SUPPORT FOR DEVELOPMENT PROGRAM II

PROGRAM ASSISTANCE APPROVAL DOCUMENT

(492 - 0450)

USAID/Philippines
SEPTEMBER 1991

SUPPORT FOR DEVELOPMENT PROGRAM II

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(492-0450)

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September 1991

ABBREVIATIONS/ACRONYMS

ADB	Asian Development Bank
A.I.D.	Agency for International Development
ASEAN	Association of Southeast Asian Nations
BAP	Bankers' Association of the Philippines
BIR	Bureau of Internal Revenue
BOC	Bureau of Customs
BOP	Balance of Payments
BSP	Budget Support Program
BSP II	Budget Support Program II
BTr	Bureau of Treasury
CB	Central Bank of the Philippines
COA	Commission on Audit
CY	Calendar Year
DOF	Department of Finance
DTI-ITG	Department of Trade and Industry - International Trade Group
ESF	Economic Support Fund
FIA	Foreign Investments Act of 1991
FY	Fiscal Year
GDP	Gross Domestic Product
GNP	Gross National Product
GOP	Government of the Philippines
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
MAI	Multilateral Assistance Initiative
MARINA	Marine Industry Authority
NEDA	National Economic and Development Authority
OPSF	Oil Price Stabilization Fund

PAAD	Program Assistance Approval Document
PASS	Philippine Assistance Strategy Statement
PEPS	Private Enterprise Policy Support
PITO	Private Investment and Trade Opportunities Project
RIG/A	Regional Inspector General for Audit
SDP	Support for Development Program
SFM	Standard Formulas of Manufacture
SHIPPERCON	Philippine Shippers' Council
USAID	United States Agency for International Development
VAT	Value Added Tax
WB	World Bank

CLASSIFICATION:

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

1. PAAD Number: 492-0450

2. Country: Philippines

3. Category: Cash Transfer

4. Date:

5. To: Malcolm Butler, Director

6. OYB Change Number:

7. From: Paul R. Deuster, OPE
Cameron L. Pippitt, DRM/DI

8. OYB Increase:
To be taken from:

9. Approval Requested for Autnorization of $ 120,000,000 and obligation in FY91 of $60,000,000

10. Appropriation Budget Plan Code:

11. Type Funding	12. Local Currency Arrangement	13. Estimated Delivery Period	14. Transaction Eligibility Date
☐ Loan ☒ Grant	☐ Informal ☐ Formal ☒ None	Sept. 1991-Sept. 1994	N/A

15. Commodities Financed

16. Permitted Source		17. Estimated Source	
U.S. only		U.S.	$3,607,000
Limited F.W.	Code 000 and Philippines* $5,000,000	Industrialized Countries	
Free World		Local	$1,393,000
Cash	$115,000,000	Other	

*Subject to the requirements of AID Handbook 1B, Ch. 18

18. Summary Description

The objective of SDP II is to assist the Government of the Philippines (GOP) in implementing economic policy and administrative reforms to improve the competitiveness of Philippine exports in world markets. SDP II will support GOP reform efforts by providing cash transfer resources that ease present foreign exchange constraints and technical support, including policy studies and training, that assist implementation. The GOP will use the dollars to service official non-military debt owed to the United States Government, multilateral institutions such as the IMF, IBRD, IDA and ADB, or other uses as may be agreed to. The cash transfer disbursements will be based on the USAID judgement that the agreed on reforms have been carried out satisfactorily. No peso generation will be required.

The provisions of the payment verification policy regarding methods of implementation and financing, financing capability of recipients, and adequacy of audit coverage have been adequately addressed in this document.

~~J.C. Stanford, Controller~~ [signature]

19. Clearances		Date
OPE:PRDeuster	[signature]	9/30/91
ODRM:RMcLaughlin		
OLA:LChiles	[signature]	9/27/91
ONRAD:KPrussner	[signature]	9/26/91
~~OD:RAJohnson~~	[signature]	9/30/91

20. Action

☒ APPROVED ☐ DISAPPROVED

Authorized Signature: [signature]

Date: SEP 30 1991

Title: Director, USAID/Philippines

AID 1120-1 (5-82) CLASSIFICATION:

Support for Development Program II

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I. SUMMARY AND RECOMMENDATION

1.	Program Title	:	Support for Development Program II
2.	Grantee	:	The Republic of the Philippines
3.	Grant Amount	:	Life of Program: $120 million
4.	Funding Source	:	Economic Support Fund (ESF)
5.	Initial Obligation	:	FY 1991
6.	Program Objectives	:	The objective of SDP II is to assist the GOP in implementing economic policy and administrative reforms to improve the competitiveness of Philippine exports in world markets.
7.	Program Description	:	A.I.D. will provide $115 million in balance of payments support grants in three tranches. The first tranche of $35 million will be transferred once standard provisions and conditions precedent have been met after grant signing. The second tranche and the third tranche of $40 million each will be transferred when other provisions mutually agreed to have been met to USAID satisfaction, including specific performance criteria on implementation of reforms. The dollars will be used to service official debt owed to the U.S. Government, multilateral institutions such as IMF, IBRD, IDA and ADB, or other uses as may be agreed to. $5 million will be budgeted for monitoring, evaluation, audit, technical assistance, training, limited commodities and policy studies.

8.	Estimated Completion Date	:	FY 1994
9.	Statutory Requirements	:	All statutory requirements have been met. (See Annex C.)
10.	Recommendation	:	That a $120 million ESF grant to the GOP be authorized, with $60 million obligation in FY 1991, based on terms and conditions described in the attached authorization Program Assistance Approval Document (PAAD).

II. OVERVIEW

The administration of Corazon C. Aquino, presently in its last nine months, has renewed its efforts to stabilize the economy, to rekindle growth, and to create the environment for rapid and sustainable economic growth. Since the Aquino administration came to power in 1986, substantial reforms have occurred. These changes have altered both the political and economic environments.

In the beginning of the administration's term of office, many reforms were rapidly undertaken. But while reforms continued to be implemented in 1988 and 1989, the pace of economic reform slowed in 1990. After strong growth during 1987-89, the economy slowed in 1990 and growth halted in early 1991 as the result of misguided policies, e.g. oil price subsidy, government salary increases, overly stable exchange rate; natural disasters, e.g. earthquake, volcano eruption, typhoons; and, man-made events, e.g. coup attempts and uncooperative Congress.

The deteriorating economic situation in 1990, however, made the need for further economic reforms more urgent and the government responded. It launched a stabilization program involving peso depreciation, oil price increases, imposition of an import levy, reduction in government expenditures and the rescheduling of external debt.

The government is also renewing efforts on fundamental structural reforms. Major actions include the passage of a Foreign Investments Law which will liberalize foreign equity participation in the economy and issuance of executive order which will phase in substantial tariff reforms over the next four years.

The Support for Development Program II (SDP II) assists, through providing balance of payments and technical support, the Government of the Philippines (GOP) in its efforts to lay the foundation for rapid and sustainable economic growth. In particular, SDP II will support the implementation of economic policy and administrative reforms to improve the competitiveness of Philippine exports in world markets. Five specific objectives of SDP II are to liberalize rules and regulations for foreign exchange transactions and holdings, streamline the duty drawback and Value Added Tax (VAT) tax credit systems for exports, liberalize interisland and shipping rates and route franchising, strengthen VAT administration to improve tax collection, and improve public debt management to lessen its impact on interest rates.

SDP II will be providing resources needed to help close an expected external financing gap over 1991 and 1992 and help the economy to regain growth. The balance of payments support will be provided in three policy performance based tranches. The first tranche is based on performance to date, while the second and third are conditioned on satisfactory performance against the specific indicators, implementation actions and objectives of the policy implementation matrix, discussed in Section IV and presented in Annex G.

The dollars provided under SDP II policy performance based tranches will be used to service official non-military debt to the United States Government and multinational institutions or for other uses A.I.D. may agree to. Based on the recent A.I.D. policy on local currency (State 202944), there will be no peso generations under SDP II, as the dollar proceeds from the cash transfer will be used solely to service GOP debts to the U.S. Government and multilateral institutions.

The SDP II program also provides for monitoring, evaluation, audit and technical support. Technical support covers technical assistance, policy studies, and training which will support implementation of SDP II policy reforms by key GOP organizations. A small amount of the technical support fund will be used for commodity purchases, e.g., personal computers, as required for the success of implementation.

A description of the present political and economic environment in the Philippines, the GOP's development strategy, and SDP II relationship to USAID assistance program and other donors' activities are presented in Section III of this document. Section IV describes the core of the SDP II policy reform program and presents the cost/benefit analysis of the Program. Section V describes SDP II program funding, allocation of program funds, and the various components. The details on the implementation of the program are specified in Section VI. Section VII contains the conditions and covenants to the program agreement with GOP.

III. THE SETTING

A. Political Setting

The "people power" revolution of February 1986 ended the twenty year regime of President Marcos. Since then, the Government of the Philippines (GOP) under President Aquino has enacted a new constitution, held Congressional and local elections at the provincial, city, municipality and village levels and restored political liberty. The Aquino Administration has undertaken a series of judicial, political and military reforms meant to strengthen these fledgling democratic institutions and sustain the reform process.

Aquino's immense popularity made for a receptive political climate for the political and economic reforms instituted in her first two years in office. Her economic reform program, which greatly contributed to economic recovery in 1987, focused attention on rural development, poverty alleviation and improvement of the delivery of basic public services such as education, public utilities and basic infrastructure.

While most of her political agenda is on track and functioning well, her economic policies failed to sustain the economic momentum that started in 1987 and peaked in 1988 at 6.6 percent growth. Among her populist policies that caused the deterioration in growth are government wage adjustments in 1988 and

1989 and oil price subsidies starting in 1989. The proportion of the number of families below the poverty income level did fall from 60 percent in 1985 to 50 percent in 1988, but indications are that the trend was not sustained. The centerpiece of her equity agenda, the Comprehensive Agrarian Reform Program (CARP), which was signed into law in 1988, suffers from credibility problems given the watered-down version of the program that was passed by Congress and the slow progress and scandals that hound implementation.

Natural calamities like the July 1990 earthquake, typhoon 'Ruping' in November 1990 and the present Mt. Pinatubo catastrophe, and man-made interventions like the December 1989 coup attempt, Middle East war and the uncooperative Congress have compounded domestic economic problems. Economic growth slowed in 1990 and halted in the first semester of 1991.

The communist insurgency and Muslim separatist activities continue to this day but have declined and the threats of military coups seem to have subsided. However, top leaders of the rightist and leftist rebel movements are still active and their respective organizations are still intact and do have access to political and financial support. Current political distractions are the request of Mrs. Marcos and her family to return the body of former President Marcos to the Philippines for burial and the divisive issue related to the proposed friendship, cooperation and security treaty between the United States and the Philippines.

Popular support for the government at the grassroots level may be eroded in the short-term by present unemployment and income loss resulting from the economic slowdown. Government's efforts at reducing poverty in the regions through its social spending programs may also be hampered.

The challenge for the Aquino Administration with barely nine months left in power is how to sustain the present economic reform and stabilization program. The task is difficult given the reductions in the standards of living since 1990 and a Congress which is not in a mood to legislate economic reforms. Furthermore, political posturing for the May 1992 elections have already begun and is much reported in the press, distracting attention from economic issues requiring government attention.

To the government's credit, the Aquino administration thus far has stuck to its economic reform commitments that were initiated in the last quarter of 1990. President Aquino is committed to bequeathing to the incoming administration next year and the Philippine people a domestic economy that is poised for higher growth in the years to come.

B. <u>Economic Setting</u>

The Philippine economic performance during the first half of the 1980s was dismal. Average yearly real GNP growth registered a negative 1.3 percent during 1981-85, while population continued to grow at 2.4 percent a year. While this was a period of worldwide recession, many developed countries, newly industrializing countries, and some developing economies began to show signs of recovery by 1983. The Philippine economy, on the other hand, not only failed to recover from the impact of external recession, but further plunged into a deeper recession during 1983-85. Real GNP registered negative growth of 7.1 percent and 4.1 percent respectively in 1984 and 1985. The deep recession helped bring about the people's revolution and the new government of Corazon Aquino in 1986.

Substantial reforms have occurred since 1986. These changes have altered both the political and economic environments. Average real GNP growth from 1986 to 1989 was 6.1 percent. Most of the reforms, however, occurred in the beginning of the new administration's term of office. In addition to drafting a new Constitution and holding elections, the government instituted various economic reforms, including dismantling of monopolies, privatization and trade liberalization.

While reforms continued to be implemented, the pace of economic reform had slowed in 1988 and 1989. Policy slippages in 1989 and 1990 caused the deterioration of the public sector deficit, acceleration of inflation and increase in interest rates. The deteriorating economic situation, including the effects of the attempted coup of December 1989, July 1990 earthquake and Middle East crisis, made the need for economic reforms more urgent. Faced with mounting current account and budget deficits and unwieldy inflation, the GOP responded, in the second half of 1990, with depreciations of the peso and upward adjustments of petroleum product prices. In addition, the GOP obtained a new 18-month IMF Standby Arrangement in February 1991 to stabilize the economy and to set the stage for sustainable growth for 1992 and beyond. As a result of these policy measures, the Philippine economy during the first half of 1991 showed signs of improved stability, although at the cost of zero growth. The government deficit is under control; inflationary pressures have receded; interest rates are lower; the exchange rate is stabilized; and, the balance of payments is positive.

In addition, fundamental reforms are being undertaken. In June 1991, the Philippine Congress passed the Foreign Investments Act of 1991 which would make the Philippines more comparable with other ASEAN countries in terms of encouraging foreign private investments. The implementing rules and regulations for this Act will be issued in October 1991. Furthermore, the Aquino Administration issued Executive Order (E.O.) 470, a modified version of E.O. 413, to reduce and simplify the tariff structure for the purpose of making Philippine industries more open, efficient and competitive. In addition, the GOP successfully negotiated a Paris Club debt rescheduling and have made progress in a commercial bank arrangement to strengthen the growth process.

Unfortunately, growth prospects for the rest of 1991 remain dim due to the June eruption of Mt. Pinatubo in Central Luzon, the continuing mudflows of the volcanic debris into surrounding lowlands, remaining pressures on the public deficit and trade balance, and the time needed to recover from the halt in economic growth in the first half. In 1992 only modest recovery is expected. A $2.7 billion external financing gap is projected for the period

1991-92. The current high level of international reserves reflects only a temporary respite in external conditions due to lack of economic growth in the first half, the nine percent temporary levy on imports, and imposition of restrictions on commercial banks' holdings of foreign exchange. See Annex E for more details on recent Philippine economic performance.

C. Philippine Development Strategy

The 1989 policy framework paper prepared by the GOP for the launching of the Multilateral Aid Initiative (MAI), entitled "The Philippine Agenda for Sustained Growth and Development" presented a comprehensive reform program. The program was developed in conjunction to and consistent with the Medium Term Philippine Development Plan for 1987-1992. In February 1991, the GOP presented to the donors, at the MAI meeting in Hong Kong, a progress report on the policy framework paper. This document provides an overview of what has been accomplished, what problems need to be addressed in order to sustain economic growth and development, and how the Philippine government proposes to address them. The underlying thrust of the current GOP efforts is to put the economy on a sustainable growth path by undertaking a stabilization program. The key macro-economic policy components of the stabilization program are deficit reduction, improvement in balance of payments, slowdown in monetary growth, and increased trade and foreign investment.

The budget deficit is to be reduced through expenditure cuts and revenue increases. The policy emphasis of expenditure cuts is on reduction of national government expenditures, controls on spending and realistic oil pricing policy. On resource mobilization the emphasis is on improving the tax collection efficiency; imposing a temporary across-the-board import levy; introducing new revenue measures and refinement of existing taxes; accelerating the sale of public assets and enterprises; and adjusting tariffs for energy and water.

In the area of balance of payments, the thrust is on accelerating the growth of exports and maintaining competitive exchange rates. A number of measures are included to promote greater trade including rationalization and simplification of the tariff structure, limiting of duty exemptions and the elimination of unnecessary quantitative restrictions.

In order to encourage the inflow of foreign investments, emphasis is on liberalization of the climate for foreign investments and foreign equity participation to open up areas presently off limits to foreign investors. The government is also accelerating the transformation of the Board of Investments from a regulatory agency into an investment and export promotion body. Additionally, the GOP has re-opened its debt-equity swap facility under new and clearer guidelines. The facility aims to attract new foreign investments while retiring portions of the debt stock.

Management of the money supply will be subject to tighter base money targets. Slowdown in monetary growth is expected to reduce double-digit inflation but not at the cost of prolonged depressed economic activity. For the monetary targets to be met, the authorities are likely to use open market operations.

D. USAID Strategy and Relevant Projects/Programs

1. Mission Strategy

The overall goal of the USAID program as agreed to in the 1989 Philippine Program Week, and as expressed in the Philippine Assistance Strategy Statement (PASS) FY 1991-95, is to promote broad based, sustainable economic growth through the active partnership of the public and private sectors in fostering open and efficient markets and an open society. Three major themes, namely policy dialogue, private sector and decentralization, cut across the USAID program's five objectives: 1) a policy and institutional framework stimulating market-based private sector growth, 2) open and competitive markets, 3) infrastructure that facilitates expanded private sector activity, 4) more efficient delivery of essential services, and 5) effective and sustainable management of natural resources.

USAID's focus on the private sector as the major engine of growth for the Philippine economy is a theme which is deeply ingrained throughout the strategy. Supporting this theme is the emphasis on policy dialogue and related performance-based policy support programs which are targeted specifically on policy changes conducive to opening up the economy, moving it systematically toward market-determined pricing, reducing artificial constraints to entry, fostering a climate which attracts private investment, and reducing government involvement in activities which belong in the private sector.

Policy reforms are crucial because inappropriate policies lead to an economic structure in which private business incentives are frequently misplaced. Specific private activities, however well planned, have little chance for success if the policy environment works against them.

The SDP II program specifically addresses two of the five Mission specific objectives, namely a policy and institutional framework stimulating market-based private sector growth, especially growth of exports; and open and competitive markets. It complements the recently signed Private Enterprise Policy Support (PEPS) Program, where the focus is on broad macroeconomic policy reforms in the trade and investment regimes which particularly and directly affect the private sector. Macro and sectoral policy reforms are extremely important, as discussed in the PASS..."major problems of the Philippines stem from the inappropriateness of development policies, or the inadequate implementation of appropriate policies, i.e., overvalued exchange rate, protectionist trade regime, uneven macroeconomic management. Through ongoing dialogue, studies, and program conditionality, USAID promotes the use of market forces in determining the exchange rate as crucial for increasing exports, improving the balance of payments situation and encouraging broad based, sustainable growth."

2. Past and Present Project/Program Assistance

USAID has directed a large share of its assistance toward improving the policy climate for the private sector. Through its policy dialogue and its program assistance aimed at bringing about policy changes in various economic fronts, USAID has been and continues to encourage the establishment of a more open and competitive economy. In 1986 and 1987, USAID provided $300 million and $150 million, respectively, under Budget Support Programs I and II (BSP and BSP II). BSP and BSP II supported policy changes aimed at trade liberalization, market-oriented exchange rate, reduced government involvement in the economy/deregulation, simplification of investment rules, fiscal and monetary responsibility. In 1989, USAID established the $218 million grant Support for Development Program (SDP). SDP provided support for policy reforms which would foster broad-based, employment-generating, private sector led development, with broader distribution of economic opportunity. The SDP policy package included reduced government involvement in the Philippine economy through privatization of government owned and controlled corporations, liberalization of interisland shipping regulations affecting private business and improved tax collection.

On August 30, 1991, the GOP and USAID signed a grant agreement of $79.828 million MAI cash transfer for the GOP to undertake and implement the Foreign Investment Act (FIA) of 1991 and Executive Order 470 (E.O. 470). The FIA is a new liberal foreign investment law designed to make the Philippines as attractive a place to invest as its neighbors. E.O. 470 reduces protection of domestic industries by reducing tariff rates and simplifying tariff classifications. The goal is to make the Philippine private sector competitive in the world market.

USAID is directing $10 million worth of assistance to accelerate private investments and trade through its Private Investment and Trade Opportunities Project-Philippines (PITO/Philippines), a parallel project to the ASEAN Representative Office's PITO Project. PITO/Philippines aims to assist Filipino businessmen gain access to new markets and enlarge its market share within established markets by providing institutional support to private sector trade organizations and by establishing trade linkages with the USA and an intra-ASEAN private sector trade network.

USAID's Small Enterprise Credit Project, which is a $13 million grant project started in 1989, as well as USAID's support for many of AID/Washington's guarantee programs in the Philippines, seek to provide assistance to private businessmen in overcoming financial constraints to the diversification of business activity and to strengthen institutional support for the private sector.

In 1988, USAID initiated a $5 million grant Privatization Project. The Privatization Project seeks to reinforce the privatization policy of the GOP by providing technical assistance to the Asset Privatization Trust (APT) and different disposition entities for the development of company-specific privatization strategies and for the implementation of privatization plans.

