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BRIEFING BOOK FOR McPHERSON TEAM VISIT

(March 11-15, 1986)

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Talking Points For Meetings

With Finance Minister Jaime Ongpin,

Trade & Industry Minister Jose Concepcion and

Central Bank Governor Jose Fernandez

Budget Deficit

I understand that because of excessive election-related spending and tax exemptions/reductions given by the previous administration, the new administration is facing a very serious budget situation. I understand the Treasury coffers are practically empty.

- To what extent is this true?
- How large a deficit is being projected?
- Can expenditures be reduced and the problems of economic depression and poverty still be adequately addressed?
- Can revenues be increased without harmful incentive effects? Can taxes be restructured to have less negative incentive effects on the rural areas?
- Would foreign assistance for general budgetary support be appropriate? What level of assistance would be needed?

## 2. Foreign Exchange Requirements

I understand that, while there is no immediate crisis in the availability of foreign exchange, the Philippines will need additional financing this year.

- What sort of arrangement is expected with the IMF?
- Is the agreement with commercial banks expected to be continued?
- How much additional financing will be needed?
- How do the dangers of speculations affect the timing of when resources are needed?
- How much is expected to come from bilateral sources, particularly the U.S.? When would it be needed or useful to be received?

## 3. Foreign Exchange Rate and Markets

I understand that the Philippines had officially freed the foreign exchange market back in October 1984, but that in practice the previous government had continued to manipulate the rate through control over the black market and government banks' trading of dollars.

- Has the new government stopped or will stop such practices?
- Is the new government committed to a free foreign exchange market and a floating exchange rate?

4. Monopoly Powers

I understand the new government is strongly opposed to "crony capitalism" of the previous government and will be moving to dismantle these structures.

- How will this problem be approached?
- What are the plans for
  - coconut monopoly
  - sugar monopoly
  - chemicals, meat imports, wheat and other monopolies?

## 5. Public Corporations

I understand that government parastatals have proliferated since 1970 and are now a considerable drain on the budget, requiring at least \$150 million in subsidies in 1984. Some of these also compete directly with the private sector in some industries and hold monopoly positions in others. I understand the new government is basically opposed to excessive government intervention in the private sector and will be moving to reduce such interventions. As part of this, I believe the number of public corporations, their subsidiaries and "acquired private corporations" will be reduced.

- Does the new government intend to completely phase out these government parastatals or do you intend a partial phase out and maintain others in selected sectors?
- How will divestitures be approached? Can we be of assistance here?

I understand that the World Bank was scheduled to conduct an appraisal based on recommendations made by the Commission on Government Reorganization for a proposed project that would dispose of selected government parastatals and develop a system of corporate planning that would make the remaining parastatals more efficient.

- Do you plan to continue with this effort?
- What will happen to:
  - National Food Authority
  - National Development Corporation?

I understand that the government financial institutions, primarily the Development Bank of the Philippines (DBP) and the Philippine National Bank (PNB), are burdened with distressed loans and non-performing assets. They are causing a considerable drain on the GOP budget resources. I also understand that there has been considerable discussion of establishing an "Asset Disposition Trust" that would be managed by an "Asset Management Corporation" to dispose of acquired assets with International Finance Company's participation.

- Do you intend to continue with this program? If not, what will be the source of financing?
- Do you plan to develop and execute a divestiture program for the disposition of these assets and, if so, will you continue to develop the "Asset Disposition Trust" concept.
- What will happen to:
  - Philippine National Bank
  - Development Bank of the Philippines?

I understand the previous administration utilized public and quasi-public funds to rehabilitate selected acquired assets before their ad hoc disposal. Do you intend to continue with this policy? If not, what will be the source of financing?

## 6. Bureaucratic Controls

I understand also as part of reducing unwarranted government interference in the economy that many controls and regulations will be removed.

- What are the priorities in this area?
- What is going happen in the fields of
  - fertilizer and pesticides
  - food and feed grains
  - exports
  - investment?
- How can we be of assistance in this area?

## 7. Trade Liberalization

I understand the implementation of the final phase of import liberalization promised for World Bank SALs has been delayed.

- Why were the reforms delayed?
- Will that liberalization be carried out? When?
- What kind of assistance would be needed in this area?

## 8. Financial Sector Reforms

I understand that the government will pursue or continue to pursue a number of reforms to improve the functioning of private capital markets. For instance, I understand that a major objective of the Agricultural Loan Fund (ALF), which we are co-financing under the Rural Financial Services Project with the World Bank, is the market-orientation of interest rates on credit provided through the ALF (and other programs, as well), in order to encourage banks to mobilize savings rather than to rely on subsidized government funds.

- In this regard, what is the government's current position on market-oriented interest rates?
- How would you assess the prospects for bringing interest rates under other credit programs in line with the ALF market-oriented rate?
- Has the GOP considered policy directions to encourage commercial lending in the rural sector?

I also understand that the private sector is burdened by heavy debt (mostly short-term) and minimal equity, making it vulnerable to economic downturns and/or dramatic increases in real interest rates.

- Are there efforts to strengthen the capital market to make it more effective in providing equity and medium- to long-term debt capital?
- In terms of private sector control, is the government planning to effect a more broadly based ownership of enterprises in the private sector? How do you expect to proceed with such a program?

9. Urban Bias

I understand that private enterprise and infrastructure support facilities are heavily concentrated in urban areas, although more than 70% of the population live in rural areas. I also understand that the private sector has failed to generate the productive employment opportunities in rural areas sufficient to sustain economic growth.

- How does the GOP intend to address this problem?
- Does the government intend to develop an investment promotion effort for the rural sector? Are there plans for infrastructure development in the rural sector?

I understand small and medium enterprise development in the rural sector will be a focus of this administration.

- What will be the elements of such a program?

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TALKING POINTS FOR MEETING WITH  
BUDGET MINISTER ALBERTO ROMULO AND  
SOLITA MONSOD, OFFICER-IN-CHARGE OF  
NATIONAL ECONOMIC AND DEVELOPMENT AUTHORITY

1. Budget Deficit

I understand that because of excessive election-related spending and tax exemptions/reductions given by the previous administration, the new administration is facing a very serious budget situation. I understand the Treasury coffers are practically empty.

- To what extent is this true?
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- What are the plans for
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  - sugar monopoly
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- How can we be of assistance in this area?

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- How does the GOP intend to address this problem?
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I understand small and medium enterprise development in the rural sector will be a focus of this administration.

- What will be the elements of such a program?

5. What measures, policies and programs, do you see as necessary to enable the agriculture sector to become the lead sector for national recovery? Are there particular issues for production or marketing of the commodities which the Philippines may have a comparative advantage? What are the major constraints you see to establishing solid and sustained rates of growth in the rural economy?

6. Our 1985 PL 480 Title II Agreement provided \$40.0 million of rice. The Agreement included implementation of several policy changes: (1) removal of price controls on milled rice; (2) opening wheat imports to the private sector and returning flour distribution to the private sector; (3) divesting the National Food Authority of its non-grain stabilization and trading activities; and (4) opening the importation and distribution of fertilizer. Are you in agreement that these policy changes should be implemented?

7. The Philippines has in comparison to most developing countries a highly developed system of local government. What role do you see for local governments in reviving the rural economy, perhaps under circumstances of greater decentralization of authority? What are the most critical infrastructure needs to support development of the rural economy?

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TALKING POINTS FOR MEETING  
WITH MINISTER RAMON MITRA (AGRICULTURE AND FOOD)

BACKGROUND

As you may know, we would like to support efforts by your government to carry out needed policy and institutional changes to establish the most positive possible environment for the agriculture sector. We share your belief that the rural sector can lead the Philippines back to economic recovery. We also share your belief that the private sector working in an environment of sound policies can be the engine of growth.

