those that are not and amortizing the associated liabilities. It would go out of business when this task is completed.

4. Further Research

Analysis of the desirability of different fiscal strategies and the assessment of the risks inherent in current policies is inhibited by a lack of knowledge of how various economic events might automatically affect outlays and receipts. The PIDS-NEDA model used in this analysis provides crude information, but much more detailed knowledge would be highly useful.

For example, it would be useful to have a computerized data base that contains detailed information on the maturity and interest rate paid on different past issues of public debt. This can be used to analyze the effects on the interest bill of changing short and long interest rates or of issuing different compositions of new debt. Similarly, the effects of a changing unemployment rate on social security and other expenditures could be analyzed.

A fiscal submodel with more comprehensive and detailed specification than what is presently contained in the existing PIDS-NEDA model is desirable. Interest payments, the single biggest item in the national budget, has to be adequately specified in the proposed fiscal submodel. It should also be able to predict the effect of full integration of the tax on interest income in the income tax system and the immediate or gradual phase out of the gross receipts tax on bank transactions.

As noted above, research on different devices for making government securities available to the small saver could open a new market for government debt. It is probably advisable to go further and to investigate the effects of such a policy on the behavior of commercial banks and other providers of savings accounts.

Currently, the small saver receives highly negative real interest rates on savings deposits. Government competition might result in a considerable increase in such rates. On the other hand, it may be necessary to proceed slowly to avoid shocking the system too much.

The impact of the Local Government Code of 1991 on the total public sector deficit has to be evaluated carefully. Under the 1991 Local Government Code, local government units are entitled to a share in gross internal revenue taxes, based on collections in the third year preceding the current one, at a rate of 30% in the first year of code implementation, 35% in the second year, and 40% in every year thereafter. At the same time, some expenditure functions have been partly or fully devolved to local governments. Further research is necessary to look into the fiscal behavior of local governments and what the net impact of the Local Government Code of 1991 on the deficits of the national government and local governments.

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