An $80 million Agribusiness System Assistance Program (ASAP) has been recently authorized. ASAP aims to promote private sector led growth in agribusiness, particularly in the subsectors of feed/livestock and fruits/vegetables. Its purpose is to improve the environment for private investment in agribusiness activity, linked to a more efficient small farm production subsector. ASAP contains $55 million for policy performance based on cash transfers. The different reforms supported under ASAP and SDP II complement and do not duplicate each other.

E. Relationship to Other Donors

1. Macroeconomic Reform Programs

Improvement in the macroeconomic policy environment is the major thrust of the IMF and World Bank in the Philippines. Several bilateral and multilateral donors also engage in discussions on macroeconomic policy issues through the MAI. This is critical because without a sound macroeconomic environment, the Philippine economy and growth will not likely flourish.

The Philippines has had several programs supporting overall macroeconomic policy reforms, the most significant being the various IMF agreements. The most recent 18 month IMF Standby Agreement for period 1991-92 supports the Philippine Economic Stabilization Plan. The centerpiece of this program is a strong effort to bring down the overall public sector deficit through measures to raise revenue, a reduction in expenditure appropriations accompanied by tighter controls on spending, and the gradual elimination of the deficit of the Oil Price Stabilization Fund (OPSF). The program also aims to put the monetary policy on a tighter and steadier course. The Standby includes a number of measures to reform the exchange market to eliminate the existing market segmentation and improve its efficiency.

Tranche releases are conditional upon the GOP's performance in remaining within specified ceilings for public sector borrowing, money supply, new external medium and long term non-concessional borrowing, ceiling on short term external debt outstanding, and ceiling on the outstanding OPSF balance.

2. Other Relevant Sector Programs and Projects

The sector loans extended by donors are aimed to address policy and resource constraints in a particular sector in an integrated fashion. The most relevant and complementary of IBRD programs/projects to SDP II are: the Public Corporations Reform Project, which supports a program of divestiture and other reforms for nonfinancial government corporations; the Financial Sector Adjustment Loan which aims to strengthen the supervisory and regulatory framework for commercial banks, to reduce intermediary costs, and to improve credit and financial policies; and the Industrial Restructuring Loan which aims to improve the structure of Philippine industry. Being designed is an Export Development Project, aimed at improving the accessibility of exporters to information on world market prices, greater availability of export financing through a credit guarantee system, and strengthening the institutions involved in promoting exports. Another project under design for FY 1991 is the Private Sector Development Project which will aim further tariff and investment reforms. These programs will reinforce and complement SDP II, given the commonality of policy issues to be addressed in the area of exports and investments.

IV. DESCRIPTION OF SUPPORT FOR DEVELOPMENT PROGRAM II

A. Goal, Purpose and Specific Objectives

The overall goal of SDP II is to achieve a high rate of broad-based and sustainable economic growth. The purpose of SDP II is to assist, through providing balance of payments and technical support, the GOP in implementing economic policy and administrative reforms to improve the competitiveness of Philippine exports in world markets.

SDP II supports reforms that benefit exporters directly by improving the pricing of Philippine exports and increasing access to inputs at world prices. SDP II also supports reforms that indirectly benefit exporters by improving the financial environment and interisland shipping. Five specific objectives of SDP II are to liberalize rules and regulations for foreign exchange transactions and holdings, streamline the duty drawback and VAT tax credit systems for exports, liberalize interisland shipping rates and route franchising, strengthen VAT administration to improve tax collection and, hence, reduce the fiscal deficit, and improve public debt management to lessen its impact on interest rates.

B. Rationale

The Philippines faces a external financing gap of $2.7 billion for the 1991-92 period. Additional resources are needed to allow GOP stabilization and reform programs to proceed as planned.

Persistent characteristics of the Philippine economic policy over the past 30 years have been the protection of domestic industries from foreign competition by erecting high tariff walls and the tendency to reduce competition among domestic industries by granting monopoly powers to a privileged few. The net result of these policies is a plethora of inefficient domestic industries that are uncompetitive in the open world market. Export earnings have frequently been short of import needs, leading to periodic balance of payments crises that have become a major cause of economic slow-down. The Philippines, which enjoyed one of the highest standard of living in Asia at the end of World War II, has now slipped behind its neighbors in spite of abundant natural resources and high human capital stock.

Today, the Philippines needs to attain high growth that is sustainable over a long period of time. To do this, it must restructure its economy from the inward-looking protective environment of the past to an outward-looking competitive stance.

Some initial steps have already been taken. By liberalizing the foreign investment law, by continuing to reduce quantitative restrictions on imports, and by reducing and simplifying tariff structures, the GOP signals to the world that the past policy of protecting domestic industries is coming to an end and that hitherto protected industries must be prepared to stand on their own feet. By adhering to the performance criteria of the IMF Standby Arrangement, the GOP shows its resolve to overcome short-run instability and lay a foundation for longer term growth based on sound macroeconomic management. In addition, the GOP continues to make progress in undertaking privatization of public enterprises and encouraging foreign private investment through the passage of a build-operate-transfer law, confirming its position on the private sector as the engine of growth.

C. Strategy for Export Competitiveness

In this general framework of policy reforms, SDP II addresses specific areas of reforms directly affecting exporters -- namely reforms aimed at liberalizing the foreign exchange transactions and holdings and at making available intermediate inputs of export products at world prices. In addition, SDP II aims at improving interisland shipping services and reducing interest costs, both of which are vital for exporters to be competitive in the world market. (See Annex F for a broader discussion of the policy issues on export competitiveness.)

1. Liberalizing Foreign Exchange Transactions

The Philippine exchange market is divided into three major segments: the official interbank market, the customer market, and the unofficial or "parallel" market, with only a tenuous linkage among them. In the interbank market, most peso-foreign exchange transactions among banks (including intervention by the Central Bank) take place in the Foreign Exchange Trading Center of the Bankers Association of the Philippines (BAP), where the "BAP reference rate" is determined. The official exchange rate is based on the BAP reference rate; the two rates are identical in practice but can, in principle, be different at the discretion of the Central Bank.

The exchange rate set in BAP floor trading also serves as the basis for the exchange rate in the customer market. However, there are two major structural problems with the interbank market, which detract from market determination of the exchange rate and efficient allocation of foreign exchange, including the needs of exporters. First, it has a limited number of participants (32 commercial banks) and these participants depend on Central Bank "guidance" in setting the exchange rate. Market transparency and full disclosure make it easier for the Central Bank to use moral suasion effectively. Second, it is a thin market, in which a relatively small volume of transaction determines the exchange rate. A reason is that commercial banks are not allowed to take foreign exchange positions beyond one month's import financing needs. Central Bank intervention, generally small in volume, accounts for more than one-half of the transactions; the rest, commercial interbank turnover, amounts to no more than 1-2 percent of the country's total foreign exchange transactions. The market is only open a half an hour each business day. On many business days, no operations take place in this market.

In the customer market, transactions take place between commercial banks (and other authorized dealers, which account for a very small volume of transactions) and their customers who represent a wide range of economic agents engaged in international transactions. The volume of transactions in this market is quite large, since most recorded balance of payments transactions are channeled through it. The absence of a large interbank market leads to a compartmentalization, with banks trading mostly with their own customers and hoarding foreign exchange so that banks can meet their demands. This makes it difficult for users, including exporters, to readily access foreign exchange. While the interbank market is possibly too transparent, the customer market is not transparent enough.

The third major segment of the exchange market, the parallel market, is the channel for a wide range of unofficial transactions not recorded in the balance of payments. The size of this market is believed to be several billions of dollars a year, including a large portion of remittances. Of an estimated total of some $3 billion, only about $1 billion of remittances are channeled through the banking system. This market serves as the safety valve for the overflow of transactions from the other two in times of strain on the balance of payments. The last such episode was in the second half of 1990, when the divergence between the official and parallel rates led to a formal devaluation. Other than this occasion, the parallel exchange rate has not diverged from the official exchange rate by more than a few percentage points since 1986.

Therefore, while the exchange rate may now be said to be market determined in a narrow and formal sense, the imperfections of the market have inhibited free interplay of the forces of supply and demand. The record indicates that the Central Bank has been successful in restraining exchange rate movements, has pre-set exchange rate targets, and has managed to achieve these targets mainly through strong guidance reinforced by small amounts of foreign exchange intervention in the narrow and thin interbank market.

The market segmentation and the lack of breadth and depth are not conducive to the evolution of a genuinely competitive environment and inhibit determination of a realistic exchange rate. The measures proposed in SDP II are based on a study by the IMF. They will contribute to the correction of foreign exchange market imperfections by broadening and deepening the market, bringing about a more competitive environment, and improving the capacity of the market to perform a smooth and efficient intermediation of foreign exchange flows in the economy. No legislation would be required by the GOP to undertake these measures.

The GOP has already taken steps to liberalize foreign exchange transactions and holdings. In particular, the GOP has drafted and circulated for comments a proposal to reopening off-floor trading; allowed a 2 percent retention of foreign exchange earnings by exporters for certain purposes, subjected to $100,000 maximum limit; and abolished the foreign exchange allocation arrangement for oil imports.

- Reopening of off-floor trading among commercial banks. Off-floor trading was permitted when the present exchange system was established in 1984, but was prohibited in late 1987 when demand for foreign exchange expanded as the economy revived. Off-floor trading would, if accompanied by adequate regulation as well as measures to "broaden" the market and other supportive measures, lead to the "deepening" of the market, more efficient and active trading, the use of more sophisticated techniques and less hoarding of foreign exchange.

- Participation in the foreign exchange market expanded to other banks and non-bank institutions. Allowing the entry of additional participants will broaden the market, increase the volume of transactions, and promote efficiency through increased competition.

- Retention limits for exporters of their foreign exchange earnings substantially expanded.

- Comprehensive study on foreign exchange rules and regulations completed.

2. Increasing Access to Inputs at World Prices

Under the Philippine tax law, exporters are entitled to duty drawback of tariffs paid on imported intermediate inputs when products using the inputs are exported. Similarly, exporters are exempted from paying the 10 percent Value Added Tax (VAT) and therefore entitled to receive a tax credit of VAT when products are exported. But in practice, the duty drawback and VAT tax credit systems operate with a 1 to 2 year delay, at a great cost to exporters. This has been a deterrence to export expansion. Under SDP II, various organizations of the GOP will streamline the duty drawback and VAT tax credit system.

The GOP has already taken major steps in this area by issuing the administrative order for establishing the one stop duty drawback center and by commissioning the Engineering Center of the University of the Philippines to design the processing system for duty drawbacks. Remaining actions are:

- One stop duty drawback center established and operated effectively. The length of processing time will be shortened to 60 days for 80 percent of completed applications.

- Procedures for prompt approval of 40 percent of VAT tax credit claims implemented. The length of processing time will be reduced to 60 days for 80 percent of completed applications.

3. Liberalizing Shipping Rates and Route Franchising

In an archipelagic country like the Philippines, an adequately and efficiently functioning water transport system is crucial to timely availability of inputs to exports as well as final exports. However, cargo shipping services have been inadequate. Government regulations on pricing (shipping rates) and entry (into shipping routes) have caused distortions in the industry and adversely affected the transport of goods and services.

The problem associated with shipping cargo rate regulations is the difficulty of accurately identifying and then adjusting rates that are appropriate for all traffic at all times. When rates are higher than what would have been "economically appropriate," the rates hinder movement of potential traffic of goods and services, constraining the country's overall export capability. On the other hand, if rates are set too low, shipping operators have little incentive to provide the shipping services; hence curtailing timely distribution of exporters' inputs and products, mostly for agricultural products.

Entry regulations also have seriously added to the inadequacy of shipping cargo services. The lack of competition and the preference given to existing "prior" shipping operators have encouraged limited and poor quality service. Overtonnaging, i.e. cargo loading beyond allowed capacity, especially in primary and secondary routes, poses a real threat to passenger safety.

In 1989, reforms to remove distortions in shipping rates were undertaken, i.e., removal of _ad valorem_ charging, and liberalization of first and second class passenger rates. Equally significant reforms were made in October/November 1990 which included the adoption of new freight and passage rate formulas with a fork tariff system of plus or minus five percent, abolition of the valuation surcharge and rate deregulation for reefer boxes, livestock and all transit goods. These reforms are partly attributable to the support provided under SDP I and the Shipping Rate Rationalization Study. While these reforms are certainly desirable, more needs to be done to correct remaining distortions, i.e., inaccuracies in the present cargo rate formula, inappropriateness of agricultural commodity classification, rigid service schedules and unrealistic third class passenger rates.

The present plus or minus 5 percent fork tariff provides limited flexibility as the overall rate setting procedures remain relatively rigid to cost variations, to the type of ship technology provided and to the type of packaging and cargo handling method offered. Further widening of the fork tariff is desirable because it will take care of wide cost variations among shipping operators and routes and also provide competition among operators.

The interisland shipping commodity classification has also contributed to the problem of inadequacy of shipping services especially for agricultural produce. The rate differentials do not reflect differences in the costs of providing services for the different commodity groups, but represent instead an attempt by government to incorporate the idea of "what the market will bear" into the rate regulation process. As a result, rates for certain commodity classes have been so low that sufficient and appropriate services are not available. These problems have been most serious for Class C-Basic (agricultural) commodities. Abolition of Class C-Basic commodity classification, coupled with the institution of a dual rate system for commodities, i.e. Class B rates if containerized and Class C rates if not containerized, will improve services available for these commodities and help induce shipping operators to provide ventilated containers for many export products such as bananas.

There is some evidence that a sellers' market exists for liner shipping services which puts upward pressures on rates. Also, many potentially desirable liner shipping services are not now being offered by the liner shipping industry. Rather than merely reacting to applications for new or expanded services, Maritime Industry Authority (MARINA) should assume a more positive role by identifying needs for services and should publicly invite operators to apply for the services.

Interisland passenger traffic exhibits seasonal peaks occurring during "summer" months (March to early June) and Christmas holidays (November to January). Regulations holding rates for Third Class passengers at levels which have not kept pace with inflation and providing rigid shipping schedules have prevented satisfying passenger demand during peak periods. This situation results in over-loading and over-crowding of passengers, thus rendering facilities inadequate, with further unfavorable implications for safety. Institution of higher seasonal Third Class passage rates during peak travel periods would help make shipping passenger capacity sufficient during these periods and reduce safety risks.

Under SDP II, MARINA and Philippine Shippers' Council (SHIPPERCON) will work together to liberalize rate and route franchising regulations. Initial steps taken, as mentioned above, include establishing fork rates of plus/minus five percent and deregulating rates on refrigerated boxes and livestock. Remaining actions include:

- Action plan adopted to liberalize liner cargo rates,

- Agricultural commodities reclassified,

- Cargo fork tariffs widened significantly,

- Action plan adopted for liberalization of route franchising, and

- Schemes adopted to introduce passenger service schedule and rate flexibility.

4. Strengthening Value Added Tax Administration

Aggregate economic stability is highly critical to exports and export development. While inflation adversely affects all segments of the economy, exporters are particularly vulnerable to differential inflation rates between domestic and trading countries. The reason is that the Philippine Central Bank has a tendency to adjust the exchange rate slowly when faced with a real effective exchange rate (REER) appreciation. In fact, during the 1st half of 1991, REER has appreciated approximately 10 to 20 percent, resulting in a substantial reduction in export incentives. As domestic inflation outpaces that of trading partners and as exchange rate adjustment lags behind the pace of price escalation, exporters are adversely affected from two sides: they are less competitive in the export market and they have less incentive to sell in foreign markets because more money can be made in the domestic market. Thus, control of inflationary pressure is highly critical for the enhancement of export competitiveness and incentives. Since a major cause of inflation is the shortage of public sector revenue relative to spending, and since VAT has a large potential to increase tax revenues, SDP II stipulates the GOP to improve its VAT collection efforts.

The GOP has started improvements by pilot testing canvassing to find new VAT registrants (Operation Suyod), introducing in selected districts a new payment control system, and proposing to Congress the expansion of VAT coverage and measures to improve the administration. Remaining steps are:

- "Operation Suyod" and installation of the New Payment Control System (NPCS) for VAT completed nationwide. As a result, there will be demonstrated improvement in efficiency.

5. Lessening Interest Rate Impact of Public Debt Financing

Mainly due to high interest rates excessive borrowing under the previous regime, some 35 to 40 percent of the GOP budget is allocated for debt service payments. Furthermore, because most domestic debt is in short-term bills that require constant turn-overs, government debt financing activities aggravate short-term interest rate fluctuations.

Under SDP II, the GOP will take actions to replace short-term bills with longer term debt instruments to reduce interest rate fluctuations and to broaden the depth of the government security market by offering to small savers opportunities to invest in high yielding government bonds.

- Action program for developing secondary market for long-term public debt instruments adopted and participation in the competitive bids for government securities widened and bidding rules improved.

- Long-term public debt instruments promoted and available, and clearing and settlement system for government securities designed and tested.

- Action program and mechanism for improving the access of small savers to government securities adopted and designed.

D. Policy Implementation Matrix

The policy agenda supported by SDP II is set forth in the draft matrix in Annex G. The final matrix negotiated with the GOP may differ in some details from this draft matrix, but it will cover the same reform areas.

Administration and implementation issues of the policy reform matrix are discussed fully in Annex I. Technical assistance including policy studies, training and modest computer assistance (in terms of hardware and software assistance) to the implementing GOP agencies will facilitate the implementation of policy change supported by SDP II.

E. Expected Impact/Benefits and Costs

This section provides a discussion of the expected economic impact of the SDP II cash transfer and the proposed policy reforms (see Annex H for the detailed economic analysis).

1. Direct Balance of Payments Effects

The transfer of SDP II funds will increase the inflow of capital and help finance the large current account deficit, which the IMF projects to be 4.5 percent of GNP in 1991 and 3.9 percent of GNP in 1992. Assuming that SDP II funds will amount to $35 million in 1991 and $85 million in 1992, the projected current account deficit will be reduced by approximately 0.01 percent of GNP in 1991 and 0.2 percent of GNP in 1992.

2. Effects of Policy Reform Actions

Given the tendency for overvaluation of the peso, the movement toward liberalization of foreign exchange transactions and holdings is expected to result in attainment of a more realistic exchange rate and allowing easier access to foreign exchange. With less frequent Central Bank intervention and with more transparent interbank transactions, market forces will likely adjust exchange rates more quickly to equilibrium levels. Under the new institutional framework, therefore, real effective exchange rate will likely depreciate in a more timely fashion. In the short to medium run, a significant depreciation may have contractionary effects on production mainly because of the lag in export response relative to the more immediate drop in imports. In the longer run, however, the contractionary impact of lower imports is expected to be swamped by export expansion as the economy adjusts to the more depreciated peso.

Since exporters are entitled to duty drawbacks and VAT tax credits, the impact on the net government revenue would be zero in the long run. By streamlining and shortening the process time, however, profitability of export activities is realized. Thus, export incentives are upgraded. The higher export incentives will likely translate into more exports in the future.

The immediate impact of improved VAT collections would be on total tax revenues and the fiscal deficit The improved fiscal position will lessen pressure on money creation and lower the rate of inflation.

Policy actions to improve public debt management would help increase financial resource mobilization, reduce the fiscal deficit, and reduce the crowding out of private sector investment by the public sector. As a result, more productive private sector investments are expected to be generated. With the change in relative prices favoring exports, such investments are likely to occur in both export-oriented activities and more efficient production for the domestic market.

The beneficial outcomes of policy reforms toward liberalized pricing and entry in the interisland shipping sector will come about through increased efficiency in the transport of goods and services in the country and increased sufficiency of appropriate interisland shipping services. The efficiency gains from shipping rate and route liberalization can be derived mainly from travel cost savings, minimization of cargo shut outs, reduction in travel and waiting time, avoidance or reduction in delays in transporting and handling cargos (reduced turnaround time in ports), minimization of weight loss, spoilage, pilferage and spillage of cargos. More significant benefits may be expected from increased sufficiency of appropriate services. such as from increased interisland trade, agricultural diversification and agro-processing.

3. Quantitative Economic Analysis of SDP II Reforms

Overall and over time, the proposed policies are expected to increase exports, reduce imports, reduce fiscal deficits, and improve the current account balance. This will improve economic stability and lead to more sustainable growth.

Although balance of payments support helps provide the needed financial stability for reform implementation and structural adjustment, the SDP II grant funds are treated as a direct program economic cost in conducting quantitative economic analysis of SDP II reforms. SDP II disbursements are assumed to be $35 million in 1991 and $85 million in 1992, adjusted for the shadow price of foreign exchange.

Through simulation of their macro impacts, the foreign exchange market, VAT and public debt management reforms are evaluated for their direct and indirect effects. These reforms are assessed using the 1989 version of the Philippine Institute of Development Studies-National Economic and Development Authority (PIDS-NEDA) annual macroeconometric model. The PIDS-NEDA model consists of 114 behavioral and structural equations and 53 identities. It is divided into four major blocks: real, fiscal, financial, and external. Because many of the exogenous variables in the model are policy-oriented, it is particularly suitable for short term policy analysis. It should be noted however, that the statistically estimated structural parameters of the economy, given the model's functional specification, are defined by the estimation period, covering 1968 to 1987 or subperiods thereof. In this respect, projections and simulations from the model are likely to underestimate the level and rate of changes in the structure of the economy.