Our 1985 PL 480 Agreement which provide \$40.0 million of rice included agreement on the implementation of several policy changes aimed at the deregulation of the importation and domestic trading of food grains and related agricultural inputs as a means of promoting increased production and a lower cost of critical food commodities. These changes included: (1) removal of price controls on milled rice; (2) opening wheat imports to the private sector and returning flour distribution to the private sector; (3) divesting the National Food Authority of its non-grain stabilization and trading activities; and (4) opening the importation and distribution of fertilizer.

TALKING POINTS

- What measures, policies and programs, do you see necessary to enable the agriculture sector become the lead sector for national recovery?
  
- Are there particular issues for production or marketing of the commodities which the Philippines may have a comparative advantage?
  
- What are the major constraints you see to establishing solid and sustained rates of growth in the rural economy?

ECONOMIC POLICY DIALOGUE

I. OBJECTIVES:

- The economy has been contracting since 1983. All major sectors are stagnating or declining and the new government faces massive unemployment, extensive urban and rural poverty and a severely depressed entrepreneurial and investment environment. Restarting the engines of economic growth (particularly in agriculture and in light industry) will be the number one priority of the Aquino regime and should be the number one short-term priority of the USG policy dialogue.

- Liberalization and Deregulation:

The major sectors of economic activity in the Philippines have been stifled by ill-conceived government regulations and by systematic encouragement of inefficient public and private monopolies. The overall impact of these policies has been to channel business energy into "rent seeking" and "skimming" activities rather than into production and distribution of new goods and services. The significant private enterprise element within the Aquino government will seek to promote deregulation and (at least partial) liberalization. The USG medium term objective should be to

aid and abet these forces in the Aquino government and to quietly strengthen their position vis-a-vis the economic nationalist/protectionist forces who will seek to replace "rapacious" government intervention with "benign" government intervention in the economy. This task will require discretion and tact in public dealings, combined with firmness in our private dealings with the key economic players in the new government.

Structural Adjustment:

The consequence of several decades of poor economic policy and excessive government intervention in the marketplace is an economic structure which is sadly deficient when compared to the majority of economies in the ASEAN region. Vast amounts of fertile and productive land are captive to inefficient plantation crops which face declining world markets. Most heavy industrial capacity is in product lines where the Philippines cannot compete with more efficient foreign producers. Labor intensive light and medium industries (where the Philippines has a potential comparative advantage) are underdeveloped and largely confined to the Metro Manila region. Tax policies, trade policies and financial/capital market policies are severely distorted in ways which discourage agricultural development and the growth of competitive export industries and which

favor the existing inefficient and highly protected sectors with the poorest growth prospects. The major donor institutions have a well developed agenda of structural reforms and have earmarked substantial resources to assist the Government of the Philippines to undertake these reforms. The poor track record of the Marcos government in complying with the structural reform conditions of such assistance has slowed the pace of World Bank and Asian Development Bank adjustment lending. The USG role in this area should be one of discrete but firm pressure on the government to improve substantially the poor performance of the last government on the implementation of agreed reforms.

## II. POLICY AGENDA FOR U.S. ECONOMIC ASSISTANCE

### A. Short term

#### o Macro Level

- Assure a competitive rate for the peso;
- Remove foreign exchange controls;
- Let market forces set the peso value in foreign exchange markets and restore market forces to the pricing of capital in the financial system;

- Cancel decrees granting monopoly powers to corporate entities in sectors such as sugar, coconuts, meat imports, chemicals, etc.;
- Initiate dissolution of major public sector financial entities (Development Bank of the Philippines, National Development Corporation, etc.);
- Remove bureaucratic controls on the majority of exports; and
- Initiate the process of divestiture of public corporations and acquired assets.

o Sector Level

- Dismantle National Food Authority as presently constituted with particular reference to its controls over grain imports and its operation of the Kadiwa Stores and Food Terminal, Inc.;
- Remove controls and elimination of public sector involvement in the importation, distribution and pricing of fertilizer;

- Eliminate price controls for feedgrains and pesticides; and
- Streamline government stabilization program for rice and other "basic commodities".

B. Medium term

o Macro Level

- Liberalize import as agreed to with the World Bank;
- Implement broad scale privatization program encompassing most public sector corporations, subsidiaries and acquired assets;
- Implement full return to private sector banking and dissolve public sector financing agencies; and
- Simplify or eliminate most government controls on domestic investment and streamline procedures for foreign investment.

o Sector Level

- Implement World Bank reform packages in sugar and coconut sectors;
  
- Return to free market pricing of all major agricultural inputs; and
  
- Return to free market pricing of all major agricultural outputs

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### III. Economic Situation

#### A. Macroeconomic Overview

##### 1. Depression

The Philippine economy is in the midst of a severe depression. In 1985 it experienced its second year of negative growth. Real gross national product (GNP) declined by almost four percent, about one percentage point less than the 1984 decline. Per capita GNP in 1985 dropped to the level achieved ten years ago. Among the major economic sectors, only agriculture, fishery and forestry sector recorded positive growth in output. Present projections are not optimistic for a quick recovery.

##### 2. Unemployment, Underemployment and Poverty

The Philippines has serious underlying problems of unemployment, underemployment and poverty. Open unemployment as of the third quarter of 1985 rose to 7.1 percent from about 6.2 percent during the same period in 1984. The underemployment rate dropped to 22.2 percent from 26.2 percent. In terms of layoffs, while there were fewer reported layoffs in 1985, job losses in the vital economic sectors such as agriculture and manufacturing remained high. The World Bank estimated that in 1983 5.4 million families lived in poverty. During 1984 and 1985 the situation has worsened.

##### 3. Government Deficit

The Government has a serious deficit problem. The budget deficit in 1985 reached an estimated P11.9 billion (about 2% of GNP), or 85 percent above the original program target. GOP revenues have fallen short in recent years due to the sharp contraction in domestic economic activities. GOP expenditures, on the other hand, have remained high, despite cutbacks in some

areas because of the need to provide substantial budgetary assistance to government financial institutions unable to meet maturing external obligations. Recent election expenditures have seriously worsened the deficit. In the near-term, the prospects for bringing down the budget deficit to more modest levels are not encouraging. GOP expenditures are expected to remain high, if not to increase considerably, because of the need to stimulate the sluggish domestic economy, reorganize the government structure, and meet increased funding demand for social services and other sectors which the new government perceives to have acute short-term needs. Revenues, meanwhile, are unlikely to keep pace with GOP spending because the economic growth will continue to be lethargic. Likewise, tax collections will likely be hampered by an imminent overhaul of the tax system by the new government.

#### 4. Balance of Payments (BOP) Problems

The country is facing serious BOP problems. In 1985, the country's BOP deficit, excluding exceptional financing and the effects of rescheduling, stood at about \$1.8 billion (5.5 percent of current GNP), a significant 22 percent increase from the previous year's deficit level. For 1986, deficit is expected to be \$1.1 billion. To maintain adequate reserves, the country will need additional \$975 million with \$450 million to come from official sources. While the present situation is not an immediate crisis, the country will need help within four or five months.

#### 5. Inflation and Liquidity

Money supply jumped significantly in December 1985 and January 1986, causing an excessive liquidity situation. The Central Bank released funds to the national government for election purposes. In December alone the money

supply increased by 22.7 percent. The Central Bank (CB) has been removing pesos from circulation through sales of Treasury and CB bills. Apparently this has been successful with P15.6 billion being withdrawn in seven working days. Inflation in 1985 was 23 percent, far below the 50 percent of 1984. So far in 1986 the annualized rate has been only 3.8 percent.

#### 6. Investment Climate and Attitudes

Investment in productive sectors of the economy has been constrained in the past by: misguided policies that have favored capital intensive, import substitution industries; a highly centralized and corrupt bureaucracy unresponsive to investors' needs; favoritism by the Marcos regime for certain "insiders" who were granted privileges to exploit areas of the economy without competition; actual and potential interventions by the government in price, marketing, and production of goods; an unstable financial, economic and political environment; an increasingly militant labor sector; a deteriorating security situation; and a system of justice that has not been evenhanded. The demise of the Marcos regime has created a new surge of optimism and confidence in both local and foreign investors because they believe reforms in many of the above areas are now more likely. However, many businessmen, both local and foreign, are professing a "wait and see" attitude. They want to see what the programs of change will be. Maintaining confidence of both local and foreign investors could dramatically increase productive investments in the medium to long term.

Philippine Economic Performance  
Percent Annual Growth

	<u>1983</u>	<u>1984</u>	<u>1985</u>
Real GNP	1.3	-5.2	-4.0
Real GNP per Capita	-1.0	-7.5	-6.3
Agriculture	-2.1	0.8	1.3
Industry	0.7	-10.6	-10.7
Services	3.6	-2.3	-1.0
Personal Consumption Expenditures	2.9	1.0	0.3
Government Current Expenditures	-3.9	-8.8	-4.0
Gross Capital Formation	-4.7	-36.7	-14.8

1985 Performance

- In 1985, the Philippines experienced its second year of negative growth.
- Real Gross National Product (GNP) declined by 4%, about one percentage point less than the 1984 decline.
- Volume of goods produced in 1985 was equivalent to the 1980 level
- Real GNP per capita in 1985 dropped to the level achieved ten years ago.

Outlook for 1986

<u>Source</u>	<u>Projection</u>
UP Economics Professor in late 1985	-0.6 to 0.9%
CRC in late 1985	-2.0 to 1.3%
Previous Administration in January 1986	1.0 to 1.5%
Current Administration	2.0%

## Balance of Payments

### Facts/Projections

- Balance of payments (BOP) deficit for 1985 was estimated at \$1.78 billion or about 5.5 percent of current gross national product (GNP); 1985 BOP deficit is 22 percent higher than deficit in 1984.
- For 1986, BOP deficit projected at \$1.06 billion. Assuming all external payment arrears were settled in December 1985, about \$975 million is needed to cover the financing gap for 1986. About \$450 million is expected to come from official sources.
- Gross international reserves of the Central Bank was estimated at about \$962.8 million as of January 1986. Based on import payments last year, this level is roughly equivalent to two months of imports.
- The Central Bank has recently bought about \$250 million in dollars from commercial banks and individuals.
- Within the next few months, no foreign exchange crisis is likely to occur unless business confidence suddenly erodes. However, additional resources will be needed within the next four to five months in order to meet foreign debt obligations without lowering current level of reserves.

### Causes

- Large BOP shortfalls are due to substantial net outflow of short - and long-term capital, amounting to \$2.55 billion and \$650 million in 1985 and 1986, respectively.
- Poor export performance in 1985 (14.2 percent drop) was due to weak markets and unfavorable prices.

**Balance of Payments\***  
(in Million US Dollars)

	<u>1984</u>	<u>1985 a/</u>	<u>1986 b/</u>
Merchandise Trade	(679)	(486)	(470)
Exports	5,391	4,628	4,930
Imports	6,070	5,114	5,400
Non-Merchandise Trade	(975)	111	(247)
Inflow	2,626	3,288	3,091
Outflow	3,601	3,177	3,338
Transfers, Net	386	379	406
CURRENT ACCOUNT	(1,268)	4	(311)
Long-Term Loans	(271)	(1,026)	(1,032)
Inflow	730	428	910
Outflow	1,001	1,454	1,942
Direct Investments, Net	6	(9)	90
Short-term Capital, Net	18	(1,526)	382
Errors and Omissions, Net	(94)	642	(400)
Gold Monetization	169	221	242
Revaluation Adjustment	(15)	(89)	-
CAPITAL ACCOUNT	(187)	(1,786)	(748)
Unremittable Arrears/Adjustments	-	-	-
OVERALL BALANCE	(1,455)	(1,782)	(1,059)
Change in Net Int'l Reserves	446	991	989
Change in Nonmonetary Arrears			
Increases ( )/Decrease	(646)	1,798	-
Exceptional Financing	(1,255)	(3,873)	(1,873)
Unremittable Arrears/Adjustments	-	(698)	-

\* Before exceptional financing

a/ preliminary

b/ projections

Source: Central Bank of the Philippines

Doc 310K, p. 48

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Financing Requirements

	<u>1985</u>	<u>1986<sup>b</sup></u>
I. Overall BOP Deficit Before Exceptional Financing	1,782	1,059
II. Rescheduling of Term Loans	3,111	1,073
Commercial Banks	2,410*	857
Paris Club	660	216
Suppliers	41	-
III. Overall BOP Deficit After Rescheduling (I-II)	-1,329	(14)
IV. Additional Priority Needs	6,326	378
Repayment of Arrears	2,690	-
Monetary Debt Service Payments by Central Bank	712	21
Monetary Debt Service Payments by Commercial Banks	2,670	79
Change in Gross Reserves of the Banking System	254	278
V. Commercial Banks Rescheduling	1,928	79
VI. Unremittable Arrears	698	-
VII. Rollover of Trade Arrears	638	..
VIII. Trade Facility Impact on CB Liabilities	1,091	(690)
IX. Financing Gap to be Filled by New Money (III+IV-V-VI-VII-VIII)	642	975
Official Sources	242	450
Commercial Banks	400	525

\*Net of maturing short-term loan of \$279 million assumed to be rolled-over in BOP.

<sup>b</sup>As of March 1986

Doc. 310K, p. 43

## Foreign Exchange Markets

There are two markets for foreign exchange - the official and the parallel (curb or black).

### Control of the Parallel Market

- Before 1983 the parallel market was controlled by the Binondo Chinese community.
- In 1983 the then minister of trade Roberto Ongpin took control of the parallel market. He apparently used the threat of and actual imprisonment to direct the Binondo Chinese operations.
- Under the new administration, it is unclear who is in control.

### Control of the Official Market

- In October 1983, in connection with a devaluation, the government imposed controls on the foreign exchange market. An allocation system was established.
- In June 1984 the first steps of freeing the market were taken.
- In October 1984 the government supposedly removed all restrictions. However, the government apparently continued to manipulate the foreign exchange rate through government banks being heavily involved in trading dollars.

### Recent Exchange Rate Movements

- In 1985, the official guiding rate fluctuated within a narrow band from ₱18.27 to ₱18.93 per dollar.
- From January to the third week of February 1986, the rate steadily rose from ₱19.00 to ₱22.05 per dollar.
- Since the installation of the new government, the peso has appreciated by about 7 percent. The current rate is around ₱20.55 per dollar.

## Trade Liberalization

### 1980 Program

- Supported by Structural Adjustment Loans (SAL) from the World Bank
  - SAL I in 1980 for \$200 million
  - SAL II in 1983 for \$302.3 million.
- Major elements:
  - five year reduction in tariffs with average effective protection rate to decline from 52% to 28%;
  - gradual reduction of import restrictions on consumer and capital goods;
  - measures to further encourage exports.

### Results

- Mid-term review in 1984 noted that overall compliance had been good.
- 1981 and 1982 import liberalizations were on schedule. 873 of 1304 non-essential or unclassified goods were liberalized.
- Since then, the scheduled liberalization of items has been slowed down in response to business concerns and increasing BOP difficulties.
- The last phase of lifting import controls and tariff reductions for 12 major industries has just been deferred until May 1986.
- Little progress has been made in reducing import licensing requirements.
- Improvements in export incentives and procedures have been introduced in recent years. However, bureaucratic red tape continues to be a major complaint of exporters.