Using the PIDS-NEDA model and current assumptions from government agencies and unpublished studies on exogenous variables, projections of key macroeconomic variables were obtained for the without SDP II case for the years 1991 to 2000. Assumptions on exogenous variables include certain changes in government policies such as the recently initiated tariff reform program and a reduction in the reserve requirement from 25 percent in 1993 to 16 percent in 2000. Particularly relevant to the determination of SDP II benefits is the change in the real Gross Domestic Product, i.e., by comparing the with and without SDP II real GDP levels, the benefits of the three reforms are obtained.

The major assumptions in the with SDP II base case are a one time devaluation of the peso in 1992 due to the foreign exchange market reforms followed by a moderate depreciation as in the without case; an increase in VAT collections by 20 percent due to an improved VAT system; and, as a result of improved public debt management, a reduction in the Treasury bill rate by one percentage point during 1993 to 1995 and by another one percentage point during 1996-2000, and an increase in the interest rate on savings deposits from 5 to 6 percent in 1993 and 1994, 7 percent on 1995, and 8 percent in 1996 to 2000. The expected effect of the foreign exchange market reforms is to change through the peso devaluation the economy's expenditure pattern, while that of the VAT and public debt management reforms is to the change both the pattern and level of expenditures directly and indirectly.

The results of the with SDP II base case are shown in the table below. The economic internal rate of return (EIRR) is a robust 44 percent. Even if only half the positive benefits are realized beginning in 1996, the EIRR is still a healthy 29 percent.

It may be noted that real GDP growth will be slower in the first four years, and the net benefits will be negative. This is due mainly to two factors: a relatively tight monetary policy which reduces the real value of funds available for investment, and structural adjustment costs. A more accommodating monetary policy, which will partially restore or maintain the real value of credit available for investment will shorten the adjustment period considerably. Structural adjustment costs arise from the change in relative prices in the economy. These include retooling costs of existing firms, but more importantly changes in investment patterns and the relatively long gestation periods of new investments accompanied by displacement of other factors of production. However, the length of the adjustment is partly a function of the historically estimated parameters of the model.

It is highly probable that structural adjustment will be faster than indicated by the projections. An alternative with SDP II simulation, which maintains the real value of credit to the private sector, results in positive net benefits beginning in 1994, thereby shortening the adjustment period to two years. Moreover, the economy will be more stable, with improvements in both balance of payments and fiscal positions beginning in 1992. Additional benefits from the other reform actions not captured by the simulation, i.e. increased efficiency and sufficient appropriate services in interisland shipping and quicker processing of duty drawbacks and tax credits, are also expected to occur much earlier and offset the costs of adjustment.

Net Benefits (in million pesos, 1991 prices)

Year	Base Case	50% Reduction in Positive Benefits
1991	-1176	-1176
1992	-5835	-5835
1993	-3431	-3431
1994	-2914	-2914
1995	-923	-923
1996	4572	2286
1997	12655	6328
1998	22711	11356
1999	37905	18953
2000	57874	28937
Economic Internal Rate of Return (%)	44.23	28.70

V. PROGRAM

A. Program Funding

SDP II program funding of the $120 million grant consists of $60 million for FY 1991 and proposed $60 million to be appropriated for FY 1992. The source of grant funds is Economic Support Fund (ESF) appropriations. Table 1 presents a summary of projected obligations, mortgage and pipeline over the life of the program.

B. Allocation of Program Funds, Method of Implementation and Financing

As shown in Table 2, SDP II will provide $115 million in grants to the GOP to assist in the implementation of policy reform actions as agreed in the policy matrix (Annex G). Funding requirements for program monitoring, evaluation, nonfederal audit (if necessary), technical assistance, policy studies, and training component of the program is estimated at $5 million (details are provided provided in Section VI. A.).

The balance of payments support component will be implemented using the cash transfer mechanism while the $5 million "projectized" components will involve AID direct and/or host country contracting of expatriate and local professionals. Professional services of local expertise are essential because of their high caliber of professionalism and familiarization of policy reform agenda. The Buy America policy will be followed and any waivers from this policy may be sought at the time of procurement. The monitoring, evaluation and audit components will be implemented through A.I.D. direct contracts using AID direct payment as method of financing. The technical assistance, policy studies, and training funding will be jointly programmed by A.I.D. and NEDA using contracts for expatriate as well as Filipino expertise. As appropriate, AID direct contracting or host country contracting will be utilized as the method of implementation; AID direct payment or host country reimbursement scheme shall be used as the method of financing.

Table 3 shows a summary financial plan indicating the method of implementation and financing for each component, while Table 4 illustrates projected expenditures by fiscal year and program component.

TABLE 1. Summary of Planned Obligations, Mortgage and Pipeline
(In $'000)

	FISCAL YEARS				Total
	1991	1992	1993	1994	
LOP Funding					120,000
Planned Obligations:					
Current FY	60,000	60,000	0	0	120,000
Cumulative	60,000	120,000	120,000	120,000	
Projected Mortgage					
(LOP - Planned Obligations)	60,000	0	0	0	
% Mortgage to LOP	50%	0%	0%	0%	
Planned Expenditures (from Table 4):					
Current FY	-	77,620	41,465	915	120,000
Cumulative	-	77,620	119,085	120,000	
Projected Pipeline					
(Cum. Planned Obligations - Cum. Planned Expenditures)	60,000	42,380	915	0	
% Pipeline to Obligations	100%	35%	1%	0%	

TABLE 2. Estimated Allocation of Program Funds
(in $'000)

PROGRAM ELEMENTS	FY 1991 Oblig.	Future Years Oblig.	Total
1. Balance of Payment Support	56,000	59,000	115,000
2. Policy Studies, Technical Assistance and Training	3,690	800	4,490
3. Monitoring, Evaluation and Audit	310	200	510
PROGRAM TOTAL	60,000	60,000	120,000

TABLE 3. Method of Implementation and Financing
(in $'000)

PROGRAM ELEMENT/ METHOD OF IMPLEMENTATION	Method of Financing	Estimated Amount
1. Balance of Payment Support/ Cash Transfer	Dollar tranche release through EFT	115,000
2. Policy Studies, Technical Assistance and Training/ A.I.D. Direct or Host Country Contract	A.I.D. Direct Payment/Host Country Reimbursement	4,490
3. Monitoring, Evaluation and Audit/ A.I.D. Direct Contract	A.I.D. Direct Payment	510
PROGRAM TOTAL		120,000

TABLE 4. Planned Annual Expenditures by Fiscal Year and Program Element
(In $'000)

Program Element	FY 1992			FY 1993			FY 1994			GRAND TOTAL		
	LC	FX	Subtotal	LC	FX	Subtotal	LC	FX	Subtotal	LC	FX	USAID
1. Balance of Payments Support	-	75,000	75,000	-	40,000	40,000	-	-	0	0	115,000	115,000
2. Policy Studies, Technical Assistance & Training a/	680	1,780	2,460	375	990	1,365	185	480	665	1,240	3,250	4,490
3. Monitoring, Evaluation and Audit a/	48	112	160	30	70	100	75	175	250	153	357	510
PROGRAM TOTAL	728	76,892	77,620	405	41,060	41,465	260	655	915	1,393	118,607	120,000

a/ The estimated expenditures include inflation and contingency allowances.

C. Dollar Uses

The $115 million cash transfer will help the GOP in maintaining external stability while implementing needed reforms. The SDP II dollars will be used to service official non-military debt to the United States Government, the International Bank for Reconstruction and Development (IBRD), International Monetary Fund, International Development Association (IDA), and Asian Development Bank (ADB) or for other agreed uses. The actual uses will be specified at the time of each disbursement. The use of SDP II dollars for a Commodity Import Program (CIP) was considered not appropriate at this time, because the initiation of a CIP would not likely increase total Philippine imports from the U.S. Instead, it would likely delay the program disbursement and impose additional management burden.

The remaining $5 million grant funds will enable the GOP and A.I.D. to monitor implementation, conduct evaluation, finance nonfederal audit (if necessary), provide technical assistance and policy studies, and finance training and limited commodities necessary for the success of the SDP II program. The assistance is being provided to support reform progress towards export competitiveness and sustainable economic growth.

D. Technical Assistance, Policy Studies and Training

Lessons learned in the SDP I implementation process include the need for technical assistance and training to implementing organizations and for continued policy reform studies to maintain momentum for further reforms. Therefore, to further the objectives of the program, SDP II will provide a funding mechanism for technical assistance, policy studies, and training related to SDP II. Technical assistance and training will be provided to organizations, such as the Central Bank, NEDA, the Department of Finance, and MARINA, for resolving technical problems (see Annex I) that will arise in the process of implementing agreed on SDP II related reforms and provide training to upgrade staff capability.

Although technical assistance and policy study issues are treated as separate topics, in actuality the distinction between the two is blurred. For instance, technical assistance can be provided to implementing organizations to undertake policy studies as well as to address technical problems associated with implementation. Out of $5 million approximately $4.49 million will be set aside for technical assistance, policy studies, and training purposes. In addition, a limited amount for commodity purchases, such as personal computers and peripheral equipment and supplies, will be provided, as determined to be critical for the implementation of SDP II. Broad areas of assistance to implementing organizations include but are not limited to the following:

- Central Bank: High caliber professional assistance in the formulacion of Central Bank top management policy with regards to the workings of the foreign exchange market and transactions; study to determine the appropriate criteria for foreign exchange holdings; comprehensive study on foreign exchange rules and regulations, including comparative country studies.

- Bureau of Internal Revenue: Training of staff on computer assisted document processing, client relations, and implementation of the new system; study review/assessment of the effectiveness of the one-stop duty drawback system and delegation of certifying authority to regional offices; and comparative study of duty drawback systems of other countries.

- MARINA: Study of liner shipping routes to develop a service regulation liberalization action plan; study of MARINA/SHIPPERCON organization to prepare action plans for more efficient MARINA/SHIPPERCON operations.

- Department of Finance: Study the need to develop a secondary market for long-term government securities, with a review of implementation options, including debt instruments and liquidity facilities; study the feasibility of marketing savings bonds to households and design different financial instruments; study alternative savings instruments that would provide positive real interest to small savers and conduct a workshop with banks and other financial institutions to formulate action plans; study the establishment of an efficient clearing and settlement system for government security dealers.

- NEDA: Study the overall impact of policy reforms under SDP II; study tour of other developing countries to examine relevant experience in economic policy formulation.

E. Monitoring, Evaluation and Audit

SDP II will fund technical services to monitor and evaluate the policy reform actions through one or more direct A.I.D. contracts. Monitoring and evaluation will include, during the implementation of SDP II and at one or more points thereafter:

- An evaluation of progress toward attainment of the objectives of SDP II;

- Identification and evaluation of problem areas or constraints which may inhibit such attainment;

- Assessment of how such information may be used to help overcome such problems;

- Evaluation, to the degree feasible, of the overall development impact of SDP II; and

- Recommendations on actions to further the objectives of SDP II.

Since the economic impact of the policy reforms will be pervasive and will extend to all segments of the economy, impact evaluations will be performed using a general equilibrium approach. For the foreign exchange market reform, increase in VAT collection, and better management of public debt, the USAID Mission proposes to estimate impact by utilizing a model, such as the PIDS-NEDA macro-econometric model. For the impact evaluation of the liberalization of interisland shipping rates and routes, quantitative benefits will be analyzed using specific rates and routes examples.

SDP II will also fund technical services for financial monitoring and non-federal audits, if necessary. Independent auditing firms may be contracted by the Mission to carry out these activities. Total cost for monitoring, evaluation and audit is estimated at $510,000.

VI. IMPLEMENTATION PROCEDURES

A. Process

1. Balance of Payment Support

The amount of $115 million will be used to service GOP obligations to the U.S. Government, IBRD, IMF, IDA and ADB. A.I.D. approval of a schedule of payments will be a condition precedent to disbursement of dollars for balance of payments support. This approval requirement will enable A.I.D. to ensure that the dollars will be disbursed as quickly as possible for eligible loan payments. To comply with the statutory provisions and regulations on tracking dollar uses, special arrangements will be undertaken to this effect. These arrangements will ensure that each dollar disbursement by the Central Bank of the Philippines is made directly and is trackable to the payee.

a. Schedule of Tranche Releases

Upon satisfaction of the legal, administrative and other non-reform performance Conditions Precedent to initial disbursement of dollars to the GOP, A.I.D. will disburse on behalf of the GOP the first tranche of $35 million for deposit in the separate account or accounts with the bank or banks specified by the GOP. Disbursement will be effected through the electronic funds transfer system.

Upon satisfaction of the conditions precedent to disbursement of the second tranche, A.I.D. will disburse on behalf of the GOP $40 million for deposit in the SDP II Dollar Special Account.

Upon satisfaction of the conditions precedent to disbursement of the third tranche, A.I.D. will disburse on behalf of the GOP $40 million for deposit in the SDP II Dollar Special Account.

b. The SDP II Dollar Special Account

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

2. Pesos

Based on a recently issued A.I.D. policy on local currency as contained in STATE 202944, local currency need not be generated when dollars are used to service external public sector debt. Since the dollar proceeds from the cash transfer under SDP II will be used solely to service the GOP's debts to the U.S. Government, IBRD, IMF, IDA and ADB, no pesos will be generated under the program.

3. Monitoring and Evaluation

USAID Office of the Program Economics (OPE) is the technical office that will coordinate overall project implementation, including monitoring and evaluation. Assistance will be provided by other USAID offices such as the Office of the Legal Adviser, Financial Management, Development Resources Management, and Contract Services Office.

a. GOP Quarterly Dollar Disbursement Reports

Dollar disbursements from the Dollar Special Account will be monitored by USAID's Office of Financial Management through GOP quarterly reports, which may be amended and are due by the end of the following quarter. They will contain at least the following information: each disbursement from the SDP II Dollar Special Account with a specification for each disbursement of the payee and the amount and date of payment, together with certifications: (i) that the GOP has obtained and is maintaining documentation for each disbursement, and (ii) that all funds disbursed from the SDP II Dollar Special Account have been used in accordance with the terms of the SDP II Grant Agreement.

b. Reform Progress Report

The GOP will submit a progress report on the policy action or results to the Office of the Program Economics when it considers the trigger indicators to have been satisfied. Joint consultations on progress will be held at least three weeks in advance of the desired disbursement date. If necessary, the GOP and A.I.D. will exchange additional information regarding the satisfaction of the policy actions.

c. Progress Monitoring

The Office of the Program Economics will arrange for third party reform progress monitoring of SDP II. Reform progress monitoring will obtain detailed periodic information on the policy reform, relevant economic causative and impact variables, and developments in the environment that can directly or indirectly affect GOP implementation progress. A team of professional contractors will be used with expertise as necessary in such fields as foreign exchange market, interisland transportation, international economics, public finance, quantitative modelling, and computer programming. Estimated cost of the activity is $210,000.

d. Evaluation Arrangements

The Office of the Program Economics will use professional services to evaluate SDP II. The evaluation will cover appropriateness of program design, review of implementation and attainment of SDP II objectives, quantitative and qualitative assessment of their impacts on the economy, implementation process and reporting evaluation, and implications for the design and development of future grants under SDP II. Professional services will be utilized with expertise in foreign exchange market, transportation, international economics, public finance, quantitative modelling and computer programming. Evaluation activities will be carried out in 1994, a few months after the third tranche release. Estimated total costs are $250,000.

With the SDP II implementation, in addition to the advent of PEPS implementation activities, the workload of the OPE will increase significantly beyond the capacity of current OPE staff. The OPE is in need of one, if not two, additional FSN professional to share the workload and to successfully carry out the new assingment.

4. <u>Technical Support</u>

A.I.D. and GOP will jointly program the SDP II funding for technical assistance, policy studies and training activities. Both expatriates and Filipino professionals will be contracted to provide services. To assure the successful implementation of SDP II program, the technical assistance and policy study program should be put in effect as soon as possible. It is planned that technical assistance, policy study, and training activities will extend beyond the time of cash transfers to maintain continuity of policy reform efforts of the GOP. The coordination of no less than 7 different GOP organizations that are involved in the policy reform implementation and the administration of a large number of policy study, technical assistance, and training activities require at least one full time professional, if not two, who will be responsible for the successful completion of the SDP II program. Estimated total costs are $4.49 million.

5. <u>Financial Monitoring and Audit</u>

The Office of Financial Management is responsible for monitoring program disbursements especially those made from the dollar special account to ensure the propriety of transactions. If necessary, the services of independent CPA firms may be contracted by OFM to carry out financial monitoring activities.

The Office of the Regional Inspector General for Audit (RIG/A) has primary responsibility for audits of A.I.D. financed assistance. If necessary, provision for financial or compliance audit is carried out through nonfederal audit. Any nonfederal audit is carried out through contracts with recognized independent public accounting firms, and is financed through funds set aside within the activity.

In addition to the Mission's financial monitoring and audit activities, the GOP Commission on Audit (COA) conducts, on an annual basis, an audit of the dollar special account to ensure that disbursements were made in accordance with the program agreement and applicable laws and regulations.

The total amount of program funds set aside for financial monitoring and audit is $50,000. Funding for COA audit is provided by the GOP.

B. <u>GOP Implementing Entities</u>

1. Department of Finance

The Department of Finance (DOF), through its International Finance Group, will be the lead implementing agency for SDP II. It will be responsible for timely and satisfactory implementation of SDP II activities including GOP monitoring and reporting requirements. DOF will also be responsible, in coordination with the Central Bank of the Philippines (CB), and Bureau of Treasury (BTr), for the preparation and submission to A.I.D. of implementation plans for the disbursement of dollars from the SDP II Dollar Special Account, prior to such disbursement.

2. National Economic and Development Authority

Together with DOF, the National Economic and Development Authority (NEDA), through the Director General and the National Development Office, will represent the GOP in dealing with A.I.D. in regard to SDP II, especially concerning technical support. Specific technical support activities will be handled directly between A.I.D. and the involved GOP agency. It also will coordinate with DOF, BTr, CB, and other entities, as necessary, in conducting a joint review with A.I.D. on the satisfaction of policy actions or results described or similar to those described in the Policy Implementation Matrix.

3. Central Bank of the Philippines

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

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

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

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

d. Obtain, maintain and certify to A.I.D. that evidence for the agreed upon payments have been made from the Dollar Special Account.

e. Prepare and submit to A.I.D. the required quarterly dollar disbursement reports, together with the required certifications related to those reports.

f. Coordinate with NEDA and DOF, in obtaining and providing inputs to the reform progress report.

4. Bureau of Treasury

The Bureau of Treasury (BTr) will:

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

b. Provide information, as necessary, to CB for the required dollar disbursement reports.

5. Maritime Industry Authority

The Maritime Industry Authority (MARINA) will be mainly responsible for the satisfactory implementation of policy actions under SDP II aimed at providing adequate interisland liner services for exports, i.e. liberalization of rate and route regulations. MARINA, in coordination with the Philippine Shippers' Council (SHIPPERCON) and with the assistance of A.I.D., will also be responsible in the implementation of various technical assistance activities, i.e. policy research, training, database upgrading. MARINA and SHIPPERCON, with AID assistance, are expected to make available staff time and existing equipment/materials for upgrading of their database systems and for staff training.

6. Bureau of Internal Revenue

The Bureau of Internal Revenue through its Value Added Tax (BIR-VAT) division is responsible for implementing policy reform actions under SDP II geared towards improving VAT collection efficiency and VAT credit system for exporters. The operations chief of the BIR-VAT division will coordinate with DOF, NEDA and other implementing agencies in the completion and submission of the reform progress report to A.I.D. including, as necessary, a joint review with A.I.D. on the satisfaction of policy actions or results.

7. Bureau of Customs/Department of Trade and Industry-International Trade Group

The Department of Trade and Industry-International Trade Group (DTI-ITG), through the Bureau of Export and Trade Promotion (BETP), will play a facilitating role at the start of the one stop shop duty drawback center. BETP, with experience from the setting up of the one stop export processing center, will oversee the whole exercise on the improvement of the duty drawback processing system. This includes assistance to the Department of Science and Technology-Institute of Technical Design and Innovation application for developing the standard formulas of manufacture (SFM) for priority export products and establishing an institutional network for the application of SFMs and attention to the hardware and software requirements of the center. Once a sufficient level of efficiency in the operations of the center is attained, BETP will pass on the managerial responsibility of the center to Bureau of Customs (BOC).