Domestic Budgetary Situation

National Government Budget  
(in billion pesos)

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985*</u>	<u>1986</u> (Proposed Program)
Revenue	38.2	45.6	57.1	68.2	80.7
Tax Revenue	33.8	39.5	50.0	60.8	72.5
Non-tax Revenue	4.4	6.1	7.1	7.4	8.2
Expenditures	52.6	53.1	67.3	80.1	87.6
Current Operations	31.0	34.6	43.6	54.8	62.0
Capital Outlays	19.4	15.1	13.6	11.7	15.4
Net Lending	2.2	2.4	10.1	13.6	10.2
Deficit	-14.4	-7.5	-10.0	11.9	-6.9
% of GNP	4.3	2.0	1.8	2.0	0.9
Financing Sources of the Deficit:					
Foreign	4.6	5.4	1.9	(0.6)	1.0
Domestic	9.8	2.1	7.8	12.7	5.9

\*preliminary actual

\*\*based on the 1986 Budget passed by the Batasan in 1985, i.e. the previous administration's budget.

Source: OBM

Budget Deficit

- The 1985 deficit reached ₱11.9 billion or 2.0% of GNP, 85% over the original target.
- The former government spent very heavily during the recent election period.
- This year's revenues are expected to fall short of target because of lower oil prices and reduction in turnover sales tax rates.
- Beginning estimates of this year's deficit are in the range of ₱17-20 billion or \$800 million to \$1 billion, i.e. 2.5 to 3 times the original budget.
- Financing of the deficit has been largely through borrowing from the Central Bank, i.e., money creation.

## Inflation/Liquidity

### Facts

- Average annual inflation rate in 1985 was 23.1 percent, far below 50.3 percent inflation rate in 1984.
- Annualized average inflation rate for first two months of 1986 was reportedly 3.8 percent.
- Money supply increased by 22.7 percent from November to December last year. Total domestic liquidity, composed of money supply, quasi-money (savings and time deposits) and deposit substitutes, rose by 9.5 percent in 1985 over the 1984 level.
- In mid-February 1986 total reserve money reached P44 billion, far above the IMF March target of less than P38 billion.
- The Central Bank has withdrawn P15.6 billion from circulation by sales of CB and Treasury bills between February 26th and March 7th.

### Causes

- The inflation rate had been lowered by
  - Monetary and fiscal restraint adopted since the second half of 1984 .
  - Weak consumer demand during the whole of 1985.
- The recent rise in liquidity was due to excessive election spending (Note: Central Bank allowed large government withdrawals in violation of IMF ceilings).

### Money and Prices

	<u>1985</u>	<u>1984</u>	<u>% Change</u>
I. Domestic liquidity (P billion)	132.7	121.2	9.5
Money supply	35.7	33.6	6.3
Quasi-money	88.4	76.3	15.9
Deposit substitutes	8.6	11.3	(23.9)
II. Consumer Price Index (1978 = 100) Philippines	352.6	286.4	23.1

Public Corporations

Types and Numbers

<u>Type</u>	<u>Number</u>	<u>Remarks</u>
a) Major Chartered Corporations	16	Includes two financial institutions. Together the 16 account for 80-85% of total public corporate assets.
b) Smaller Public Corporations	74	Also by special charters.
c) Wholly-owned Subsidiaries	174	Created under corporate law by a) and b) parents.
d) Acquired Assets Private Corporations	c 300	Taken over by government financial institutions (GFIs) including those foreclosed and those whose debts have been converted to GFI majority or minority equity holdings.

Sectoral Distribution

<u>Sectors</u>	<u>Public Corporations a + b above</u>	<u>Subsidiaries c above</u>
Financial	17	42
Infrastructure	16	12
Industry	13	96
Agriculture and Trading	18	20
Education and Culture	<u>26</u>	<u>4</u>
Total	90	174

Additional Facts on the Public Corporations (a + b + c):

- At the end of 1983, the book value of capital assets was at least \$32 billion.
- They employ about 132,000 persons.
- Their drain on the government budget is significant:
  - In 1984 their net losses were at least \$36 million beyond budget subsidies of over \$120 million.

-- While the Social Security System (SSS) and the Philippine National Oil Company (PNOC) were strong 1984 net income earners, the biggest losers were:

- Development Bank of the Philippines (DBP) - \$395 million (estimated at \$1.7 billion for 1985)
- Philippine National Bank (PNB) - \$60 million
- National Sugar Trading Corporation - \$36 million

- The World Bank is conducting appraisal of a rationalization program to dispose of selected parastatals and make the remaining corporations more efficient.

Prospects for privatization appear to be unpromising:

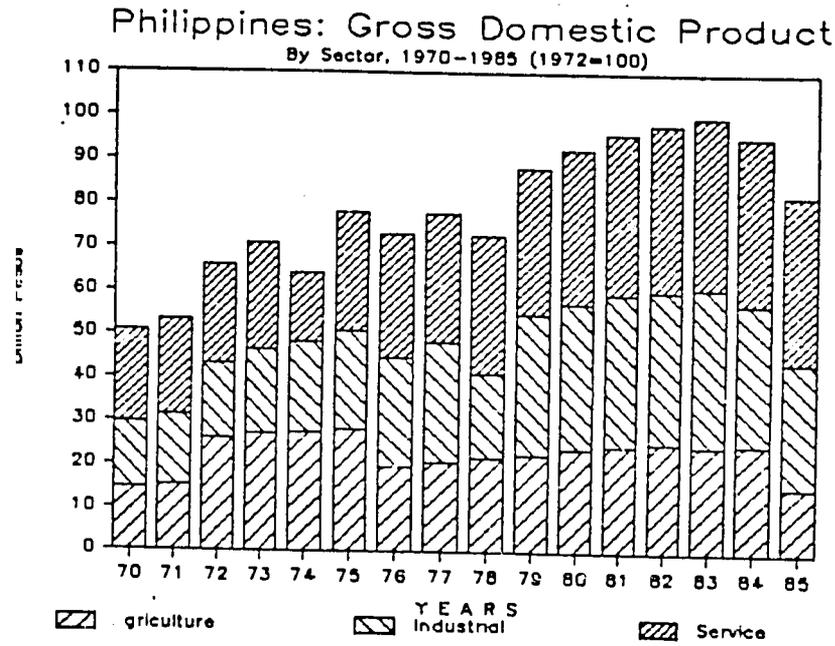
- Little attention has been paid by the GOP to formulating an overall divestment plan. Divestiture is now executed on an ad hoc bases by the GFI's involved.
- The financial markets, particularly the capital markets, are underdeveloped and underutilized as means of mobilizing domestic and foreign savings for medium to long-term capital financing for investment in productive enterprises. Characterized by heavy debt (much of it short-term) and minimal equity, many private enterprises have been and continue to be vulnerable to economic downturns and/or dramatic increases in real interest rates.
- Philippine stock market trading value relative to GNP is only .3% as compared to 23.9% in Hong Kong and 4% in Korea.
- Despite the existence of two stock exchanges only 130 companies are traded on the exchanges and, of these, only 48 are among the top 1,000 companies in the Philippines.

## AGRICULTURE OVERVIEW

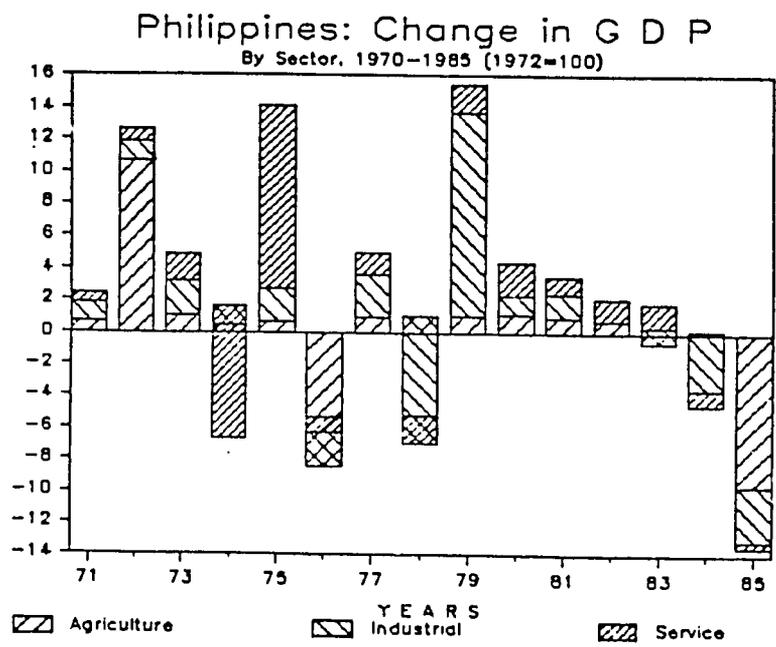
During the previous administration, many macroeconomic and sector level policies and programs depressed the rural economy. Past government interventions depressed agricultural products prices and incomes, significantly increased production costs, dampened employment opportunities, and reduced the incentives to farmers and agribusiness to make productivity-increasing investments. (See Graphs 1, 2, 3)

Macroeconomic and industrial sector policy distortions that hindered the rural sector included overvalued exchange rates, high tariffs and tax incentives for industries, investment incentives skewed towards industry, and increasing regulation and intervention in marketing.

Sectoral policies that hindered growth included government sanctioned private sector monopolies, (see Sugar, Coconut, Wheat/flour, attached) export taxes on agricultural outputs high import tariffs on agricultural inputs, suboptimal commodity pricing policies, lack of incentives to increase production and productivity, subsidized credit programs that ruined the rural financial system, and extensive exploitation of natural resources for personal gain.



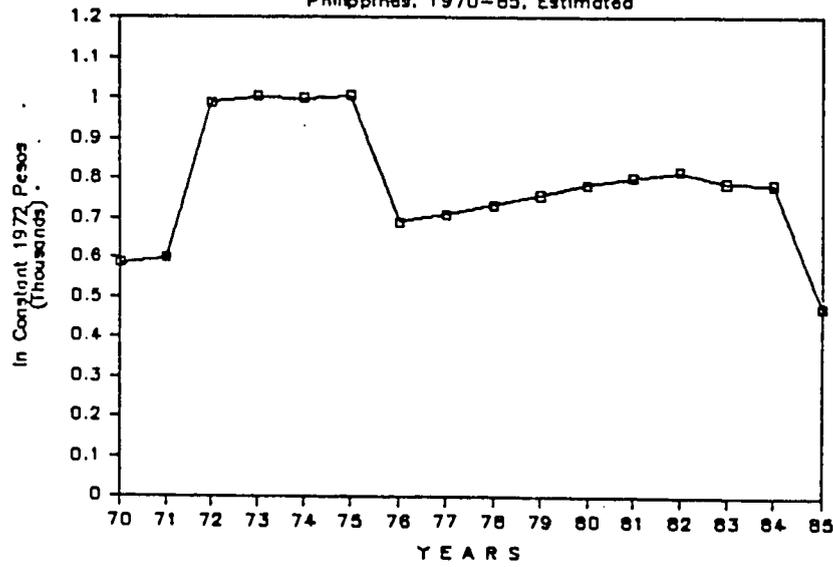
Graph 1.



Graph 2.

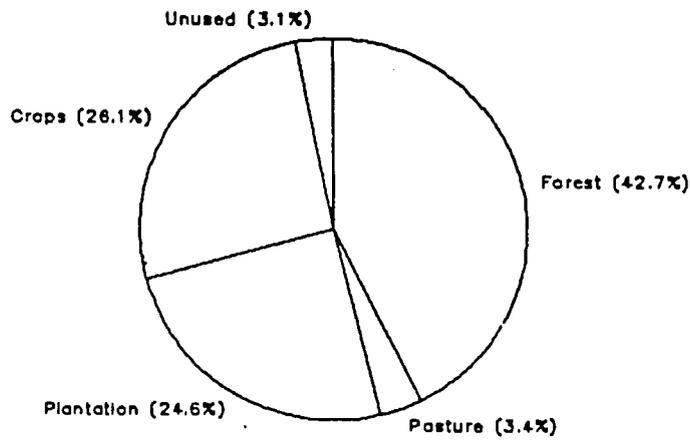
### AGRICULTURAL GDP/RURAL POPULATION

Philippines, 1970-85, Estimated



Graph 3.

### Philippines: Actual Land Use, 1980



Graph 4.

The policy reform agenda has been defined fairly well through the IMF, WB, ADB and AID programs. The agenda covered policies involving monopolies, public/private roles in the economy, rural development focus, government accountability and reorganization, and participatory planning. The policies, which the previous administration was reluctant to implement, can now be addressed without need to greatly enhance the agenda.

There are several policy areas where the U.S. already has an agenda established under current agreements. These policy changes are focused on reducing the government's role in agricultural markets and include:

- Market oriented interest rates. The interest rate and institutional reforms agreed upon as part of the WB and AID loans to the Agricultural Loan Fund have the potential to develop a self-sustaining rural financial system through rural savings mobilization, increased profitability of rural lending, enhanced agricultural lending capabilities, and increased understanding of the financial system. Pressures for subsidized credit programs are still politically strong.

- Deregulate milled rice prices and establish well-conceived grain stabilization program. Even though the price controls on milled rice have been officially lifted, the National Food Authority (NFA) has continued to intervene in the market at inappropriate times and with lower than market prices. Undue uncertainty exists in the rice economy due to the lack of a clearly and publically articulated rice stabilization program. (See Rice and Graphs 5 and 6)
  
- Private sector wheat importation and wheat flour distribution. The licensing power of NFA was used by the previous government to attempt to establish a private monopoly. The removal of all permit and licensing requirements and unhampered access to foreign exchange by the private sector is needed. (See Wheat and Graph 9)
  
- Divestiture NFA non-grain activities divestiture. The new administration has moved to place NFA within the Ministry of Agriculture and Food (MAF). This could lead to a significant change in its functions. The GOP is obligated to conduct a study leading to the divestiture of the subsidized food stores (KADIWA) and a large wholesale structure, Food Terminal, Inc. (FTI).

- 34 -
- Open fertilizer importation and distribution to the private sector. The Fertilizer and Pesticide Authority has issued directives for increased private sector participation in the market. But it continues to import fertilizer under WB and ADB sector input loans and license and allocate fertilizer imports. The MAF imports high priced fertilizers under Japanese assistance. A 10 peso per bag levy for the Planters Products, Inc. (PPI) debt repayment agreement with private banks complicates free market forces and taxes producers. Prices remain high for farmers due to government control and intervention, high transportation and distribution costs, and limited competition in the market. (See Fertilizer and Graph 10)
  
  - Coconut and sugar monopolies. Elimination of these monopoly arrangements were included in the IMF stand-by agreement and is a stated objective of the new government. (See Sugar and Coconut Monopolies, attached.)

The institutional and administrative system in the agricultural sector has been misdirected and underfunded. Most prior emphasis was on GOP involvement in the productive aspects of the agricultural economy -- grains, sugar, coconuts, timber and wood products. The previous administration neglected the basic

public services necessary for continued growth and increased productivity -- policy analysis, agricultural research, extension, irrigation and other rural infrastructure. This resulted in high cost, counterproductive market interventions that drained public resources, a fragmented network of public and parastatal sector institutions, graft and corruption in rural infrastructure projects and weak policy analysis, program development and budgetary processes.

## Rural Credit

### GOP Involvement

- GOP interest rate control and subsidization policies have been at direct variance with the incentives necessary for mobilizing savings.
- Subsidized agricultural credit programs administered by the Central Bank and provided through Ministries/Agencies limit the interest rate spread that the rural banks can charge the subborrowers.
- Rural banks have come to depend on highly subsidized government funds rather than on savings deposits because Central Bank rediscounting rates have been lower than the rates the rural banks pay on time deposits.
- Between 1972 and 1983, borrowing by the rural banking-system from the Central Bank grew 35.9% annually compared to 23.2% growth in deposits, in the rural banking system.
- One third of the total rural banking system depends on Central Bank funds for up to 75% of their loanable resources.
- Ratio of borrowings to net worth deteriorated from 31.5% in 1960 to 363.5% in 1983.
- As of December 1983, agricultural loans were more than 3 times the amount of rural deposits.
- Use of financial institutions as conduits for government funds led to high default rates because the financial intermediaries, whose exposure was limited, had little incentive to supervise and collect loans.
- 33% of the loan portfolio of rural banks is past due, and 90% of that is in agricultural loans.
- Heavy rural banking system dependence on Central Bank rediscount funds resulted in a major downturn in agricultural lending when availability of Central Bank rediscounts was reduced from P8.16 billion in 1983 to P2.7 billion in 1984.
- Rural banks' capabilities in loan preparation, appraisal, supervision and collection are weak.
- Rural banks have weak management information systems, cumbersome lending procedures, poor deposit and loan portfolio management, and employ rudimentary planning and evaluation techniques.