VII. CONDITIONS AND COVENANTS

The following are the conditions and covenants proposed for SDP II:

A. Conditions Precedent to Initial Disbursment

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

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

2. Signature certification of authorized GOP representatives and designation of additional representatives.

B. Conditions Precedent to First Dollar Disbursement for BOP Support

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

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

2. an Implementation Plan specifying (i) the responsibilities and interrelationships of the entities involved in the receipt and disbursement of U.S. dollar funds, (ii) a schedule of payments, identifying payees, amount and due dates of the loans proposed to be made by the Grantee using U.S. dollars provided in the tranche release and any interest earned thereon; and (iii) the type of documentation to be obtained and maintained by or on behalf of the Grantee evidencing the use of U.S. dollars disbursed from funds provided through the program; and

3. technical support implementation plan and agreement on the scopes of work for monitoring, evaluation, and priority technical assistance services.

C. Conditions Precedent to Second and Third Dollar Disbursement for BOP Support

Prior to disbursement of the second and third tranches in addition to the Conditions Precedent 1, 2, and 3 under B, the GOP and A.I.D. shall have concluded consultations acceptable to A.I.D. on GOP progress towards the objectives of SDP II, on satisfaction of the specific implementation actions and indicators of the Policy Implementation Matrix, and on the operations of the technical support component.

D. Terminal Date for Conditions Precedent to A.I.D. Dollar Disbursements

The terminal dates for the above conditions precedent for A.I.D. disbursement are 60-days after grant signing for initial disbursement; December 31, 1991 for first BOP support disbursement; September 30, 1992 for the second BOP support disbursement; and June 30, 1993 for the third. A.I.D. may agree in writing to a later date or terminate the agreement by written notice to the GOP.

E. Other Special Covenants

1. U.S. Dollar Account

U.S. dollars being held in the account identified by the GOP shall not be commingled with funds from any other source except that the account shall include interest, if any, earned on funds held in the account. This Account shall also include any GOP refunds for unacceptable disbursements from the account including interest on such GOP refunds. The GOP shall promptly furnish to A.I.D. in form and substance satisfactory to A.I.D.:

a. Documentation evidencing deposits into the account, and

b. Monthly statements of balances held in the account, including interest, if any, earned on funds held therein.

2. Disbursements from U.S. Dollar Account

U.S. dollars held in the account referred to above shall be disbursed by the Central Bank of the Philippines in accordance with the implementation plan to service official non-military debt obligations of the GOP to the United States Government, the International Monetary Fund, the IBRD, the International Development Association, or the Asian Development Bank, in accordance with the schedules of payments provided. Funds held in the account shall be used solely for the foregoing purpose, or for such other purposes as A.I.D. and the GOP may mutually agree upon, until all funds held in said account have been disbursed from time to time for such purpose.

ANNEX A

REQUEST FOR ASSISTANCE

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ANNEX A-1

Republic of the Philippines
DEPARTMENT OF FINANCE
Manila

September 23, 1991

Mr. Malcolm Butler
Mission Director
U.S. Agency for International
Development (USAID)
Roxas Blvd., Manila

Dear Mr. Butler:

As you are aware, the concerned Philippine Government agencies have been working closely for several months now with USAID officials in formulating the policy reform program to be implemented under the Support for Development Program (SDP) II. This includes macroeconomic and sectoral reform measures that will enhance export competitiveness and alleviate persistent balance of payments constraints. In behalf of my Government, I would like to formally request that this program be supported by $60 million in grant assistance.

Of the amount being requested, $4 million will be allocated for a technical support component that will facilitate the implementation of the agreed policy reform measures.

Furthermore, we would appreciate the Mission's assistance in augmenting program financing by an increment of up to $60 million to support the policy reform package earlier agreed upon .

We trust that favorable consideration would be extended by your Government on this request and look forward to your early reply.

Very truly yours,

JESUS P. ESTANISLAO
Secretary

cc: Sec. Paderanga, NEDA

ANNEX R

REDELEGATION OF AUTHORITY FOR PAAD DEVELOPMENT AND AUTHORIZATION

ACTION: AID-3 INFO: AMB DCM AA ECON RA/S

VZCZCML0483
RR RUEHML
DE RUEHC #0316 1620656
ZNR UUUUU ZZH
R 110655Z JUN 91
FM SECSTATE WASHDC
TO AMEMBASSY MANILA 8390
BT
UNCLAS STATE 193316

11-JUN-91 TOR: 07:41
CHRG: AID
DIST: AID

AIDAC

E.O. 12356: N/A
TAGS:
SUBJECT: SUPPORT FOR DEVELOPMENT II (SDP II) - PAIP APPROVAL

REFERENCES: A. MANILA 9143 (THE PAIP); B. 87 STATE 325792 OF 23 OCT 87; C. 90 STATE 208563 OF 27 JUN 90

1. DECISION: AA/APRE APPROVES THE PROGRAM ASSISTANCE INITIAL PROPOSAL (PAIP) FOR THE SUPPORT FOR DEVELOPMENT PROGRAM II AND DELEGATES TO THE DIRECTOR, USAID/PHILIPPINES AUTHORITY TO AUTHORIZE THE PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD) FOR THE PROGRAM FOR 120 MILLION DOLLARS OF ESF FUNDS IN FY 1991 AND FY 1992. BEFORE APPROVING THE PAAD, THE MISSION SHOULD ADVISE AID/W OF THE POLICY AGENDA AND BENCHMARKS TO BE ACHIEVED FOR EACH PLANNED DISBURSEMENT AS IT DID FOR THE SDP I PROGRAM.

2. PAIP REVIEW: ENE PROJECT REVIEW COMMITTEE REVIEW OF THE PAIP WITH MISSION PROGRAM ECONOMIST PAUL DEUSTER APRIL 22 NOTED THAT THE AREAS OF REFORM FROM WHICH THE MISSION WILL IDENTIFY SPECIFIC REFORMS AND BENCHMARKS FOR DISBURSEMENTS ARE CONSISTENT WITH CURRENT STRATEGY AND THE FINDINGS OF THE RECENT EVALUATION OF SDP I.

3. SPECIAL ACCOUNT: IN PROVIDING FOR A DOLLAR SPECIAL ACCOUNT IN THE PAAD, THE MISSION SHOULD BE GUIDED BY REFS B AND C. REF B, SECTION 5 (C) (IV) REQUIRES THAT USE OF SPECIAL ACCOUNT DOLLARS "FOR SERVICING DEBT OWED TO MULTILATERAL DEVELOPMENT BANKS AND THE IMF IS SUBJECT TO PRIOR CONCURRENCE OF THE APPROPRIATE REGIONAL ASSISTANT ADMINISTRATOR." PRC REVIEW WITH DEUSTER AGREED THAT THE PREFERRED ALTERNATIVES OF USING THE DOLLARS FOR U.S. IMPORTS OR DEBT TO THE U.S. ARE NOT PRACTICABLE OR ARE INCONSISTENT WITH OUR OBJECTIVES UNDER CURRENT CIRCUMSTANCES. ACCORDINGLY, THE AA/APRE CONCURS IN USE OF THE SPECIAL ACCOUNT DOLLARS FOR MULTILATERAL DEBT SERVICE. HOWEVER, THE MISSION SHOULD REVIEW CIRCUMSTANCES AT THE TIME OF THE PAAD AND BEFORE EACH DISBURSEMENT TO DETERMINE WHETHER USE OF SPECIAL ACCOUNT DOLLARS FOR IMPORTS FROM THE U.S. OR FOR U.S. DEBT IS APPROPRIATE AT THAT TIME.

ACTION TAKEN

4. LOCAL CURRENCY: THE PAAD SHOULD ALSO REFLECT THE RATIONALE FOR NOT SEEKING TO GENERATE LOCAL CURRENCY UNDER

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5C(2) - ASSISTANCE CHECKLIST

Listed below are statutory criteria applicable to the assistance resources themselves, rather than to the eligibility of a country to receive assistance. This section is divided into three parts. Part A includes criteria applicable to both Development Assistance and Economic Support Fund resources. Part B includes criteria applicable only to Development Assistance resources. Part C includes criteria applicable only to Economic Support Funds.

CROSS REFERENCE: IS COUNTRY CHECKLIST UP TO DATE

Yes. It is included in the PAAD for the Private Enterprise Policy Support Program (492-0457).

A. CRITERIA APPLICABLE TO BOTH DEVELOPMENT ASSISTANCE AND ECONOMIC SUPPORT FUNDS

1. **Host Country Development Efforts** (FAA Sec. 601(a)): Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.

2. **U.S. Private Trade and Investment** (FAA Sec. 601(b)): Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

1. and 2. Objective of the program is to assist the GOP in implementing policies to improve the competitiveness of Philippine exports in world markets thus directly fostering a), b), d), and e). The program will not impact upon c) or f). It is expected that there will be increased U.S. technical assistance and investment opportunities as a result of this program.

3. **Congressional Notification**

a. **General requirement** (FY 1991 Appropriations Act Secs. 523 and 591; FAA Sec. 634A): If money is to be obligated for an activity not previously justified to Congress, or for an amount in excess of amount previously justified to Congress, has Congress been properly notified (unless the notification requirement has been waived because of substantial risk to human health or welfare)?	Yes. The waiting period for the Congressional Notification expired without objection on August 19, 1991.
b. **Notifice of new account obligation** (FY 1991 Appropriations Act Sec. 514): If funds are being obligated under an appropriation account to which they were not appropriated, has the President consulted with and provided a written justification to the House and Sentate Appropriations Committees and has such obligation been subject to regular notification procedures?	N/A
c. **Cash transfers and nonproject sector assistance** (FY 1991 Appropriations Act Sec. 575(b)(3)): If funds are to be made available in the form of cash transfer or nonproject sector assistance, has the Congressional notice included a detailed description of how the funds will be used, with a discussion of U.S. interests to be served and a description of any economic policy reforms to be promoted?	Yes.
4. Engineering and Financial Plans (FAA Sec. 611(a)): Prior to an obligation in excess of $500,000, will there be: (a) engineering, financial or other plans necessary to carry out the assistance; and (b) a reasonably firm estimate of the cost to the U.S. of the assistance?	Yes.

5. **Legislative Action** (FAA Sec. 611(a)(2)): If legislative action is required within recipient country with respect to an obligation in excess of $500,000, what is the basis for a reasonable expectation that such action will be completed in time to permit orderly accomplishment of the purpose of the assistance?	No legislative action is required.
6. **Water Resources** (FAA Sec. 611 (b); FY 1991 Appropriations Act Sec. 501): If project is for water or water-related land resource construction, have benefits and costs been computed to the extent practicable in accordance with the principles, standards, and procedures established pursuant to the Water Resources Planning Act (42 U.S.C. 1962, <u>et seq</u>.)? (See A.I.D. Handbook 3 for guidelines.)	N/A
7. **Cash Transfer and Sector Assistance** (FY 1991 Appropriations Act Sec. 575(b)): Will cash transfer or nonproject sector assistance be maintained in a separate account and not commingled with other funds (unless such requirements are waived by Congressional notice for nonproject sector assistance)?	Yes.
8. **Capital Assistance** (FAA Sec. 611(e)): If project is capital assistance (<u>e.g.</u>, construction), and total U.S. assistance for it will exceed $1 million, the Mission Director certified and Regional Assistant Administrator taken into consideration the country's capabiity to maintain and utilize the project effectively?	N/A
9. **Multiple Country Objectives** (FAA Sec. 601(a)): Information and conclusions on whether projects will encourage (b)	Yes to (a), (b), (d), (e). N/A to (c) and (f). (See A.1)

development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture and commerce; and (f) strengthen free labor unions.

10. **U.S. Private Trade** (FAA Sec. 601(b)): Information and conclusions on how project will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

The program will help promote economic stability and growth which in turn will increase imports from the U.S. including technical assistance and commodities. U.S. private investors should be able to take advantage of enhanced trade opportunities. (See A.1)

11. **Local Currencies**

a. **Recipient Contributions** (FAA Secs. 612(b), 636(h)): Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized in lieu of dollars.

Grantee contributions will include support costs for U.S. technical assitance.

b. **U.S. -Owned Currency** (FAA Sec. 612(d)): Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?

No.

c. **Separate Account** (FY 1991 Appropriations Act Sec. 575). If assistance is furnished to a foreign government under arrangements which result in the generation of local currencies:

No local currencies will be generated.

(1) Has A.I.D. (a) required that local currencies be deposited in a separate account established by the recipient government, (b) entered into an agreement with that government providing the amount of local currencies to be generated and the

terms and conditions under which the currencies so deposited may be utilized, and (c) established by agreement the responsibilities of A.I.D. and that government to monitor and account for deposits into and disbursements from the separate account?

(2) Will such local currencies, or an equivalent amount of local currencies, be used only to carry out the purposes of the DA or ESF chapters of the FAA (depending on which chapter is the source of the assistance) or for the adminsitrative requirements of the United States Government? — N/A

(3) Has A.I.D. taken all appropriate steps to ensure that the equivalent of local currencies disbursed from the separate account are used for the agreed purposes? — N/A

(4) If assistance is terminated to a country, will any unencumbered balances of funds remaining in a separate account be disposed of for purposes agreed to by the recipient government and the United States Government? — N/A

12. **Trade Restrictions**

a. Surplus Commodities (FY 1991 Appropriations Act Sec. 521(a)): If assistance is for the production of any commodity for export, is the commodity likely to be in surplus on world markets at the time the resulting productive capacity becomes operative, and is such assistance likely to cause substantial injury to U.S. producers of the same, similar or competing commodity? — N/A

b. Textiles (Lautenberg Amendment) (FY 1991 Appropriations Act Sec. 521(c)): Will the assistance (except for programs in Caribbean Basin Initiative countries — No.

under U.S. Tariff Schedule (Section 807," which allows reduced tarriffs on articles assembled abroad from U.S.-made components) be used directly to procure feasibility studies, prefeasibility studies, or project profiles of potential investment in, or to assist the establishment of facilities specifically designed for, the manufacture for export to the United States or to third country markets in direct competition with U.S. exports, of textiles, apparel, footwear, handbags, flat goods (such as wallets or coin purses worn on the person), work gloves or leather wearing apparel?	
13. **Tropical Forests** (FY 1991 Appropriations Act Sec. 533(c) (3)): Will funds be used for any program, project or activity which would (a) result in any significant loss of tropical forests, or (b) involve industrial timber extraction in primary tropical forest areas?	No.
14. **Sahel Accounting** (FAA Sec. 121(d)): If a Sahel project, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of project funds (either dollars or local currency generated therefrom)?	N/A
15. **PVO Assistance**	
a. **Auditing and registration** (FY 1991 Appropriations Act Sec. 537): If assistance is being made available to a PVO, has that organization provided upon timely request any document, file, or record necessary to the auditing requirements of A.I.D., and is the PVO registered with A.I.D.?	N/A. The program does not involve PVO assistance.
b. **Funding sources** (FY 1991 Appropriations Act, Title II, under heading "Private and Voluntary Organizations"): If assistance is to be made to a United States PVO	

cooperative development (other than a cooperative organization), does it obtain at least 20% of its total annual funding for international activities from sources other than the United States Government?	
16. **Project Agreement Documentation** (State Authorization Sec. 139 (as interpreted by confirmation of the date of signing of the project agreement, including the amount involved, been cabled to State L/T and A.I.D. LEG within 60 days of the agreement's entry into force with respect to the United States, and has the full text of the agreement been pouched to those same offices? (See Handbook 3, Appendix 6G for agreements covered by this provision).	This information will be cabled within the required time period.
17. **Metric System** (Omnibus Trade and Competitiveness Act of 1988 Sec. 5164, as interpreted by conference report, amending Metric Conversion Act of 1975 Sec. 2, and as implemented through A.I.D. policy): Does the assistance activity use the metric system of measurement in its procurements, grants, and other business-related activities, except to the extent that such use is impractical or is likely to cause significant inefficiencies or loss of markets to Untied States firms? Are bulk purchases usually to be made in metric, and are components, subassembles, and semi-fabricated materials to be specified in metric units when economically available and technically adequate? Will A.I.D. specifications use metric units of measure from the earliest programmatic stages, and from the earliest documentation of the assistance processes (for example, project papers) involving quantifiable measurements (length, area, volume, capacity, mass and weight), through the implementation stage?	Yes.

18. **Women in Development** (FY 1991 Appropriations Act, Title II, under heading "Women in Development"): Will assistance be designed so that the percentage of women participants will be demonstrably increased?	Yes.
19. **Regional and Multilateral Assistance** (FAA Sec. 209): Is assistance more efficiently and effectively provided through regional or multilateral organizations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs.	No.
20. **Abortions** (FY 1991 Appropriations Act, Title II, under heading "Population, DA," and Sec. 525):	N/A
a. Will assistance be made available to any organization or program which, as determined by the President, supports or participates in the management of a program of coercive abortion or involuntary sterilization?	No.
b. Will any funds be used to lobby for abortion?	No.
21. **Cooperatives** (FAA Sec. 111): Will assistance help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward a better life?	No.
22. **U.S.-Owned Foreign Currencies**	
a. **Use of currencies** (FAA Secs. 612(b), 636(h); FY 1991 Appropriations Act Secs. 507, 509): Describe steps taken to assure that, to the maximum extent possible, foreign currencies owned by the U.S. are utilized in lieu of dollars to to meet the cost of contractual and other services.	N/A. No U.S.-owned foreign currencies.

b. Release of currencies (FAA Sec. 612(d): 612(d)): Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?

23. **Procurement**

a. **Small business** (FAA Sec. 602(a)): Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed?	Yes.
b. **U.S. procurement** (FAA Sec. 604(a): Will all procurement be from the U.S. except as otherwise determined by the President or determined under delegation from him?	Yes.
c. **Marine insurance** (FAA Sec. 604(d): If the cooperating country discriminates against marine insurance companies authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company?	The Philippines does not discriminate against U.S. marine insurance companies.
d. **Non-U.S. agricultural** procurement (FAA Sec. 604(e): If non-U.S. procurement of agricultural commodity or product thereof is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity? (Exception where commodity financed could not reasonably be procured in U.S.)	N/A
e. **Construction of engineering services** (FAA Sec. 604(g) : Will construction or engineering services be procured from firms of advanced developing countries which are otherwise eligible under Code 941 and which have attained a competitive capability in international markets in one of these areas? (Exception for those countries which receive	N/A

direct economic assistance under the FAA and permit United States firms to compete for construction or engineering services financed from assistance programs of these countries.)

f. **Cargo preference shipping** FAASec.03): Is the shipping excluded from compliance with the equirement in section 901(b) of the Merchant Marine Act of 1936, as amended,that at least 50 percent of the gross tonnage of commodities (computedseparately from dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent such vessels are available at fair and reasonable rates?	N/A
g. **Technical assistance** (FAA Sec. 621 (a)): If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? Will the facilities and resources of other Federal agencies be utilized, when they are particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs?	Yes.
h. **U.S. air carriers** (International Air Transportation Fair Competitive Practices Act, 1974): If air transportation of persons or property is financed on grant basis, will U.S. carriers be used to the extent wuch service is available?	Yes.
i. **Termination for convenience of U.S. Government** (FY 1991 Appropriations Act Sec/ 504): If the U.S. Government is a party to a contract for procurement, does the contract contain a provision authorizing termination of such contract for the convenience of the	Yes. All contracts will contain such a provision.

United States?

j. **Consulting services** (FY 1991 Appropriations Act Sec. 524): If assistance is for consulting service through procurement contract pursuant to 5 U.S.C. 3109, are contract expenditures a matter of public record and available for public inspection (unless otherwise provided by law or Executive Order?) — Yes.

K. **Metric conversion** (Omnibus Trade and Competitiveness Act of 1988, as interpreted by conference report, amending Metric Conversion Act of 1975 Sec. 2, and as implemented through A.I.D. policy): Does the assistance program use the metric system of measurement in its procurements, grants, and in its procurements, grants and other business-related activities, except to the extent that such use is impractical or it likely to cause significant inefficiencies or loss of markets to United States firms? Are bulk purchases usually to be made in metric, and are components, subassemblies, and semi-fabricated materials to be specified in metric units when economically available and technically adequate? Will A.I.D. specifications use metric units of measures from the earliest programmatic stages, and from the earliest documentation of the assistance processes (for example, project papers) involving quantifiable measurements (length, area, volume, capacity, mass and weight), through the implementation stage? — Yes.

l. **Competitive Selection Procedures** (FAA Sec. 601(e): Will the assistance utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?is for consulting service through procurement contract pursuant to 5 U.S.C. 3109, are contract expenditures a matter of — Yes.

24. Construction	N/A
a. Capital project (FAA Sec. 601(d)): If capital (e.g., construction) project, will U.S. engineering and professional services be used?	
b. Construction contract (FAA Sec. 611(c)): If contracts for construction are to be financed, will they be lent on a competitive basis to maximum extent practicable?	
c. Large projects, Congressional approval (FAA Sec. 620(k)): If for construction of productive enterprise, will aggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprise in Egypt that were described in the Congressional Presentation), or does assistance have the express approval of Congress?	
25. **U.S. Audit Rights** (FAA Sec. 301(d)): If fund is established solely by U.S. contributions and administered by an international organization, does Comptroller General have audit rights? organization, does Comptroller General have audit rights?	N/A
26. **Communist Assistance** (FAA Sec. 620(h): Do arrangements exist to insure that United States foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the Communist-block countries?	Yes.
27. **Narcotics**	
a. Cash reimbursements (FAA Sec. 483): Will arrangements preclude use of financing to make reimbursements, in the form of cash payments, to persons whose illicit	Yes.

drug crops are eradicated?

b. **Assistance to narcotics traffickers** (FAA Sec. 487): Will arrangements take "all reasonable steps" to preclude use of financing to or through individuals or entities which we know or have reason to believe have either: (1) been convicted of a violation of any law or regulation of the United States or a foreign country relating to narcotics (or other controlled substances); or (2) been an illicit trafficker in, or otherwise involved in the illicit trafficking, of any such controlled substance? — Yes.

28. **Expropriation and Land Reform** (FAA Sec. 620(g): Will assistance prelude use of financing to compensate owners for expropriated or nationalized property, except to compensate foreign nationals in accordance with a land reform program certified by the President? — Yes.

29. **Police and Prisions** (FAA Sec. 660): Will assistance preclude use of financing to provide training, advice, or any financial support for police, prisons, or other law enforcement forces, except for narcotics programs? — Yes.

30. **CIA Activities** (FAA Sec. 662): Will assistance preclude use of financing for CIA activities? — Yes.

31. **Motor Vehicles** (FAA Sec. 636(i): Will assistance preclude use of financing for purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicle manufactured outside U.S., unless a waiver is obtained? — Yes.

32. **Military Personnel** (FY 1991 Appropriations Act Sec. 503): Will assistance preclude use of financing to pay pensions, annuities, retirmenet pay, or adjusted service compensation for — Yes.

prior or current military personnel?

33. **Payment of U.N. Assessments** (FY 1991 Appropriations Act Sec. 505): Will assistance preclude use of financing to pay U.N. assessments, arrearages or dues?	Yes.
34. **Multilateral Organization Lending** (FY 1991 Appropriations Act Sec. 506): Will assistance prelude use of financing to carry out provisions of FAA section 209(d) (transfer of FAA funds to multilateral organizations for lending)?	Yes.
35. **Export of Nuclear Resources** (FY 1991 Appropriations Act Sec. 510): Will assistance preclude use of financing to finance the export of nuclear equipment, fuel, or technology?	Yes.
36. **Repression of Population** (FY 1991 Appropriations Act Sec. 511): Will assistance preclude use of financing for the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights?	Yes.
37. **Publicity or Propaganda** (FY 1991 Appropriations Act Sec. 516): Will assistance be used for publicity or propaganda purposes designed to support or defeat legislation pending before Congress, to influence in any way the outcome of a political election in the United States, or for any publicity or propaganda purposes not authorized by Congress?	No.
38. **Marine Insurance** (FY 1991 Appropriations Act Sec. 563): Will any A.I.D. contract and solicitation, andsubcontract entered into under such contract, include a clause requiring that U.S. marine	Yes.

fair opportunity to bid for marine insurance when such insurance is necessary or appropriate?

39. **Exchange for Prohibited Act** (FY 1991 Appropriations Act Sec. 569): Will any assistance be provided to any foreign government (including any instrumentality or agency thereof), foreign person, or United States person on exchange for that foreign government or person undertaking any action which is, if carried out by the United States Government, a United States official or employee, expressly prohibited by a provision of United States law?

No.

C. CRITERIA APPLICABLE TO ECONOMIC SUPPORT FUNDS ONLY

1. **Economic and Political Stability** (FAA Sec. 531(a)): Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA?	Yes.
2. **Military Purposes** (FAA Sec. 531(e)): Will this assistance be used for military or paramilitary purposes?	No.
3. **Commodity Grants/Separate Accounts** (FAA Sec. 609): If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made?	N/A
4. **Generation and Use of Local Currencies** (FAA Sec. 531(d)): Will ESF programs or other program assistance be used to generate local currencies? If so, will at least 50 percent of such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106?	N/A
5. **Cash Transfer Requirements** (FY 1991 Appropriations Act, Title II, under heading "Economic Support Fund," and Sec. 575(b)). If assistance is in the form of a cash transfer:	
a. **Separate account:** Are all such cash payments to be maintained by the country in a separate account and not to be commingled with any other funds?	Yes.
b. **Local currencies:** Will all local currencies that may be generated with funds provided as a cash transfer to such a country also be deposited in a special account, and has A.I.D. entered into an agreement with that government setting forth the amount of the local currencies to be generated, the terms and conditions under which	No local currencies will be generated under this Program.

they are to be used, and the responsibilities of A.I.D. and that government to monitor and account for deposits and disbursements.

c. **U.S. Government use of local currencies:** Will all such local currencies also be used in accordance with FAA Section 609, which requires such local currencies to be made available to the U.S. government as the U.S. determines necessary for the requirements of the U.S. Government, and which requires the remainder to be used for programs agreed to by the U.S. Government to carry out the purposes for which new funds authorized by the FAA would themselves be available. — N/A

d. **Congressional notice:** Has Congress received prior notification providing in detail how the funds will be used, including the U.S. interests that will be served by the assistance, and, as appropriate, the economic policy reforms that will be promoted by the cash transfer assistance? — Yes.

ANNEX D

CERTIFICATION PURSUANT TO UTILIZATION OF GRAY AGREEMENT

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ANNEX D

CERTIFICATION PURSUANT TO UTILIZATION OF GRAY AMENDMENT ORGANIZATIONS

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

Malcolm Butler

MALCOLM H. BUTLER
Director, USAID/Philippines

ANNEX E

RECENT PHILIPPINE ECONOMIC PERFORMANCE

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RECENT ECONOMIC PERFORMANCE

A. Macroeconomic Performance

1. Recent Economic Performance: 1990

The Philippine economy grew at a sluggish 3.3 percent in 1990 after three consecutive years of strong economic performance, averaging at 5-6 percent. Delays in the implementation of needed reforms (e.g. delays in adjustments of domestic petroleum prices and the exchange rate as well as delays in the implementation of new tax measures) and higher-than-anticipated government spending are major policy slippages that created economic imbalances in 1990 resulting in sluggish economic performance. Economic imbalances during the period were exacerbated by the adverse effects of the July earthquake concentrated in Northern and Central Luzon, the August oil price shocks and the November typhoon ('Ruping') that wrought havoc in the Visayas and Northern Mindanao.

1.a Consolidated Public Sector Deficit and Domestic Interest Rates:

Unanticipated expansion of the consolidated public sector deficit (CPSD) is regarded as the main cause of economic imbalances in internal aid and external accounts last year. While expansionary, the 1990 CPSD estimated at Pesos 58.5 billion or 5.2 percent of GNP, caused high yields on government debt, depreciation of the local currency and unprogrammed expansion of money supply. CPSD has three parts, namely: national government deficit, monitored government corporate sector deficit and deficits in the nonbudget operations such as those from the oil price stabilization fund (OPSF) and the Central Bank (CB).

The national government deficit showed the largest expansion from Pesos 19.6 billion in 1989 to Pesos 40 billion in 1990. Revenue collection, estimated to have increased by over 20 percent, improved substantially but was not sufficient to match the increase in current and capital expenditures of the national government. The increase in current spending was attributed to the costs of the full implementation of the wage standardization program and high interest payments due to excessive reliance on domestic debt financing that caused interest rates to soar. Further improvements in the GOP's disbursement systems and project implementation boosted absorptive capacity leading to higher capital spending.

Deficit of the monitored government corporations rose to Pesos 12.5 billion in 1990 from Pesos 4.4 billion in 1989. Decline in internal cash generation of most government corporations specially the National Power Corporation (NPC) and higher capital outlays of Philippine National Oil Company (PNOC) and National Food Authority (NFA) explain the hefty deficit of the monitored government corporate sector.

An additional Pesos 7.4 billion was added to the OPSF deficit in 1990 after incuring a Pesos 9 billion of payables in 1989. The failure to adjust domestic petroleum prices in the wake of higher international prices led to higher outstanding claims by the oil companies on the OPSF.

The CB's net financial loss from operations increased to Pesos 22.2 billion in 1990 from a deficit of Pesos 20.8 billion in 1989. Losses from its foreign exchange swap and forward cover arrangements, arrears in the payment of emergency loans to ailing financial institutions during 1983-1985, delay in debt service payments of government corporations and interest losses from having assumed Philippine National Bank (PNB) and Development Bank of the Philippines (DBP) foreign debt payments have contributed to the sustained financial losses of the CB.

For the period 1990, nominal and real interest rates were clearly on an uptrend. This reflected higher public sector demand on the economy's resources and lender's demand for premiums to offset increased risks associated with rising inflationary expectations and expectations of further depreciation in the foreign exchange rate. The 91-day treasury bill rate was 25.4 percent in the first quarter 1990 compared to 15.7 percent a year-ago, 23.2 percent in the second quarter vis-a-vis 17.3 percent in the same quarter last year and 28.4 percent in the third quarter 1990 versus 23.5 percent a year-ago.

1.b <u>Monetary Growth and Inflation:</u>

Expansionary fiscal policy and concern over high domestic interest rates caused wild swings in the growth of monetary aggregates in 1990 but in general, monetary growth was rapid during the period. After the growth of base money was reduced to 27 percent at the end of the first quarter 1990 from a high of 36 percent at the end of December 1989, monetary policy turned expansionary in the second and third quarters.

GOP was withdrawing its CB deposits to finance the deficit while domestic interest rates were rising due to higher government borrowing requirements that included replenishment of government deposits with the CB. Base money growth accelerated to 29 percent by end-June and 34 percent by end-September. CB had to reintroduce its own short-term securities to slow down monetary growth in September 1990. Reserve requirements had to be raised from 21 percent to 23 percent in November and another to 25 percent in December 1990 to stabilize based money growth at 23.5 percent.

Inflation as a consequence averaged 12.7 percent in 1990. However, towards the last quarter of the year, inflation showed signs of surging past the yearly average because of expectations of a major devaluation and adjustments in petroleum prices which transpired in end-October and December, respectively. Year-end inflation was recorded at 14.2 percent.

1.c <u>BOP and the Exchange Rate:</u>

The current account deficit widened by $1.2 billion in 1990 to $2.7 billion. As a share of GNP, the current account imbalance was 5.8 percent. The expansion of the current account deficit was attributed mainly to the deterioration in the trade balance. Terms of trade fell by 6 percent as indicated by soft export prices for traditional exports, slackened world demand for electronic goods and garments and steep crude oil price increases. Coupled with supply constraints caused by the effects of the power shortages in the second and third quarters of 1990, the earthquake in July and the strong typhoon in November, exports of manufactures and other items could only muster a 4.7 percent growth. Imports, on the other hand, driven by buoyant demand and the abrupt rise in international crude oil prices grew by 17.2 percent in 1990. Imports of capital goods outpaced the rest owing to the investment recovery and refurbishment of equipment in the air transport and power sectors. Net merchandise trade registered a deficit of $4 billion, 1.5 times the deficit in 1989.

Services account consisting of nonmerchandise trade and transfers registered surpluses of $618 million and $714 million, respectively in 1990. Higher worker's remittances as the number of workers deployed overseas rose, more efficient channels of repatriating earnings of overseas workers through the banking system, increased ESF drawdowns and higher operating expenses of multinational corporations boosted invisible receipts to $4.8 billion. Invisible payments, on the other hand, amounted to $4.2 billion as interest payments declined to $2.2 billion in 1990 from $2.4 billion in 1989 due to lower foreign interest rates and the impact of the debt buyback.

Capital account balance was a surplus of $1.49 billion in 1990, slightly lower than the surplus of $1.52 billion in 1989. All the major capital accounts accumulated surpluses including the errors and omissions. The surplus in the net foreign direct investments of $469 million, however, was 44.3 percent lower than the year-ago surplus of $843 million. Suspension of approvals for new debt conversion and the uncertainty brought about by deteriorating economic developments and worrisome political signals in the Philippines may have affected adversely the perception of foreign investors. Inflows of medium- and long-term loans consisted of the drawdown on the pipeline of existing commitments estimated at $485 million, new commitments worth $1.49 billion and rescheduling of $1.77 billion. Balance on medium- and long-term loans is $392 million slightly ahead of the estimate for 1989. High domestic interest rates may have attracted speculative foreign capital reflected by errors and omissions as it rose by 61.9 percent to $620 million in 1990.

Overall balance of payments, however, was a deficit of $183 million in 1990 as the capital account surplus, gold sales and revaluation adjustments failed to offset the hefty current account deficit. As a consequence of the BOP deficit, gross international reserves declined from $2.3 billion as of December 1989 to $2 billion as of December 1990. This corresponds to less than 1.5 months of imports.

External debt as of December 1990 stood at $28.549 billion, $933 million more than the year-ago estimate of $27.616 billion. As of June, however, external debt was $27 billion, down from $28.6 billion in 1987, due to the impact of the debt buyback operation last January 1990 and previous debt-equity and other conversion schemes. Increased borrowings from multilateral and official bilateral creditors and the slowdown in debt conversions for the most part of the year explain the increase in the debt stock after June. The face value of debt retired under various debt conversion schemes in 1989-90 is $650 million or $300 million lower than the face value of debt retired in 1988 at $950 million. Debt service ratio after rescheduling is 28.2 percent in 1990. Share of external debt to GNP is 64.4 percent.

Monetary expansion put pressure on the peso to depreciate in the first few months of the year and was intensified by the steep increase in the import prices of crude oil. From 22.4 pesos: 1 U.S., in December 1989, the exchange rate fell to 25 pesos: 1 U.S. in end-August. Despite this, the spread between the official and curb rates remained relatively high at 6 percent in August and almost 10 percent in September, compared to an average spread of one percent in 1989. The Banker's Association of the Philippines (BAP) and CB adopted measures that restricted exchange rate spreads on customer transactions, provided special arrangements to furnish oil importers with foreign exchange and imposed limits on the opening of non-oil trade credits to ensure adequate supply of foreign exchange to oil importers and import-dependent exporters while discouraging speculative activities last September-October. Despite these arrangements and the substantial sales of dollars by the CB in the interbank market, the pressure on the exchange rate continued. The rate fell to 28 pesos: 1 U.S. in end-October. The resulting real effective depreciation for 1990 was estimated at 14.5 percent vis-a-vis trading partners and 16 percent vis-a-vis competitors.

1.d Economic Stabilization Actions in the Last Quarter:

Towards the end of 1990 when there were clear signs of an economic slowdown, the GOP adopted policy actions to buck the worsening trend. Earlier it was mentioned that a major devaluation took place in end-October 1990 that may have doused foreign exchange speculation and brought some degree of stability in the foreign exchange markets. Last December, petroleum prices were adjusted to reflect the reality of higher crude oil prices abroad. From an average of Pesos per liter in September 1990, the Energy Regulatory Board (ERB) approved an average increase of Peso /liter. Pres. Aquino's technocrats put together a deficit reduction package for 1991 consisting of budget cutting and revenue enhancing measures despite refusal by Congress to act on the administration's tax proposals. The Aquino administration must be given credit for adopting these reforms in the face of severe political constraints and despite certain loss in political support.

2. 1991

2.a First Quarter:

The stabilization measures adopted by the GOP in the last quarter will have to be complemented by adequate financial support to reduce the adjustment costs. The Extended Fund Facility (EFF) of the IMF obtained in 1989 is not the appropriate program to support the current economic policy package since an EFF normally supports a country's medium term reform program and not a stabilization package. Given recent external and domestic developments and trends and the 1990 economic imbalances as reflected by the hefty fiscal and trade gaps, double digit inflation and high interest rates, a stand-by arrangenent, which supports an economic stabilization program, is more appropriate. Last February 5, 1991, the GOP sent a Letter of Intent (LOI) with an Economic Memorandum to the IMF Managing Director for an 18 month stand-by arrangement.

The IMF Board approved the GOP's application for an 18-month SLA in the last week of February, following the review and approval of an IMF technical review team of the GOP's economic stabilization program. IMF endorsement of the country's stabilization plan means access to more IMF facilities (e.g. Compensatory Contingency Financing Facility), ODA assistance, debt reduction facilities and drawdowns on creditor bank loans. The SLA will provide financial support for the economic stabilization measures to be adopted by the GOP for CY 1991 and 1992. Following are the targets (quarterly performance criteria):

	Mar.31	June 30	Sept.30	Dec.31
	(In billions of Pesos)			
Domestic Sector Ceilings				
Base money	117.4	116.8	114.5	133.6
Public sector borrowing requirement (PBSR)	16.7	20.5	17.3	27.4
OPSF outstanding balance	-11.8	-9.4	----	-----
External Sector Floors/Ceilings	(In millions of U.S.$)			
Net International Reserves (NIR) of the monetary authority (floor)	-300	-400	-50	800
Short-term external debt outstanding	4,350	4,350	4,350	4,350
Approvals of external borrowing with maturities of 1 - 12 years	350	700	1,100	1,500
Approvals of external borrowing with maturities of 1 - 5 years	200	200	200	200

Source: IMF

2.a.1 Compliance with the End-March Performance Criteria:

Just recently, the CB reported that the first performance-based tranche of the IMF amounting to SDRs 37 million was released. This assumes that the GOP hurdled the end-March performance criteria.

	Program	Actual
	(In billions of Pesos)	
Domestic Sector Ceilings		
Base Money	117.4	117.1
Public sector borrowing requirement (PBSR)	16.7	-1.0
OPSF Outstanding Balance	-11.8	-10.4
	(In millions of U.S. Dollars)	
External Sector Floors/Ceilings		
Net International Reserves (NIR) of the Monetary Authorities	-381	-201
Short-term external debt outstanding	4350	3810
Approvals of external borrowing with maturities of 1-12 years	350	56

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	Program	Actual
	(In millions of U.S. Dollars)	
Approvals of external borrowing with maturities of 1-5 years	200	----

Source: IMF

It is clear that the public sector borrowing requirement (indicator of allowable public sector deficit to be financed) is way below what was originally programmed under the first tranche of the IMF standby-loan agreement. Fiscal operations of the national government registered a surplus of Pesos 1.8 billion ($67 million at Pesos27:1 U.S.$) in the first quarter of 1991 compared to a deficit ceiling of Pesos 13.1 billion ($485 million). While revenues were Pesos 3 billion over the target, expenditures were lower than expected by Pesos 12 billion ($444 million). The latter is due to tighter rein on spending, reduced interest costs and the delay in the approval of the 1991 budget. By end-April, the surplus ballooned to Pesos 4.4 billion ($163 million at 27 pesos: 1 U.S.$).

The aggregate deficit of the 14 monitored non-financial public corporations comprises the other major component of the public sector borrowing requirement. Estimated at Pesos 0.6 billion ($22 million) for the period, the deficit is substantially below the programmed deficit of Pesos 3 billion. The cumulative OPSF deficit of Pesos 10.4 billion ($385 million) as of end-March is still below the target of Pesos 11.8 billion ($437 million).

As of June this year, preliminary reports indicate a sharp turnaround in the fiscal operations of the GOP from the surplus as of April to a modest deficit of Pesos 5 billion ($185 million). Release of the cost of living allowances to government employees as well as other expenditures that were deferred due to the delay of the passage of the 1991 budget may have quickly wiped out the initial surplus. Pressure for GOP expenditures to increase and the budget deficit to expand in the coming months is expected from the costs of the rehabilitation program due to the Pinatubo eruption. Counterpart funds for ODA-assisted public investment projects are needed badly if drawdowns on ODA credits scheduled this year are to be made.

Pressures are mounting for a reduction, if not a rollback to December 1989 levels, of petroleum prices and the abolition of the 9 percent import levy. While Pres. Aquino has steadfastly refused to realign domestic petroleum prices to prevailing levels of international crude oil prices until the OPSF deficit is eliminated this August, the source of revenues to replace those obtained from the temporary 9 percent import levy is still uncertain. Recently, she has certified as urgent the legislation of new taxes (simplified income tax for business and professional income, refinements in the VAT and an affluent consumption tax) for Congress, which convened last July 22. IMF estimates a tax yield of Pesos 5 billion on an annual basis that may allow a 2 percentage point reduction in the import levy. Unless the package of tax measures are approved by Congress, Finance Secretary threatens further cutbacks in government spending will be made that may further reduce growth prospects and cut short the delivery of basic social services.

Monetary policy in the first quarter remained consistent with the program resulting in compliance with the base money target. Fiscal discipline facilitated compliance with the monetary target. The reduction in the fiscal deficit, however, has reduced the volume of treasury bills sold to the public which serves to siphon off liquidity. Unless the CB siphons this liquidity through its own debt instruments, meeting the ensuing monetary targets is likely to be difficult.