World Bank - AID Project

- Under the World Bank Agricultural Credit Project/AID Rural Financial Services Project, the Central Bank agreed to lend funds to participating private banks at market oriented interest rates. Interest rates from the participating banks to and borrowers are completely unregulated. Project-funded policy studies will encourage and define further policy and systemic change, such as the phase-out of subsidized credit under other programs. Technical assistance and training will respond to management weaknesses in the rural financial system.

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## The Sugar Monopoly

### Sugar Facts

- Sugar industry employs some 1/2 million persons and sustains another 2 to 5 million
- Sugar farms
  - 5 hectares or less account for 60% of total number
  - 25 hectares or more account for 62% of total hectarage
- Total hectarage was about 382,000 in crop year 1984-1985 down from a maximum of 544,579 hectares in crop year 1975-76
- Total raw sugar production runs around 1.3 million metric tons with total value of \$ 373 million at US 13 cents per pound
- Total exports 222,877 tons to U.S. or 24% of total exports (crop year 1984-1985)
- Present stocks are around 433,000 metric tons

### Results of Government Monopoly

#### In sugar trade (since 1974)

- loss to producers of at least \$1.4 billion over the past ten years
- an increase in the marketing chain resulting in more mark-ups and redistribution of profits to favored paper traders
- loss of foreign exchange due to financing of operations through foreign loans without corresponding benefits from foreign exchange earnings
- loss to economy of at least \$146 million because of agencies' operating losses.

#### In milling (since 1983)

- increase in foreign debt by \$508 million
- losses of the mills due to excess capacity, poor infrastructure and minimum capital investment of owners.

## The Coconut Monopoly

### Coconut Facts

- About 1/3 of the population or at least 20 million persons derive some income from coconut and their by-products.
- There are around 500,000 coconut farms. Average size is three hectares. 75% are less than 1.5 hectares.
- Estimated hectarage in 1985 was 3.2 million.
- Total 1985 production in copra terms was 2 million metric tons (consists of 1.1 million metric tons in coconut oil, .6 million metric tons in copra meal; and the remainder in dessicated coconut and other by-products).
- Value of 1985 production:
  - coconut oil (at \$540/M.T.) - \$594 million
  - copra meal (at \$80/M.T.) - \$48 million
- Total 1985 exports:
  - coconut oil - 644,499 metric tons valued at \$348 million
  - copra meal - 444,828 metric tons valued at \$36 million
- 49% of total coconut oil exports in 1985 went to the U.S.; U.S. does not import copra meal.

### Monopsony Control

Achieved thru unaccounted for use of coconut levy funds (around \$127 million/year) which financed

- United Coconut Planters Bank (UCPB)
- UNICOM, private milling and marketing company for coconut products.

While unorganized coconut farmers nominally own 70% of UCPB, they have no effective control. Eduardo Cojuangco had previously controlled these organizations. The Minister of National Defense, Juan Ponce Enrile, will remain as Chairman of the UCPB Board for another year.

Results

- UNICOM paid coconut farmers at least 9-15% below what would have been the competitive price.
- UNICOM's attempts to exploit limited monopoly power in international markets have resulted in substitution away from coconut oil and depressed national earnings.
- Another Cojuangco monopoly in hybrid coconut seedlings has limited selection of new varieties to one of suspect productivity.
- A 1985 Presidential Decree mandates the substitution of coconut fatty alcohol (to be produced by a Cojuangco-West German firm joint venture) for petroleum-based materials in the production of laundry detergents by June 1986. If this is implemented, laundry product prices would increase by 40% to 50%. This would cost consumers an additional \$93 million per year.

RICE

Rice Facts:

- Rice is the major food staple of the Philippines.
- Rice accounts for 18 percent of GVA for agriculture.
- 1985 production estimated at 8.2 million tons paddy rice. Equivalent to 5.3 million MT of milled rice, valued at 28.5 million pesos
- Area harvested is 3.2 million hectares.
- Average yield is 2.5 MT/Ha., low by Asian standards (see Graph)
- Current support price of 3.50 pesos/kg. is above the world market price

GOP Rice Programs:

- The Ministry of Agriculture and Food (MAF)- sponsored MASAGANA 99 program was initially successful in introducing new high yielding varieties and increased production and yields.

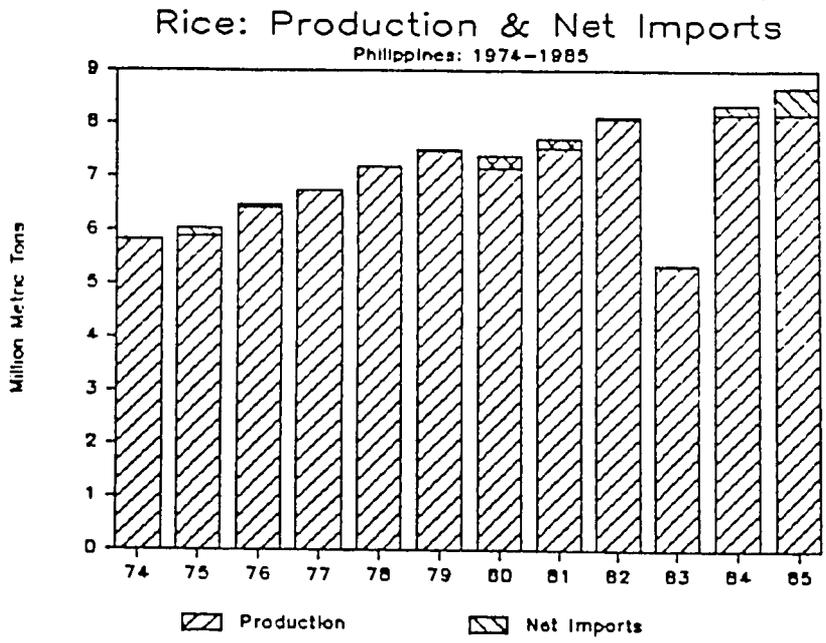
- National Food Authority (NFA) is responsible for rice market stabilization. NFA controls import volume, release price of imports, procurement of domestically grown rice at a set support price. Until recently it also controlled the price of retail milled. This program has not effectively stabilized the market nor allowed the private sector to store, transport and mill rice because:

- (1) The support price is a guiding price for which NFA acts to influence the markets, but is not a buyer of last resort. The current support price is 3.50 pesos/kg.
- (2) The NFA sale of milled rice is on a continuous basis and is not restricted to evening out seasonal fluctuations. The recent sales of milled rice by NFA at prices in the range of 5.15 to 6.00 pesos are inadequate to cover the true costs associated with the 3.50 peso support price. NFA intervention into the milled rice market undercuts the private millers and traders.