Recent reports suggest that the CB may have overshot the base money target of Pesos 116.8 billion in June by Pesos 3.2 billion but were well within the reserve money ceiling of Pesos 113 billion. Excess base money was attributed to the effect of collecive deficiencies in the reserve requirements of commercial banks which were not captured in the calculation of reserve money. A pickup in economic activity is also expected and with the coming Christmas season, these may translate into higher money demand before the year is over. CB monetary policy in the second semester is expected to be relatively tight to prevent future slippages in compliance with the monetary targets. As an indication of this trend, the CB in the week of July 22-29 has raised the yield on its own short debt instruments (reverse repurchase agreements) by a quarter percentage point to 18.25 percent and the cost of borrowings through its repurchase window to 13.25 percent.

CB reports a level of gross international reserves of $3.3 billion as of June 7, 1991, the highest ever posted in 11 years. Due to the low level of imports because of weak economic activity, the negative effects of 9 percent import levy and the CB imposed-limits on foreign exchange holdings of commercial banks as well as more efficient channels of repatriating overseas manpower remittances through the banking system, the market is currently flooded with foreign exchange which the CB has exploited to raise its reserve position.

2.b Impact:

2.b.1 Prices:

From 35.15 percent as of January 1, 1991, the average yield on 91-day treasury bills as of March 20 fell by 1200 basis points to 23 percent. As a consequence of the reduction in the public sector deficit, the GOP can afford to turn down bids on the sales of government debt with a low asking price or high yields. The exchange rate appreciated from Pesos 28: 1 U.S.$ as of January 1991 to Pesos 27.806: 1 U.S.$ by end-May indicative of the weak import demand, albeit the strengthening of the U.S. dollar in the world currency markets casted doubt on the market trend of the peso appreciation. Although the average year-on-year inflation for March is 18.8 percent, which is higher than the year-on-year inflation for January, inflationary expectations are lower than they were at the start of the year because of lower crude oil prices and a credible deficit-reduction program of the GOP. Inflation in the succeeding months are expected to taper off.

2.b.2 GNP:

GNP, at constant 1985 prices, for the first quarter this year barely grew at 0.2 percent, confirming the slowdown in the economy. In a recession, personal consumption is expected to perform well but growth for the first quarter was moderate at 4.6 percent compared to 5.5 percent a year-ago. Government consumption expenditures fell by 2.7 percent as the austerity measures of the government continued. Gross domestic capital formation or total investments fell by 15.6 percent mainly because of high interest rates and exchange rate at the start of the year, the Gulf crisis and the 9 percent import duty tax. Hardest hit among the investment sectors is construction which fell by 33.95 percent.

The only bright spot in the gloomy first quarter horizon is the real growth of exports estimated at 8.4 percent. The devaluation in end-October 1990 may already be taking effect although the full impact on exports is expected a year from now. Reported export growth for the first quarter 1991 exceeds any of the quarterly percent changes of exports in 1990. As a consequence, its percent share to GNP for the quarter is 33.2 percent even higher than totalinvestments. Imports, on the other hand, posted growth of 2.6 percent which is considerably lower than the year-ago quarterly change of 17 percent. This development is another indication of a weakened economy.

On the supply side, agriculture, fishery and forestry sector grew by 4.6 percent. Industrial output declined by 4.4 percent while the service sector managed a 1.9 percent growth.

2.b.3 BOP, External Debt and Paris Club Rescheduling:

After rescheduling, a BOP surplus of $28 million was registered in the first quarter 1991, a major turnaround from the $369 million deficit recorded in the same period last year. As of April, the BOP surplus grew to $268 million, a sharp reversal of the $512 million deficit for the same period last year.

Improvements in the nonmonetary capital accounts and the current account explain surplus. The current account deficit as of April 1991 is $695 million, 22.3 percent lower than the deficit of the same period last year. Merchandise imports grew by 2.3 percent to $3.95 billion while merchandise exports increased by 5.9 percent to $2.72 billion leading to a trade gap of $1.23 billion or 4.8 percent lower than last year's trade deficit of $1.28 billion. Under the economic program, exports are projected to grow by 13.1 percent while import growth is estimated at 4.8 percent in 1991. Surplus in the net nonmerchandise and net transfers were $275 million and $252 million, respectively.

From a net outflow position of $334 million in April last year, net nonmonetary capital shifted to a net inflow position of $745 million. The balance in the medium- and long-term loans amounted to an inflow of $311 million despite the decrease in loan availments. Net inflow of direct foreign investments is $203 million, up by 31.8 percent from $154 million posted last year. Short-term capital likewise registered a net inflow of $155 million as of April, 34.8 percent higher than the estimate a year-ago due to the rise in net availments of export advances.

As of end-February, the country's external debt stood at $29.376 billion, $503 million more than January's debt position of $28.873 million. Out of $687 million of total net loan availments in February, inflows from medium- and long-term loans amounted to $657 million, among them releases from the International Monetary Fund and Japan's Eximbank. The IMF disbursed a total of $438.57 million during the period, representing a full drawdown of $397.93 million (277.1 million Special Drawing Rights) from the compensatory and contingency financing facility (CCFF). Japan's Eximbank released the first tranche of the $300 million financial sector adjustment loan amounting to $174 million.

Just recently, the GOP rescheduled its Paris Club debt payments from July 1991 up to the end of 1992 on debts prior to April 1984 including principal and interest falling due as a result of the last rescheduling in 1989. As a consequence, the GOP realized a "nominal" cashflow savings of $1.5 billion up to the end of 1992. The terms of rescheduling for the Philippines are 10 years grace period and 20 years maturity for the official development assistance (ODA) loans while the terms for the non-ODA loans were eight years grace and 15 years over-all maturity. According to the Finance Secretary Estanislao, the GOP's head negotiator, the present terms were more favorable than the 1989 Paris Club rescheduling.

GOP is seeking a $500 million co-financing deal with the foreign commercial banks and the Asian Development Bank as part of the residual financing in CY 1991-92. To attract the foreign creditor banks to provide 50 percent of the package, the GOP is willing to treat this amount in equal footing with multilateral debt similar to those from ADB, thus reducing the lending risk to the banks. The maturity schedule, interest rate, debt amount and other terms still needs to be negotiated between the banks and the GOP before the year is over.

2.b.4 <u>Public Sector Deficit:</u>

Deep cuts in expenditures and improvements in revenue performance explain the Pesos 4.4 billion cash surplus in the first four months of the year. Overall revenues were estimated at Pesos 74.78 billion, higher by Pesos 4.9 billion or 7 percent than the revenue target of Pesos 69.88 billion. This resulted from the higher-than-anticipated revenue take of the Bureau of Internal Revenue (BIR) at Pesos 42.17 billion, Pesos 1.17 million more than the BIR target of Pesos 41 billion for the first quarter. On the expenditure side, the national government spent Pesos 17.77 billion less than the programmed expenditure level of Pesos 88.13 billion during the period or Pesos 70.36 billion. Interest payments alone had a 36 percent share of total expenditures or Pesos 24.98 billion. The cash surplus of Pesos 4.4 billion during the period and net drawdowns on external loans of the GOP of Pesos 5.82 billion retired domestic debt worth Pesos 10.24 billion.

2.c <u>Prospects</u>

Given the positive impact of the GOP's economic stabilization package in the first quarter, GOP could have earned the 'credibility' needed to sustain the effectiveness of the policy package. While the second quarter estimates are still preliminary, it is expected that the fiscal, monetary and trends in the first quarter have been sustained.

There is pressure to increase fiscal spending due to the damage to public and private property caused by the eruption of Mt. Pinatubo estimated to be over Pesos 2 billion and the need for counterpart funds to avail of existing ODA loans supporting the GOP's capital projects. Recent reports claim that as of May this year, the national government has incurred a deficit of Pesos 58 million. Although negligible compared to GOP operations, this may be indicative of the trend for the remainder of the year. It will not be suprising if the GOP will ask the IMF for higher deficit targets in view of the recent calamity and the need for more counterpart funds to carry out foreign-assisted capital projects.

By mid-August this year, GOP is set to reduce domestic petroleum prices by an average of Peso 1. in response to mounting public pressure. By this time, the OPSF deficit would have been wiped out while allowing a small buffer for an increase in crude oil prices to $21 per barrel and a depreciation of the currency to Pesos 30:1 U.S.$. This development may relieve the system of cost-push inflationary pressures.

Reduction of interest rates and foreign exchange stability as well as more favorable external factors (e.g. U.S. economic recovery) may justify a re-evaluation of growth prospects this year. GOP projected a 1.5 percent real economic growth this year, but with the better-than-expected economic performance in the first quarter, the economy may have bottomed out faster than anticipated. Currently, government economists are talking about a 3-3.5 percent economic projection for the year.

Certain to bolster economic activity over time is the recent signing into law of the foreign investment bill. The law allows foreign investors to enter into any industry or sector other than those industries restricted by the Constitution, for security reasons, public health and the scaled-down negative list as determined by NEDA. A special feature of the law is that 36 months after NEDA has issued the implementing guidelines, the scaled-down version of the negative list will govern the entry of foreign capital. The negative list will cover those existing enterprises "adequately serving the needs of the economy and the consumer and do not require further foreign investments." NEDA recently approved the list of industries 'strategic to the development of the economy' in the Investment Priorities Plan (IPP). These strategic industries that are export-oriented and have existing or potential comparative advantage will be prioritized under the IPP.

If the participation of the debt-equity conversion scheme of the CB is any indication, substantial foreign investment inflows are expected. Under the first debt-equity auction held under the CB's new program guidelines held last February 20, 52 companies entered 144 bids totalling $215.2 million, far above the $75 million quarterly limit set by the CB to minimize the program's inflationary impact.

Revised CB projections on the BOP show a current account deficit of $1.762 billion in 1991 or 4 percent of GNP and $1.794 billion or 3.8 percent of GNP in 1992. Overall BOP is expected to be a surplus of $1.412 billion in 1991 and $1.454 billion in 1992. GOP is currently working on a new set of BOP and financing gap projections that will account for the foreign exchange losses or the additional external financing requirements as a result of the damage wrought by the eruption of Mt. Pinatubo. Preliminary estimates of the GOP range from $400-$500 million, which may be on the high end of the range.

The revised EO 470 was issued last July 20. Close to 4,000 items will conform to the four-tier tariff structure: 3 percent, 10 percent, 20 percent and 30 percent. The modified EO will allow 208 of the 5,000 items in the Tariff Code to have permanently a 50 percent tariff rate. For over 1,200 items subject to a 50 percent rate; the rate will be phased down to 30 percent over a period of time. The phase down will be implemented in five stages, starting immediately and continuing each July first for the next four years.

Following are the key macroprojections for 1991:

a. Real GNP growth of 1.5 percent.

b. Year-end inflation (CPI-based) of 9.5 percent.

c. Current account deficit of $1.762 billion or 4 percent of GNP.

d. Consolidated public sector deficit equal to 3.7 percent of GNP of which the national government deficit is 2 percent of GNP.

e. Base money year-end growth of 10.9 percent.

f. Gross official reserves of $3.5 billion or 3.4 months of imports.

g. Debt service ratio after rescheduling of 25.2 percent.

h. External debt of $30.5 billion or 69 percent of GNP.

2.d Financing Gap (1991-92)

2.d.1 New Money Residual:

Projections on the portion of the $2.7 billion financing gap during 1991-92 in which funding sources still have to be identified, otherwise known as new money residual were recently revised by the CB. The upward revisions reflected updates on current and capital account assumptions as well as the outcome of the recent Paris Club rescheduling. The new money residual was revised upwards from $872 million to $914 million in 1991 and from $1.27 billion to $1.7 billion in 1992. The increase reflected downward revisions in the assumption on export growth (from 13-14 percent growth to 7-10 percent) and amounts rescheduled under the Paris Club rescheduling agreement as well as higher increases in the net international reserve level from $1 billion to $1.41 billion in 1991 and from $962 million to $1.45 billion in 1992.

The revised projection on new money residual of $2.7 billion during 1991-92 assumes that the foreign commercial banks will provide about $400 million in additional support during 1991-92. Recent reports claim that creditor banks have agreed to provide the Philippines with a $350 million package consisting of a cash component equal to $200 million and resources for interest rate reduction up to $150 million. The latter will finance the issuance of temporary interest rate reduction (TIRR) bonds which will effectively lower interest rates paid by the country within the next four to five years, after which market rates will apply.

Given present interest rate trends abroad, the bank offer is not too exciting from the point of view of CB officials. This offer in which the GOP has up to August 20 to accept or work out an alternative, replaces the proposed co-financing scheme between creditor banks and Asian Development Bank (ADB) worth $400 million under ADB's under Compensatory Financing Scheme (CFS). Overseas Economic Cooperation Fund (OECF), however, is proposing a new CFS, in which it will put up $200 million to be linked with ADB's $250 million forestry sector loan, leaving $50 million to be picked up by the creditor banks. According to reports, GOP still wants creditor bank participation in new money financing totalling $400 million whether or not this is linked to ADB's CFS.

Under the CFS scheme, ADB would extend two loans: the first for itself and the second to be resold to the foreign bank consortium or any other interested multilateral institution but ADB will remain on record as the lender for both loans. The scheme elevates the creditor banks incoming debt exposure to the level of multilateral debt and thus reduce their lending risks. Furthermore, the final tranche equal to $114 million of the new

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money from the 1989-90 bank financing package was released by the creditor banks after obtaining waivers and the $3 billion trade facility has been extended.

Negotiations with the creditor banks are ongoing to determine how much their final contribution will be and under what scheme. For as long as the GOP remains committed to the IMF-endorsed stabilization program, access to external financing either from public or private sources is likely to be assured.

2.d.2 Likely Funding Sources of New Money Residual:

GOP's financial strategy to cover the new money residual of $2.61 billion for the 1991-92 period involves Paris Club debt restructuring and new money from official and private creditors.

It was reported earlier that the GOP concluded an agreement with the Paris Club debtors to reschedule close to $1.5 billion of principal and interest falling due between June 1991 up to 1992 (which explains the GOP request for extension of the present SLA facility and the IMF approval). About $514 million of the total restructured amount is in 1991 which will address more than half of the residual financing requirements estimated for this year while the remaining $1 billion is in 1992.

From official sources, the GOP is eyeing an additional contribution of $663 million during 1991-92. This year, $133 million of quick disbursing funds is sought by the GOP from official sources. One possibility is the acceleration of the ADB/OECF 2nd Forestry Sector Loan totalling $100 million which is scheduled to be disbursed next year. In 1992, the $530 million of additional disbursements is projected to come from the OECF's Financial Sector Loan and WB's Structural Adjustment Loan (SAL) III. One of the conditions for the tranche release of SAL III is the disbursement of the financial sector loan. The latter, however, requires the passage of certain legislation (see discussion below). While Congressional approval of these proposed reform acts are not politically sensitive as the proposed tax legislations by the Aquino administration, Congress may not have the time nor is in the mood to legislate further reforms until after the 1992 elections.

While still uncertain at this point, the foreign creditor banks is expected to assume the balance of roughly $400 million.

2.d.3 Uncertainty of ODA Availments:

Delays in the passage of laws necessary for the release of several World Bank (WB) loans (e.g. Philippine Deposit Insurance Corp. Act and Central Monetary Authority Act which are tied to the release of the $450 million financial structural adjustment loan) and cuts in government budget severely affecting counterpart project funds of the GOP have held back the release of scheduled disbursements from multilateral project loans. As a consequence, the GOP was $68 million short of the first semester 1991 target of $520 million new money inflows (part of the new money indicative and not the new money residual). There are undisbursed program loans from the WB totalling $100 million and lower-than-programmed releases from the Asian Development Bank and the Overseas Economic Cooperation Fund.

Congress is currently in session but it is uncertain what the upper and the lower chambers will be able to accomplish given that 1992 is an election year. Since the majority of the solons are seeking reelection next year, the passage of new tax laws and reforms in both chambers is expected to be difficult. As such, further cuts in GOP expenditures are likely to be done once the GOP decides to reduce the temporary 9 percent import levy.

In a scenario where fiscal adjustment will be made entirely on the basis of expenditure cuts, one of the resulting tradeoffs is reduced absorptive capacity. The flow of foreign exchange from official donor sources may slowdown and thus affect debt service capacity. This is likely to occur unless the GOP considers these options: a renegotiation for lower counterpart funds required by these multilateral project loans; conversion of some of the latter to program loans; further expenditure cutbacks to be limited to current spending only (tradeoff is higher unemployment); depreciation of the exchange rate further to attract foreign exchange in the informal markets; or a combination of the preceding options. Renegotiation of the policy conditionalites in some of these multilateral program loans that will not require Congressional action in the next two years will also help. Otherwise, fiscal adjustment through deeper budget cuts alone can raise the BOP funding gap in 1991-92 by substantially more than what was originally programmed.

B. Constraints Facing the Philippine Economy

The orientation of Philippine macroeconomic and industrial policies dictated the pace and quality of industrial economic growth and development. From 1950 to 1970, inward-looking economic policies and industrial strategies led to the promotion of import substituting industries. From 1970 onwards along with import substitution, the GOP started promoting the exports of light manufacturing namely semi-conductors and electrical parts as well as garments. Since the orientation of policies still favored import substituting activities, the export manufacturing base failed to diversify and its net value added remained modest. While these two types of industrial enclaves continued to exist side by side, the orientation of economic and industrial policies have resulted in market distortions and production inefficiencies and their duration may have reinforced these inefficiencies.

In the eighties, reforms were initiated to remove the protectionist structures, expose the economy to more international trade and competition and encourage more foreign investments. Under the Aquino administration, reforms were recently instituted to further liberalize trade (EO 470) and foreign investment rules (signing into law of the legislation liberalizing foreign investments). While these are major steps in the direction towards greater external orientation, more needs to be done to correct the the orientation of trade and investment rules and incentives and policies in general and their implementation, from an internal to an external orientation.

The inward-looking orientation of macroeconomic policies have created several constraints to the growth of the private sector investments in export activities and contributed to the expansion of debt beyond the economy's capacity to pay. Of immediate concern are the following nine macro constraints to economic growth: foreign exchange scarcity, public sector deficit, excessive monetary growth and inflation, underdeveloped capital markets, inadequate infrastructure, distorted investment incentives and a protectionist trade regime which the GOP is addressing or attempting to address in various reform activities.

1. Foreign Exchange Constraints:

The main problem of the Philippine foreign exchange market is market segmentation which has resulted in the apparent lack of volume in the interbank trading market. The market structure is not conducive to the evolution of a genuinely competitive environment and therefore inhibits the determination of a realistic exchange rate. This is compounded by a foreign exchange policy

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that tends to delay the adjustment of the foreign exchange rate whenever warranted by market fundamentals (e.g. declining terms of trade).

The exchange market is divided into three major segements: official interbank market, customer market, unofficial or "parallel" market with only a tenuous linkage among them. In the interbank market, most foreign exchange transactions among the commercial banks take place in the Foreign Exchange Trading Center of the Bankers Association of the Philippines (BAP), situated in the floor of the Central Bank Building, where the "BAP reference rate" is determined. The BAP reference rate is officially regarded as the basis for conversion rates used in private (mainly the customer market) and public foreign exchange transactions.

There are two major structural problems with the interbank market, which detract from the efficient determination of the exchange rate. First, it has limited number of participants and trading time (from 4:00-5:00 pm on weekdays). Market transparency and full disclosure also characterize interbank trading. Given few participants and market transparency, the CB is able to use moral suasion more effectively.

Sudden surges in the daily reference rate are immediately subject to CB 'correction' by direct intervention in the market through actual sales or purchases of foreign exchange (Note: new trading rules were adopted in 1989 in which the CB could no longer influence the rate through back-to-back transactions that do not involve real resources). The CB intervention equates the weighted average of the day's trade to the CB's desired exchange rate.

Because of CB control, commercial banks are not encouraged to 'square off' their foreign exchange positions via the interbank market. The effect becomes self-reinforcing. Given the small amounts usually traded, a bank would be at a trading disadvantage if they tried to unload or source large amounts from the trading floor. As a consequence, the volumes traded in the interbank market are relatively thin.

Thin trading activity does not provide the CB with an efficient feedback mechanism on whether the CB's exchange rate target is consistent with its international reserve targets. Disallowing off floor trading hinders meaningful volumes of interbank flows from "export" banks to "import" banks. The interbank market structure and the present system of CB regulations over the foreign exchange market encourages banks to prefer to hold on to foreign exchange and service importers.

While the exchange rate may be said to be market-determined in a narrow and formal sense, the market imperfections and CB control have inhibited free interplay of the forces of supply and demand. The record indicates that the CB has been successful in restraining exchange rate movements, has pre-set exchange rate targets and has managed to achieve these targets mainly through strong guidance reinforced by small amounts of foreign exchange intervention in the narrow and thin interbank market.

The absence of an effective market-clearing foreign exchange bourse has generated the perception that Philippine foreign exchange policies are not sustainable and prone to sudden devaluations. This translates into high precautionary demand for foreign exchange as reflected by the high foreign exchange balances held by banks and nonbank users of foreign exchange. In times of foreign exchange uncertainty, this is exacerbated by the behavior of exporters and importers who delay receipts and advance payments. Since the foreign exchange balances held especially by the banks are not related to the current volume of trade, a 'contrived scarcity' results, which the CB interprets wrongly as bank speculation to profit excessively from interbank trading.