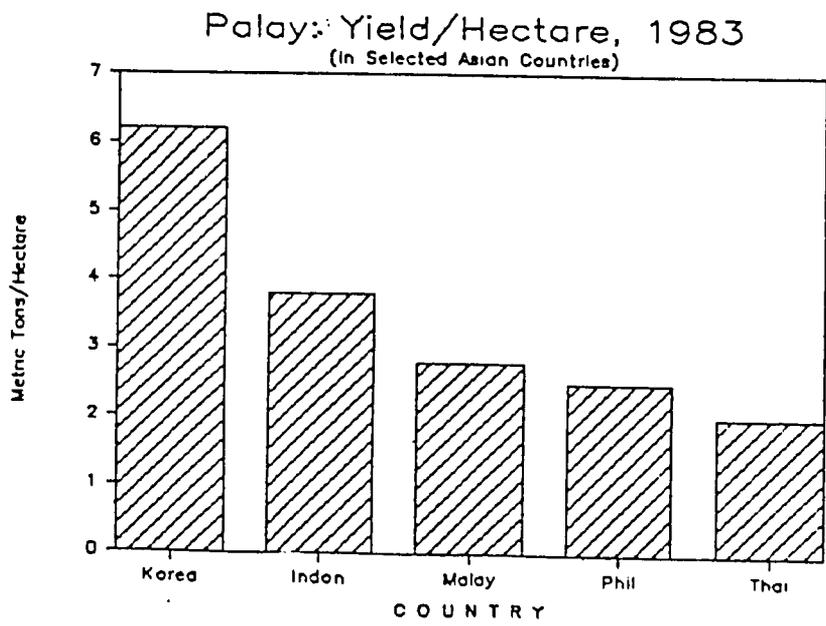
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(3) NFA does not announce prices at which it will intervene in the milled rice markets nor the level at which it will procure paddy rice (historically this has been 6 to 12 percent of the crop). The private trade does not receive a clear definition of the ground rules for NFA's interventions.



Graph 5.



Graph 6.

CORN

CORN FACTS

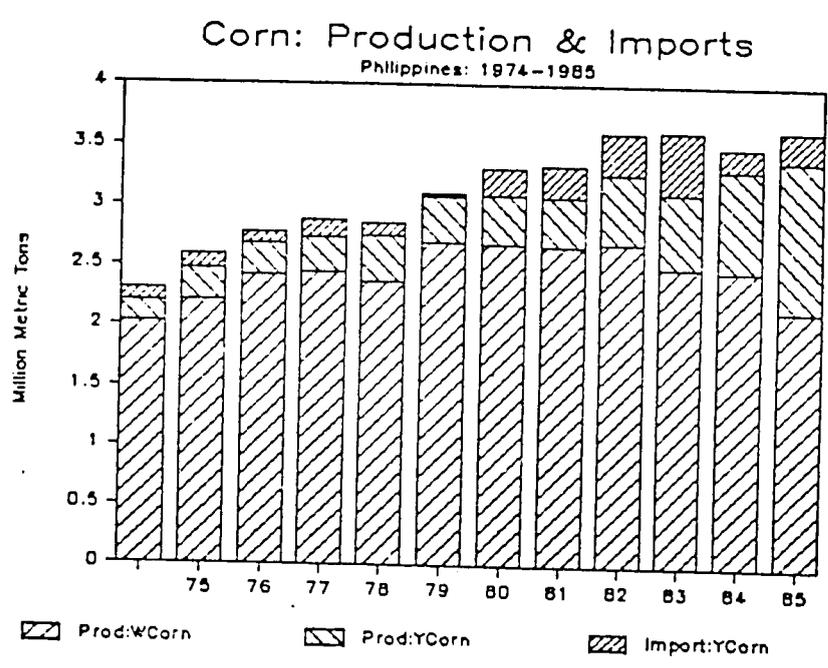
- Corn is the second most important staple food.
- 1985 production was 3.4 million MT; approximately 64% was white corn and 36% yellow corn. Yellow corn production is used entirely for animal feed.
- Estimated 1985 production area is 3.3 million hectares.
- Average corn yields are 1 MT/ha. This is relatively low compared to both Asian and world standards (see Graph 8).
- Total corn production grew 7% per year 1972-1982, last year's production was the same as 1981-82.
- Approximately 64% of total production is for food; 27% for animal feed; 9% for industrial use, seeds and others. Average consumption directly as food is 25 kg. per capita compared with 105 kg. for rice.

- Total imports of yellow corn were 251,000 MT in 1985, 183,000 MT in 1984, down from 528,000 MT in 1983. Imports have declined due to increased local production, dampened demand for meat, and peso devaluation.
  
- The country is aware of its agronomic and land potential and aspires to be an exporter of corn. However, high domestic production costs (especially for fertilizer) of about ₱5,000 or \$260 per hectare prohibit exports.
  
- Private sector research has developed seeds, pest control, fertilizer, water and other recommended practices.

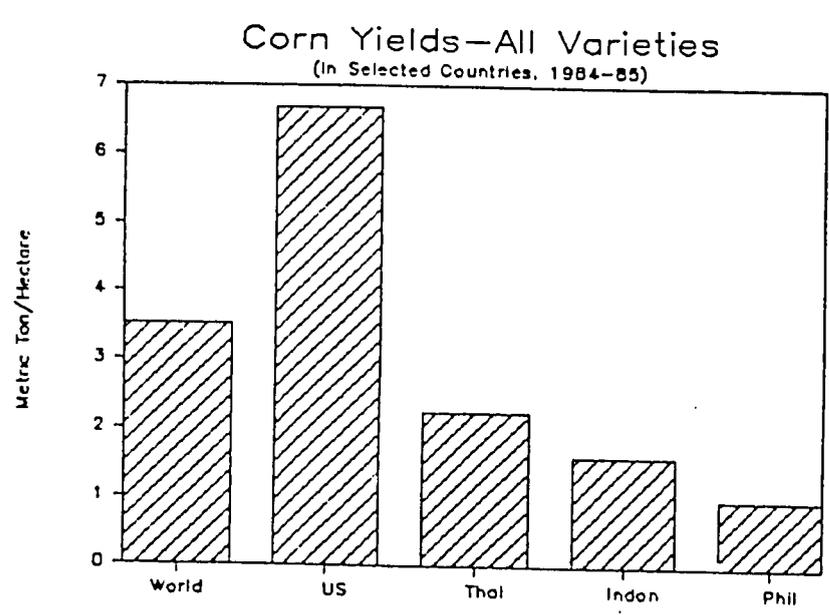
#### GOVERNMENT INTERVENTION

- The Government provides subsidized credit for yellow corn production and intervenes in the domestic market through selective NFA purchases, monopolization of corn imports, and changes in corn import regulations for livestock feeders.

- The 1985 support price of ₱2.90/kg. was approximately equal to the 1985 average farmgate price. The harvest price was ₱2.60/kg. in August-October 1985. The NFA released imported corn at ₱3.90/kg. prior to the harvest season which dampened market prices. The border price of imported corn has been about ₱2.30/kg.
  
- Uncertain NFA policies for import and pricing have inhibited normal private marketing. Drying and storage facilities are inadequate. Serious wastage results.
  
- Philippine yellow corn is priced above the world market. Domestic prices (\$145-170/MT) have averaged 30% higher than border price of (\$100-140/MT).



Graph 7.



Graph 8.

## WHEAT

### WHEAT FACTS

- Wheat is the third cereal grain consumed behind rice and corn.
- All wheat is imported. Wheat imports in 1985 were 663,000 long tons valued at \$121.8 million.
- Wheat imports expected to rise to 850,000 MT with changes in the administration and the NFA.
- Since 1974, wheat imports have been from the U.S. and usually under CCC credits (exception was Marcos cronoy Cojuangco imported from Japan and Germany last year).
- Wheat consumption per capita is five times as large in Manila as in rural areas.
- Note: Small efforts have been undertaken to produce wheat in Northern Luzon. CIMMYT has run several trials over the past few years, but it is not clear that wheat production is economical.