There are other inefficient and costly market practices that may prevent the emergence of a modern and dynamic market. Too much transparency in the interbank market makes it conducive to the CB's 'jawboning' while the reverse is true for the customer market resulting in big banks "leading" the market with others tending to follow. Others are the absence of same day delivery of foreign exchange; typically informal bidding procedures in the customer market rather than the "firm order method"; documentary stamp tax of 1.5 centavos per 100 pesos of each interbank buying transaction; and the lack of any significant forward and swap markets despite the potential large needs for such instruments from exporters, importers and domestic and foreign investors.

2. Public Sector Deficit:

The consolidated public sector consists of the national government, the monitored government corporations, CB, local government units and social security institutions. Data on the public sector deficit from the seventies onward show that the national government, the monitored government corporations and the CB have been responsible in varying degrees for the chronic overall fiscal imbalances. Local governments and welfare institutions normally yield surpluses in their operations.

Under the Marcos government, from the latter part of the seventies to the mid-eighties, the deficit of the 14 major government corporations were mainly responsible for the public sector deficit estimated at 3-5 percent of GNP, followed by the national government deficit. Under the Aquino administration, however, the privatization of government parastataals attached to the monitored government corporations and their rehabilitation and strict monitoring of operations led to improvements in their financial operations. But pump priming by the Aquino government in 1986 to revive a depressed economy, financed mainly by high yielding short-term government debt led to hefty and chronic NG deficits, high nominal and real interest rates, abrupt expansion of the public domestic debt and higher budget share of interest payments. The CB's sustained net financial losses from operations due to losses from its foreign exchange swap arrangements, arrears in the payment of emergency loans given in the past, delay in debt service payments of the peso counterpart obligations of government corporations and interest losses from having assumed PNB and DBP foreign debt payments, most of which resulted from the 1983-85 foreign exchange crisis, made a significant contribution to the public sector imbalance. Starting 1989 when the GOP failed to adjust domestic petroleum prices to higher international crude oil prices causing a pile up of outstanding claims on the OPSF which reached a high of Pesos 16 billion, the OPSF deficit became a major contributor to the overall public sector deficit.

The CB's chronic net losses from operations over the past five years averaging at Pesos 20-22 billion, raised by a significant amount the consolidated public sector deficit. A bailout plan for the CB was instituted last year in which the national government will be assuming most of its nonperforming assets due to fiscal related operations, it will take time before the CB's financial position will improve. Until the CB deficits are pared down and a surplus recorded, there is always the potential threat of excess liquidity and inflation.

Maintenance of domestic petroleum prices that were set during December 1990 despite lower prevailing international crude oil prices is expected to wipe out the OPSF deficit by mid-August 1991. In response to the public clamor for a reduction, the GOP, very recently, has reduced petroleum prices by an average of Pesos 1.17 per liter. The reduction, however, is capable of raising a small buffer to cushion the expected increase in crude oil prices to $21 per barrel late this year and a depreciation of the exchange rate to Pesos 31:1 U.S.$. If the GOP seriously pursues oil price deregulation, there will be less chances for an oil price subsidy happening in the future.

The Aquino government's spending agenda and priorities as well as the manner of deficit financing led to public sector deficits that grew worse in the 1989-90 period. Besides the high budget share of interest payments due to deficit financing via short-term debt, the Aquino administration has introduced a wage standardization plan that was more expensive than anticipated. While there are merits in upgrading government compensation levels, it must be balanced with the costs of doing so. On the other hand, capital spending rose due to improvements in the GOP's disbursement systems and project implementation. Presently, the budget cutbacks under the GOP's economic stabilization plan are limiting the GOP's counterpart funding for donor-assisted projects and thus, affect the GOP's availments of official development assistance (ODA).

Since the GOP cannot backtrack on its wage compensation scheme without adversely affecting the morale and productivity of its government employees, reduction of interest payments is one of the priorities in reducing the deficit through the restructuring of public debt held by the government social security institutions and reduction of the volume of debt offered in the government securities market. The GOP has prioritized its expenditures and scaled back or eliminated unnecessary ones while tightening its cash disbursement processes so that funding warrants may be issued only when actual cash resources are available. The GOP's deficit reduction program have led to a modest deficit of Pesos 5 billion ($185 million) as of June 1991 but it may be at the cost of foregone social and economic investment opportunities. At the start of the year, GOP floated a series of tax proposals and reforms before Congress but given that 1992 is an election year, Congress is not in a mood to legislate new tax proposals.

3. <u>Excessive Monetary Growth and Inflation:</u>

The public sector deficit consisting of the CB's financial losses and the deficits of the national government, OPSF and 14 nonfinancial government corporations are mainly responsible for creating excess domestic liquidity and double-digit inflation that worsened in the 1989-90 period. Some of the excess liquidity may have stimulated higher importations which partly explains the $2-3 billion trade gap experienced during the period. The coup attempt in December 1989 may have raised demand for money abruptly and exacerbated the trend in money supply growth. Dollar purchases of the CB mainly in the interbank market since the start of the year that resulted in an international reserve position considered the highest since the post-war period, was attained at the cost of infusing Pesos 27 billion into the system.

Siphoning excess liquidity out of the financial system may mean the issuance of more government debt with high yields which will again lead to the vicious cycle of higher interest payments and budget deficit. Reserve requirements are already at a record high of 25 percent and the CB has reintroduced its own short-term securities in the market. To aid the CB in siphoning excess money supply, the GOP should refrain from withdrawing its deposit balances with the CB while shifting GOP deposits from the specialized government banks and private banks, if any, to the CB. Finally, the passage of new tax laws would boost CB efforts to mop up excess liquidity. Revenues from new taxes would reduce the deficit and allow the government to issue out debt with modest yields only for the purpose of siphoning excess money.

Double digit, year-on-year inflation of 17-18 percent in the first semester of 1991 was mainly a result of the public sector deficit that created excess liquidity. Other factors responsible are the major devaluation in end-October 1990 and the year-end petroleum price adjustments. While the year-on-year inflation is still high, the month-to-month levels since the start of the year show a declining trend. It is expected that sustained control of the government deficit and domestic liquidity will eventually douse inflation.

4. Taxation:

Several aspects of the tax system affect economic growth. Among these are the tax rates, tax structure and tax collection efficiency. Prevailing tax rates in the Philippine tax system are considered optimal given the GOP's revenue objectives and per capita income levels. However, the tax structure shows an excessive reliance on indirect taxes, a reliance which has not decreased over time despite improvements in per capita income. Data shows that during the last five years, the ratio of indirect taxes to total taxes has remained constant at around 70 percent. The higher proportion of indirect taxes indicates a higher distortionary effect and reduces the competitiveness of Philippine industries. Income earners are penalized twice since they pay income and indirect taxes while the poor is no better off since it is still made to pay some form of tax through the taxed goods they buy. This type of tax structure also serves to complement and reinforce the potential for inflation in an economy that is import dependent. Direct taxes form a low proportion of total taxes as well as of GNP. Compared to its ASEAN neighbors, the Philippine tax structure is perhaps the most regressive.

Direct taxes grew by an average of 25.4 percent annually from 1987-90, which is slightly higher than the estimated average growth of indirect taxes during the period (23.4 percent). Growth of total taxes for the period 1987-90, therefore, is 23.8 percent.

Nontax income, on the other hand, grew at an unprecedented average annual rate of 30 percent in 1987-89 due to the proceeds of the Presidential Commission on Good Government (PCGG)-sequestered assets and the privatization of government-owned and/or controlled corporations, their subsidiaries and acquired assets and interst income on GOP deposits with the CB.

Various reforms in the tax system were instituted under the Aquino administration to improve collection efficiency and plug the leakages in the tax system. Apart from introducing VAT in 1988, the GOP has also introduced major reforms in the income tax system, corporate tax system and excise taxes. The income tax system with tax rates from 1 to 35 percent covers compensation income, business and professional income with personal exemption allowances and business deductions for the latter two. Personal exemptions are adjusted to account for the effects of inflation and thus, improve the equity aspect of the individual income tax. There is also the option for spouses to file separate returns thereby reducing the marginal effective tax rate on the secondary earner (working wives). Corporate tax rates have been unified at 35 percent. Recently, the GOP has shifted back to specific taxes on petroleum products to minimize the inflationary impact. Other major reforms refer to the institutionalization of the system for evaluating the value of imports (employment of Societe General Surveillance) and its eventual application on a 'global' basis, and the adoption of the fair market value system in the assessment of the value of imports for taxation purposes.

The Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC) adopted managerial and organizational reforms to increase collection efficiency and reduce graft and corruption in their ranks. Recently, financial incentives have been proposed for BIR collectors and examiners whose collection performance are better than expected.

Despite reforms to improve the tax structure and collection efficiency, the tax collection to GNP ratio remains low. The ratio in percent peaked at 13.6 percent in 1990 from 10.7 percent in 1986. Given poor economic conditions and high inflation in the 1991-92 period, the tax to GNP ratio is expected to decline. According to BOC officials, the 9 percent import levy has reduced import demand leading to a lower tax base for import duties. With double-digit inflation of 17-18 percent in the first semester, VAT collections managed a mediocre 10 percent growth during the period. This indicates low tax responsiveness to nominal income growth that may reflect poor collection efficiency. For most taxes, the income elasticity is the same.

Constrained by low overall collection efficiency and given the need to finance the fiscal deficit, the GOP resorts to new taxes (in 1991, the Aquino administration is asking Congress to approve new tax measures expected to raise no less than Pesos 10 billion).

This raises the tax burden causing more tax evasion (or increased collection inefficiency) that raises the likelihood of more additional taxes in the future. Without addressing collection efficiency, the potential for a vicious cycle may be generated.

Meanwhile, the revenues obtained through the privatization of public enterprises and the disposal of nonperforming assets (NPAs) have slowed down. Privatization has been dogged by legal, technical and bureaucratic problems. Sales of sequestered assets brought in Pesos 800 million in 1988, Pesos 500 million in 1989 and another Pesos 800 million in 1990. More revenues were generated through the disposal of the NPAs. From a peak of Pesos 5.2 billion in 1988, disposition of NPAs slowed down to Pesos 3.7 billion in 1989 and Pesos 3.5 billion in 1990. The GOP's pressing revenue requirements in 1991-92 could speed up the privatization process and the disposition of the NPAs. Aside from revenue generation, the process would stop the drain on fiscal resources caused by continued dependence of some existing government corporations on the national government.

5. Trade Regime:

A restrictive trade regime was put in place as early as the 1950s to promote import substituting industries. There were short periods of decontrol but on the whole, the import substitution bias has persisted until now. In the 1980s, however, the GOP undertook major trade reforms. The trade reform agenda consisted of: (1) 1981-85 Tariff Reform Program; (2) import liberalization; (3) indirect tax realignment. Only the import liberalization component was shelved due to the BOP crises starting in 1983. Under the Aquino government, the thrust of the reforms were continued.

The import liberalization program resulted in the lifting of quantitative restrictions (QRs) on imports for 1,477 lines of the Philippine Standard Classification Code (PSCC) from 1986 to 1989. By the end of 1989, only 8 percent of the total number of PSCC lines are regulated from around 34.1 percent in 1985. By sector, the nontariff coverage for agriculture and fisheries was about 30.6 percent close to that for manufacturing with 32.1 percent. The coverage went down to 1.6 percent for agriculture while that for manufacturing went down to 9.4 percent in 1988. These findings suggest greater liberalization in the agricultural sector. Across the manufacturing sector, the liberalization was not uniform. There was virtually no liberalization in the electrical machinery and transport equipment. High nontariff coverage included the non-metallic mineral products and food processing sectors.

The import liberalization program has caused the steady decline of the average effective protection rates (EPRs) from 49 percent in 1985 to 36.5 percent in 1988 (based on price comparisons whenever feasible). EPRs declined for all importables and improved for exportables with the removal of export taxes. The gap between between the two has narrowed down. Studies show that the liberalization episodes from 1986 to 1988 reduced the disparities in EPRs accross sectors. However, the reduction was not significant enough to substantially alter the inherent biases of the protection structure against exports and agriculture. Further reforms are needed to lower the level and dispersion of the effective protection.

Under the recently-approved EO 470, a revised version of EO 413, the average EPR is expected to be reduced to 19 percent from the present level of 25 percent. Preliminary analysis shows no meaningful changes are expected in the EPR of exportables while the average EPR of importables is likely to go down by 21 percent from 47 percent to 37 percent.

Furthermore, the trade reform episodes were not supported by a consistent exchange rate policy in favor of exports. While the real effective exchange index has improved in 1986-88 after the major devaluations in 1984. But it has appreciated in 1989 from the 1988 year-end level of 65.73 to the 1989 year-end estimate of 71.83. Last December 1990, the index has improved in valued after the exchange rate was devalued in October 1990 from Pesos 25: 1 U.S.$ to Pesos 28: 1 U.S.$. Preliminary estimates for the first semester this year show that the real effective exchange rate may have appreciated by 10 percent due to double-digit Philippine inflation and the appreciation of the nominal exchange rate to Pesos 27: 1 U.S. $.

6. <u>Investment Incentives:</u>

In 1967, a system of investment incentives was institutionalized known as the Investment Incentives Act of 1967. This was later suplemented in 1970 by the enactment of the Export Incentives Act (RA 6135). In 1983, Batas Pambansa (BP) 391 introduced innovative forms of incentives. Under the Aquino administration, EO 226 otherwise known as the 1987 Omnibus Investment Code (OIC) further made amendments to the system. The new Foreign Investment law this year is expected to be complemented by a 'universal' system of investment incentives.

Comparative and empirical analyses of BP 391 and EO 226 show that the former is a better promoter of labor-intensive and export industries. The increment of the internal rate of return (IRR) of an exporter is three to four times as large as that of nonexporters under BP 391. Under EO 226, which differentiates between pioneer and nonpioneer enterprises, the exporters' benefits were reduced by half while those benefits accruing to nonexporters almost doubled.

The capital-labor ratio (estimated by project cost divided by employment) declined drastically during the period 1983 to 1986 when BP 391 was effective, from Pesos 512,740 per employee in 1982 to Pesos 83,660 in 1986. It started increasing with EO 226, more than twice in 1988 to Pesos 224,290 per employee. Average cost per firm indicative of firm size has also risen.

The effects of the 1987 OIC seems to have reinstated the bias of the incentive system towards capital intensity and large firms prior to 1983. Stated in another way, the gains from removing the factor bias in the incentive system with the implementation of BP 391 seems to have been eroded by the 1987 OIC.

Presently there is a bill in Congress that seeks to harmonize or reduce the variability of the investment incentives across sectors, including the provision of accelerated depreciation and net loss carry forward and a reduction of the tariff on capital equipment to 10 percent. Under this proposal, the BOI would still grant tax concessions to a set of preferred investment activities but under a shortened Investment Priorities Plan (IPP). Because these measures would apply equally to both domestic and export oriented production, it is expected that their implementation would not reduce existing biases against investment mainly for exports.

The GOP's export promotion measures are aimed at granting exporters access to intermediate inputs at world prices. Tax and duty exemptions on imported intermediate inputs of exporters are extended through the following:

a. Locating in an export processing zone (EPZ);

b. Using bonded manufacturing warehouse (BMW) facilities;

c. Importing under Customs Administrative Order 3-78.

d. Individual drawback scheme of the Bureau of Customs (BOC); and,

e. Fixed drawback scheme of the BOI.

The main limitation of the tax and duty exemption system under the export promotion program is its lack of automaticity in the availment of the export incentives. Studies show that there are the number of requirements are too many and the procedures long and complex for an exporter to avail of these incentives. One noteworthy bureaucratic requirement is the need for an exporter, except those located in an EPZ, to obtain BOI certification of non-availability of domestic substitutes for the imported raw material.

The signing into law of the new foreign investment act will do well in enhancing direct foreign investment flows in the country. The three year transitory provision which allows foreign investments in most sectors/industries except those disallowed by the Constitution, which is included in the scaled down version of the negative list, relaxes the restrictiveness of the prevailing foreign investment law. If properly marketed abroad, the new foreign investment law is expected to generate direct foreign investment flows of $700-800 million in 1991-92. Unless political considerations dominate the implementing rules and regulations of the law currently being prepared by NEDA, the new investment law is expected to lead to 'additionality' in foreign investments.

Other factors affecting the level of direct foreign investment flows into the Philippines are the the relatively inexpensive, well educated, English speaking labor force and other noneconomic considerations affecting the risk perception of foreigners. The labor advantage of the Philippines is slowly being eroded by recent hefty wage adjustments and militant labor unionism. As far as noneconomic considerations are concerned, there is a continuing perception that the Philippines remains politically unstable and that there remains a risk to the personal security of foreigners.

7. <u>Underdeveloped Capital Markets:</u>

The Philippine capital markets are characterized by the thin volume of financial assets traded/bought and high intermediation costs. This state of financial underdevelopment have led to high cost of money and credit rationing. Overregulation of the banking sector has created an oligopolistic banking structure.

Intermediation cost drives a wedge between bank loan and deposit/savings rates. Lending rates are pressured to rise while savings rates are depressed. Assuming a savings behavior responsive to interest rates, the high cost of intermediation encourages savings in the form of nonfinancial assets.

In the Philippines, the high costs of financial intermediation consists mainly of the high reserve requirements, gross receipts tax (GRT) and agri-agra banking requirement. Among the three, the reserve requirements at 25 percent is the largest cost factor for now. Given the need to rein in excess liquidity and lower inflation, the CB thinks that at least in the short-term, the resulting tradeoff in having a high reserve ratio is acceptable. The GRT imposed on bank transactions is basically a revenue measure. Currently, there are plans to scrap this tax but only on condition that new tax measures are put in place to compensate for the expected revenue loss from the abolition of the GRT. The agri-agra requirement imposed by the GOP stipulates that a certain percentage of the bank's loanable funds should be allocated to agricultural/agri-business projects and land reform. As an alternative, however, banks are allowed to purchase reserve eligible government securities. Without sufficient collateral and government guarantees, most agri-related loans are considered high risk by banks, encouraging them to purchase instead government securities. Thus, the agri-agra requirement becomes an instrument of deficit financing.

Given that nominal savings rates are depressed by the costs of intermediation, real yields on deposits have been consistently negative or below inflation despite the adoption of financial reforms (centerpiece is the abolition of all interest rate ceilings) in 1981. This has retarded the mobilization of financial savings, particularly in the countryside, while nurturing among household savers, a savings behavior unresponsive to interest rates and a preference for nonfinancial assets.

Small wonder why time deposits, deposit substitutes and other interest bearing financial assets as a ratio to GNP are relatively small compared to the ratios for other ASEAN countries. Other factors like poor confidence in the financial system after the Dewey Dee scandal in the early eighties, the 1983-85 economic crisis and coup rumors/plots have raised the preference of household savers for cash and unproductive, nonfinancial assets.

Given the same set of disincentives, institutional investors, on the other hand, prefer to invest in short-term debt instruments that offer attractive yields rather than invest in long-term private and public securities. This 'quick buck' mentality has led to sustained preference for treasury bills and thus, high interest rates since 1986, crowding out private borrowers in the capital markets and underdevelopment of the long-term funds market.

GOP's debt financing of the public sector deficit via high yielding treasury bills and preference by institutional investors for short-term investments reinforced the credit rationing practices of the banking sector. Given the oligopolistic structure of the banking system, the borrowings of the multinationals and large family corporations are prioritized since these entities have sufficient assets that can be put up for collateral as well as an enviable credit track record. The bias for short-term investments by institutional savers forces the banks to prioritize low risk lending at the expense of small to medium scale enterprises especially in the countryside. Informal lending practices are also sustained by the banks' credit rationing practices.

In the stock markets (Makati and Manila Stock Exchanges), thin volume of stocks are traded. The markets are dominated by a few big issues and trading is subject to large swings in volume and prices. The top ten stocks contribute almost 80 percent of market capitalization, a much higher level of concentration in the stock markets of other ASEAN countries. Capitalization of existing and new firms via stock offerings in the stock markets is rarely done given the family-based structure of corporations in the Philippines. This has stunted the growth in the volume of shares traded in the stock markets and limited the range of possible stock investments. As a result, the price of existing and new shares of the big, 'Triple A' corporations are driven up, rendering them affordable only to institutional investors. This hinders new enterpreneurs and enterprises that prefer broad-based equity participation, from generating capital through the stock markets, feeding the vicious cycle which keeps stock market volumes thin.

The GOP is contemplating moves to reduce intermediation costs, liberalize banking in the Philippines and other financial sector reforms supported by donor resources that hopes to increase the efficiency of the domestic capital markets and develop long-term sources of funds. Even if these reform actions are implemented just before the end of Pres. Aquino's term, sustaining these reforms is uncertain since the GOP's public sector deficit problem is still a major threat and that the new government's commitment to these financial reforms are at this time uncertain.