WHEAT/FLOUR MONOPOLY

- From 1975 to 1985 the National Food Authority (NFA) held a monopoly on wheat imports. NFA determined requirements, let ten , awarded contracts for delivery directly to the flour mills. NFA mark up on wheat was 20 to 40 percent.
- From 1983 to 1985 NFA monopolized flour distribution as well. NFA made substantial profits and a black market resulted due to the NFA use of licensing of bakers to deny some flour.
- NFA made ₱940 million in 1985 on wheat/flour alone (flour millers estimate).
- NFA attempted to blunt the objective of returning the importation of wheat to the private sector under the 1985 PL-480, Title I Agreement: first, by using its licensing authority to attempt to establish a private, crony monopoly and then to force a market sharing arrangement between the millers and bakers.

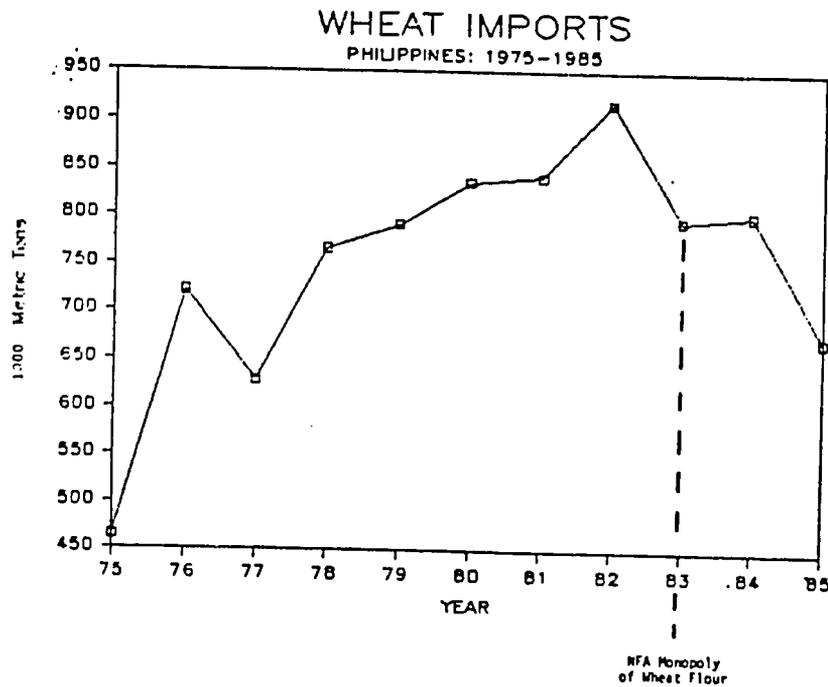
## FERTILIZER

### Fertilizer Facts:

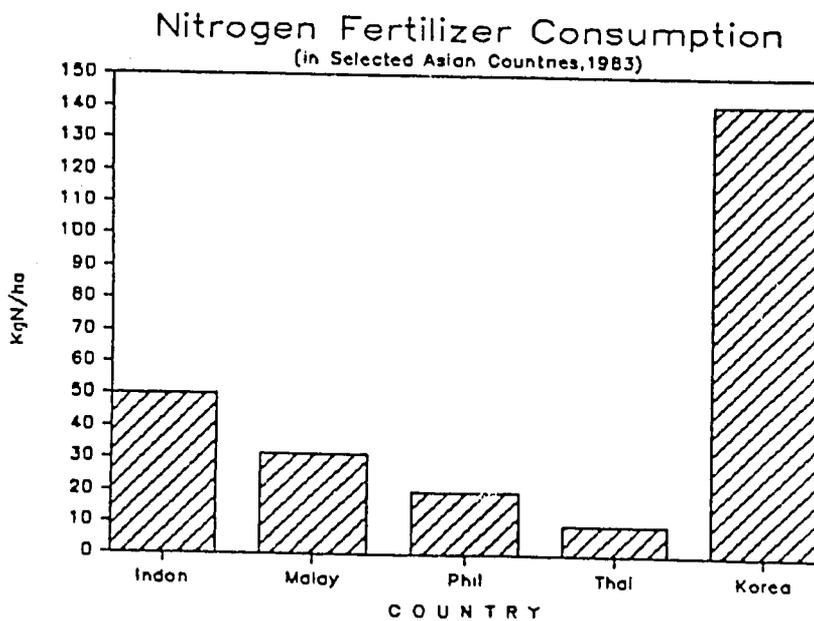
- Fertilizer is used primarily for rice, corn, banana, pineapple and sugar
- Philippines imported 0.6 million metric tons of fertilizer valued at \$93 million in 1985. The 1984 approved WB and ADB Input Loans and bilateral Japanese fertilizer program provided the funding for all imports in 1985.
- Fertilizer use is 19.6 kg/ha. (nitrogen) -- one of the lowest rates in Asia (See Graph 10).
- Farmers need 4.5 kg. of paddy rice to purchase 1.0 kg. of urea, one of the highest ratios in Asia.
- Price levels have declined. Current ex-warehouse price for a 50kg bag of urea is 190 pesos compared to 275 pesos a year ago.
- The number of firms importing and distributing fertilizer has increased from 4 to 24 over the past year. Planters Products, Inc. (PPI), the previously dominant fertilizer firm has had its market share declines from 60 percent to 20 percent over the past two years.

Fertilizer sector problems:

- A 10 peso/bag levy on all fertilizer was imposed to aid PPI cover its debt service as a condition of the commercial bank debt rescheduling in 1985.
  
- The Fertilizer and Pesticide Authority (FPA) maintains licensing and allocation authorities and is the agent for the procurements under the WB and ADB Loans.
  
- The government-operated Philippine Phosphatic Fertilizer (PHILPHOS) plant is nearly operational. It will manufacture ammonium sulfate and phosphate fertilizers -- not urea, which is most important for rice. It is closely linked with FPA (until the new government the same person was the head of both). It is not considered an efficient plant and could potentially have a negative impact on fertilizer supply and pricing if protected.



Graph 9.

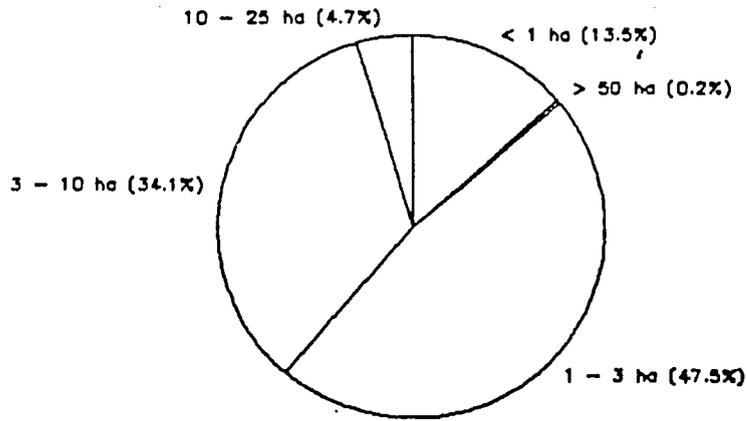


Graph 10.

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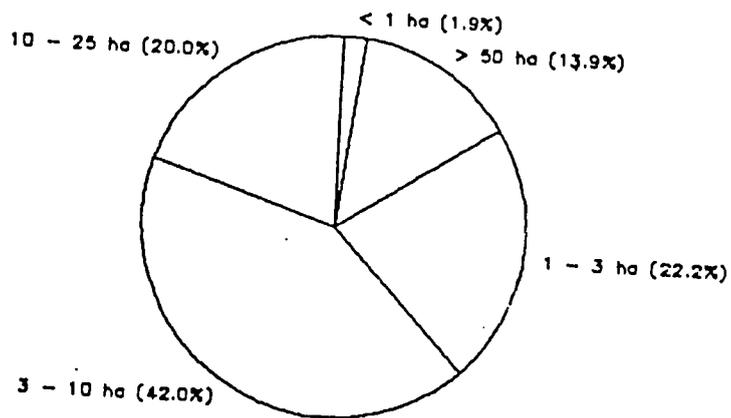
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### LAND DISTRIBUTION, PHILIPPINES By Number of Farms, By Farm Size



Graph 11.

### Philippines: Land Distribution By Farm Size, By Area



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Graph 12.