8. <u>Infrastructure:</u>

The main infrastructure issues affecting industrial efficiency and competitiveness in the Philippines relate to the reliability of electric power and the adequacy and cost of transportation. Periodic power shortages became a major problem in 1989 and 1990 as rapidly rising demand outstripped power supply. Inadequate power supply is mainly attributed to the lack of investments in power generation capacity and partly because of implementation problems of the GOP's plans to fill the existing power gap. Power outages became frequent in the first half of 1990 as a drought reduced hydroelectric production and several old power plants broke down under pressure of constant operation.

The present power program of the GOP relies on the use of combustion turbines to cope with short to medium run needs and the operation of new power plants (largely based on geothermal sources) from 1993 onwards to cope with demand over the long run. Until 1993, therefore, the cost of power will rise in the Philippines because incremental demand will be satisfied mostly through the importation of energy. If the price of oil rises in the future, the outlook for cost will even be bleaker and subject to wild fluctuations experienced in the oil markets.

Over time, anti-competitive regulations have accumulated in the transport sector (mostly interisland shipping and road transport) that by now impeded rather than enhance the growth of the sector as well as that of the economy, especially through facilitating exports. Major regulatory bottlenecks are the franchising requirements for passenger and freight services, measured capacity criteria to control entry into the industry, restrictions on imports of transport equipment and spare parts and fare control. All these restrictions have made the transport industry relatively unattractive for existing as well as potential investors and have resulted in an industry characterized by high cost, low profits and deteriorating service. Moreover, there is no reason to believe that these restrictions have achieved benefits in terms of safety or service.

Road and ship transport affects a vast spectrum of Philippine industry and transportation costs affect production costs significantly. Given that the tr sport sector is potentially competitive, there is little justif.cation for the sort of entry, route and fare regulations that presently exist. There is an urgent need to deregulate entry, routes and rates in both the interisland shipping and the road transport industry and to facilitate fleet modernization and expansion through the lifting of import restrictions on equipment and spare parts. Import restrictions also need to be lifted since there is little hope of meeting requirements in a timely and cost-effective fashion through reliance on domestic production.

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ANNEX F

BACKGROUND ON EXPORT COMPETITIVENESS IN THE PHILIPPINES

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ENHANCING EXPORT COMPETITIVENESS FOR SUSTAINABLE GROWTH

A. Export Substitution/Promotion in the Philippines:

Increasing exports is crucial for obtaining foreign exchange to pay Philippine debt service and import payments. Transition to export-led growth requires reorientation of the country's macro and industrial policies. Export orientation of the economy would lead to an industrial sector that is competitive, effectively utilizes labor, capital and raw materials and absorbs a greater share of the labor force. Finally, the linkage between the agricultural and industrial sectors would also be enhanced since the quality and volume of agricultural output provides raw materials required by the industrial sector.

1. Profile of the Export Sector:

As of May 1991, the 10 principal merchandise exports of the Philippines are semiconductors and electronic microcircuits, garments, crude coconut oil, bars/rods of copper, gold from copper ores, banana and plaintains, lumbers, copper concentrates, shrimps and prawns and canned pineapple. Garments and semiconductor exports account for over 60 percent of the composition of manufactured exports and more than 40 percent of total Philippine exports as well. In dollar terms, both export products rake in over $1.1 billion annually since 1987. In 1990, garment and semiconductor exports totaled $1.78 billion and $1.96 billion respectively.

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Upcoming manufactured exports and their corresponding values are as follows:

		1990	1989
		(FOB, Million U.S.$)	
1.	Textile yarns/fabrics	93	87
2.	Footwear	109	96
3.	Travel goods and handbags	43	41
4.	Wood manufactures	117	88
5.	Furniture and fixtures	189	204
6.	Chemicals	261	279
7.	Non-metallic mineral manufactures	57	45
8.	Machinery and transport equipment	150	115
9.	Processed food and Beverages	207	206
10.	Iron and Steel	77	76
11.	Baby Carr., Toys, Games and Sporting Goods - 2	-67	51
12.	Basketwork, wickerwork and other articles of plaiting materials	128	134
	Total Manufactured Exports	5707	5192

(Note: Total includes garments and semi-conductor exports)

Source: Central Bank of the Philippines

Traditional agricultural exports which dominated the export sector in the sixties and seventies and nontraditional agro-based exports yielded $1.39 billion in 1990 and $1.43 billion in 1989. Traditional agricultural exports are coconut products (copra, coconut oil, dessicated coconut, copra meal and cake), sugar and sugar products, fruits and vegetables (bananas, pineapple, canned pineapple, etc.) Nontraditional agro-based exports include shrimps and prawns, ramie fibers, dried seaweeds and, among the fruits category, fresh mango.

Exports of forest products brought in $94 million in 1990 and $197 million in 1989. These consists mainly of lumber, plywood and veneer sheets/corestocks. Last year, log exports were officially banned in response to the degradation of the country's forests. Mineral product exports, made up of copper concentrates, copper metal, gold, iron ore agglomerates, chromium ore and nickel was valued at $723 million in 1990 and $829 million in 1989. Exports of petroleum products amounted to $155 million in 1990 and $95 million in 1989.

Total manufactured exports in 1990 accounted for 69.7 percent of total exports in 1990 compared to 66.4 percent in 1989. The rising share is indicative of the transformation of the country's export structure considering that in 1986 the share of manufactured exports was 55.9 percent. Reduced earning capacity of agricultural and mineral exports due to weak international commodity and mineral markets have contributed as well to the dominance of manufactured exports.

2. Strengths and Weaknesses:

2.a Sources of Strengths:

Emerging manufactured export products (e.g. footwear, furniture and fixtures) are characterized by higher labor absorption. This impacts positively on the country's employment situation. Furthermore, these labor-intensive export activities encourage the development of family enterprises outside Metro Manila, close to the source of basic raw material supply.

Nontraditional agro-based export products are also being developed. Shrimps and prawns, mangoes, dried seaweeds and ramie fiber exports are gaining prominence. This growing diversification shelters the country's capacity to earn foreign exchange from unfavorable developments in a single product or market.

The GOP and private sector are consciously of promoting export activities and encouraging foreign investments. The thrust to develop export processing zones and industrial parks in various parts of the country is an example of indirect export promotion as well as encouragement of industry dispersal. The GOP has recently embarked on a reform agenda to provide a policy environment conducive to exports and to raise substantially industrial efficiency. The GOP and the private sector continue to improve their coordination in promoting export products through participation of buyers and suppliers in trade fairs, dissemination of trade information, improvements in design and packaging, etc.

2.b Sources of Weakness:

Performance of exports for the period 1988-90 sustained the share of exports to GNP in real terms at 30 percent. However, it was insufficient to arrest the deterioration in the current account. Exports, on the whole, have contributed to income generation and employment ('real' effects) as well as to foreign exchange earnings. The table below gives an indication of the movement of exports and the current account gap:

	Export Growth ($, In %)	Current Account (Million $)
1988	23.7	-423
1989	10.6	-1465
1990	4.6	-2642

Source: IMF

Trade data for the past three years show that deterioration of the current account deficit can be partially explained by declining export performance (albeit the oil price shocks in 1990 exacerbated the situation). External factors (e.g. weak markets abroad and depressed international prices) no doubt have constrained export growth in the short run. But due to the strong policy bias against export activities, the absolute export level remains modest compared to export earnings of other ASEAN member countries.

Earlier, the dominant role of electronics and garment exports was highlighted. Granted special incentives by the GOP in the mid-seventies, these export activities responded and grew to provide the bulk of the country's foreign exchange earnings. Both of them, however, have weak linkages with the rest of the economy and therefore, produce minimal multiplier effects. They are characterized by enclave production, typically in export processing zones and involving primarily assembly and packaging operations. Spinoff benefits in the form of backward linkages, entrepreneurial development or technological advance have been minimal, despite significant growth of export volume in the last decade or so.

Furthermore, production is import intensive. While domestic value added has grown in the garment sector, the electronics sector has experienced a decline. Current import intensity ratios of these industries are around 56 percent and 80 percent, respectively, implying a weak capacity to generate value added. This translates into low labor absorption and modest net foreign exchange contribution. Moreover, the world market for semi-conductors has had significant downturns in the 1980s and the world industry characterized by shakeouts, making the prospects of semi-conductor exports uncertain and unreliable for consistent, long run export earnings.

The processing of agricultural products, particularly fruits, vegetables and marine products is one activity where the Philippines has comparative advantage. However, its linkage with the manufactured export sector is relatively weak. Except for processed food and beverage, there are very few processed export items which are agro-based. Since the sixties and seventies, exports of coconut and sugar have been basically raw or unprocessed products. Such products, along with mineral ones, suffer volatile price swings in the international commodity markets.

While the prospects of wood-based export manufactures (wood manufactures, furnitures and fixtures, basketworks, etc.) look promising, their volume growth is constrained by declining domestic supply of wood, particularly rattan and other tropical hardwood. Imports of raw wood from surrounding ASEAN countries are also limited due to the tightening environmental and forest protection laws in other resource rich developing countries and competition from Japan and Taiwan.

Lack of market diversification, similar to product diversification, is another source of weakness. Over 50 percent of Philippine exports are bound for the United States and Japan. The European Economic Community (EEC) market absorbs 17-18 percent of the country's exports while the Middle East market share is barely 2 percent. The ASEAN region and Hong Kong have a combined market share of 11-12 percent. Export dependence on two major markets alone makes the Philippines vulnerable to market and policy developments in those developed countries.

Perhaps the major source of weakness in the development of the country's export potential is the lack of an appropriate policy environment conducive to the growth and expansion of export activities. Policies on the exchange rate, investment incentives, trade and complementary macroeconomic and industrial policies conspire against export activities while promoting import substitution industries. While the present reform actions of the GOP are geared towards promoting exports, they often fall short of what is needed to enhance export competitiveness.

3. Policies Enhancing Export Competitiveness:

Policies that raise export competitiveness can be classified into core export strategy and complementary/supportive policies. Core export strategy contains a set of policies that directly neutralizes the policy bias of the system against export activities and thus have the greatest impact on exports. Complementary policies refer to those that address various macro and sectoral constraints that undermine the efficiency of the country's agro-industrial production and impact indirectly on export activities.

Given the present stage of economic development and sources of anti-export bias, core export strategy would appropriately refer to the foreign exchange market policy reforms, incentives to promote investments in export industries, administrative reforms to facilitate exports and export financing. Supportive policies, on the other hand, would include policy issues on public debt management, tax reforms and privatization, free entry and pricing in interisland shipping, infrastructure development through the private sector and energy price deregulation.

B. Core Export Strategy:

1. Foreign Exchange Market Reforms:

1.a Recent Experience/Status:

As explained in the preceding section, the Philippine foreign exchange market is characterized by market segmentation with tenous linkages among segments. The inter-bank market is regarded as the wholesale market for foreign exchange transactions among commercial banks. From these transactions, a BAP reference rate for the day is established, which serves as the basis for the exchange rate in the customer market.

The customer market or retail market covers transactions between commercial banks and their customers who represent a wide range of economic agents engaged in international transactions. The volume of transactions in this market is quite large since most recorded balance of payments transactions of the private sector are channeled through this market.

A third major segment of the market is the parallel market which is the channel for a wide range of unofficial transactions not recorded in the balance of payments. The size of this market is believed to be several billion dollars a year, with remittances of overseas contract workers being a major component. Of an estimated total remittances of some $3 billion, only about $1 billion are channeled through the banking system. This market serves as a safety valve for the overflow of transactions from the other two markets in times of foreign exchange scarcity or BOP crisis. Demand for foreign exchange in the parallel market perks up whenever the gap between the official or BAP reference rate and the parallel market rate exceeds 10 percent. Such a discrepancy between the parallel and official markets, even after monetary restraint is imposed by the CB, generally leads to a formal devaluation of the BAP reference rate, as demonstrated recently in the last quarter of 1990.

As a consequence of market segmentation, the rate determined in the wholesale market is not 'credible' as the market-determined rate. Since the daily volume traded in the inter-bank market is relatively small, market participants cannot reconcile the resulting BAP rate with an 'equilibriating' exchange rate that matches actual demand and supply for foreign exchange in the system. A much larger volume is traded in the customer market where the rates quoted do not get reflected in the official or BAP reference rate. Because of the thin volume of foreign exchange traded daily on the BAP floor, the limited number of participating banks, the ever-present CB 'guidance' in the trading floor and the host of CB rules and regulations governing trading, foreign exchange positions, foreign exchange retention limits, etc., the BAP rate can hardly qualify as a truly market-determined exchange rate.

Recently, however, the CB has started to liberalize the rigid structure of the market in an attempt to integrate the transactions within the formal wholesale and retail markets and thus arrive at a market-determined exchange rate. In the latter part of 1990, the CB devalued the exchange rate by an amount which led to a 17 percent depreciation of the real effective exchange rate. In the Letter of Intent submitted to the IMF last February 1991 requesting for an 18 month Standby Arrangement, the GOP promised to preserve the gains from the recent devaluation. The GOP also referred to policy actions intended to reform market segmentation.

Presently, there are ongoing talks with the CB and the BAP on the resumption of off-floor trading. Off floor will give the banks more flexibility in conducting their foreign exchange transactions and may increase the volume of transactions traded. Recently, the CB has allowed exporters to retain at least 2.5 percent of their foreign exchange receipts but not greater than $100,000. This is a boon to small and medium scale exporters who may now have less incentive to hold on or delay remittance of their foreign exchange earnings. The CB has also required commercial banks to sell in the inter-bank market their foreign exchange in excess of their exchange requirements. The foreign exchange requirement of a bank is based on a month's worth of letter of credits (L/Cs) held by the bank. As a consequence, the exchange rate has appreciated from Pesos 28: 1 U.S.$ as of December 1990 to a level slightly below Pesos 27: 1 U.S.$ during the third week of August 1991. Weak import demand as a consequence of sluggish economic activity and the 9 percent import levy has also affected the demand for foreign exchange.

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1.b Remaining Tasks:

Following policy reform actions are recommended to further liberalize the foreign exchange market and arrive at a market determined exchange rate:

- Determine the basis and establish the limits of foreign exchange holdings by the commercial banks. This reform action is in preparation for the implementation of off-floor trading. This regulation should provide the incentive to commercial banks to 'square off' their foreign exchange positions externally or through the interbank market rather than internally or with their customer or client base.

- Reopen off-floor trading among commercial banks. Flexibility of trading among commercial banks and increase in volumes traded in the interbank market are expected to result from the resumption of off-floor trading.

- Authorize offshore banks and foreign exchange broker and dealers to participate in the foreign exchange market. Allowing the entry of additional participants will promote efficiency through increased competition, bring in the experience of offshore banks and increase the volume of transactions.

- Expand the retention limits on foreign exchange holdings of exporters. While the imposition of present retention limits is a major step in the right direction, expanding the allowable limits could reduce dollar hoarding among exporters, who are uncertain about getting foreign exchange for their import requirements.

- Abolish the CB and/or BAP's special foreign exchange allocation arrangements. This creates a market within a market. Policy prioritize foreign exchange demand among various agents that leads to various exchange rates causing inefficient allocation of scarce foreign exchange.

- Abolish the documentary stamp tax for inter-bank transactions. The tax raises trading costs and therefore, discourages higher trading volume.

- Strengthen the CB role in monitoring and supervising the new interbank market (with off-floor and on-floor). Competition among banks should be encouraged but with adequate and appropriate CB supervison to discourage dollar hoarding.

2. <u>Tax Reforms:</u>

2.a <u>Recent Experience/Status:</u>

Raising new revenues will cutdown the consolidated public sector deficit and thus relieve the system of inflation and high interest rates. Currently the Philippines is committed to the IMF to generate an additional twenty billion pesos in revenues (roughly 2 percent of GNP) so that the nine percent import levy can be removed.

SDP I supported reforms meant to raise the efficiency of the Value Added Tax (VAT) system. As a new tax, VAT required a strong administrative underpinning to get collections off to a good start. Given the variety of economic activities covered by VAT, the revenue yield should be at least proportionate to GNP in current prices. Over time as VAT collection efficiency improves, the income elasticity of VAT should be greater than one.

At the moment, the Aquino administration have submitted to Congress proposals to modify business, professional income and VAT taxes, and to impose a new affluent consumption tax. These proposal are intended to compensate for the revenue loss when the 9 percent import levy is finally abolished before the end of the year. IMF estimates that the combined yield of these tax measures, if they were to be approved, amounts to Pesos 5 billion.

2.b <u>Remaining Tasks:</u>

- Broaden VAT coverage to services. Present coverage extends to manufacturing activities and wholesale and retail trade.

- Strengthen anti-smuggling enforcement procedures by increasing the share of imports covered by "fair market values", as a basis for the CIF valuation of imports for duty and tax purposes. Globalize the Comprehensive Inspection and Surveillance System (CISS) to nearly all ports of origin for Philippine imports.

- Obtain Congressional approval of the submitted tax proposals, namely: affluent consumption tax, simplified business and professional income tax, etc.

- Computerize of the VAT system, including training and software, will strengthen the monitoring and supervision of the VAT.

3. <u>Reduction of Effective Protection Rates on Imports:</u>

3.a <u>Recent Experience/Status:</u>

Despite the trade reforms that started in 1981, the present system of protection supports an industrial sector that basically retains its import substituting habits. While some producers/manufacturers starting in the eighties were forced to export and thus earn foreign exchange, they tended to do so to the extent that their import requirements were supported. As a result, export activities either failed to expand and diversify or increase their value added content.

Exports, overall and in most sectors, suffer from negative protection--that is, value added is lower than it would be if inputs at world prices were made availabe to the local producer/exporter. As a consequence of the input differential price (between domestic input price and world market price), value added of exportables are inhibited from increasing. Others technically refer to the price difference as an export tax. While the average negative protection has declined slightly in the latter half of the eighties, some sectors show an increase, including mining, paper, rubber products and basic metals.

Quantitative restrictions on 1,323 items were removed in the period 1986-88, while the GOP reformed about 200 tariff rates. As of February 1990, restrictions on another 100 products were lifted and tariffs on 190 more items were lowered. Currently, 237 products in List B are designated to be liberalized. Of these, 41 have recently been certified by the Monetary Board as suitable for the next phase of trade liberalization.

In July 1990, Pres. Aquino proposed a more radical reform of the tariff system - Executive Order (EO 413) - which would have reduced the level and dispersion of nominal rates from the 0 - 50 percent range to 3 - 30 percent range. In the face of considerable opposition, that measure has been modified to provide for at least some containing 50 percent tariff rates, intermediate rates, and phased implementation over four years. This modified EO 413 is known as EO 470, which has been recently issued by the GOP.

3.b <u>Remaining Tasks:</u>

- Streamline the duty drawback system by establishing a one stop rebate center. Improving the drawback system will reduce the negative protection on exportables across sectors. A one stop center can serve to minimize the administrative bottlenecks surrounding the implementation of the drawback system.

- Update and expand the application of the standard formula of manufacture for all export items. Having these standard formulas will simplify and thus, facilitate the computation of duty drawbacks for exporters.

- Reduce the length of processing time for completed duty drawback applications to at least 60 days or less pursuant to the Customs code. This will encourage drawback application as well as expansion of export operations.

- Streamline the VAT tax credit system to reduce the processing time for completed applications. This will contribute significantly to the reduction of negative protection of exportables.

4. <u>Incentives to Promote Investments in Export Industries:</u>

4.a <u>Recent Experience/Status:</u>

In the second half of the eighties, the Philippines attracted far less direct investment in the export industry than some of its neighbors owing to its restrictive laws and regulations governing foreign investments in key sectors. While perceptions of

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political instability also serve to discourage investment in the short term, the investment rules and regulations including incentives play a critical role.

The first legislation on investment incentives, known as the Investment Incentives Act of 1967, has been amended and codified three times. Under the Aquino administration, a new Omnibus Investment Code (OIC) was put in place in 1987 through EO 226. Through all these changes, the general thrust has remained unchanged: fiscal inducements in the form of various types of tax exemptions or deductions offered to "new and necessary", "pioneering" or basic industries. Under the Marcos government, the Batasan Pambansa (BP) 391 served as the legal framework for the granting of investment incentives. EO 226, unlike the preceding investment incentive legislation, provides uniform incentives to exporters and nonexporters.

A comparison of EO 226 and BP 391 shows that the former does not promote investments in exports more aggressively than the latter since the EO reduced by half the potential benefits given to exporters when compared with the benefits to exporters under the BP. While firms proposing to export at least 50 percent of their output are allowed to register with the BOI and take advantage of the investment incentives, even if their activities are not explicitly listed in the investment priorities plan, it is worth noting that the Investment Priorities Plan (IPP) itself is biased in favor of highly protected sectors. Of 236 items listed under the IPP in 1988, more than half were subject to tariff rates in the range of 30 percent, while practically all were subject to import controls. Thus, it is not suprising to find that the share of export projects to the total approvals has fallen in recent years.

At present, there are plans to provide accelerated depreciation and net loss carry forward to all enterprises and reduce the tariff on capital equipment to 10 percent. Under these proposals, while the BOI will continue to grant tax concessions in preferred areas, the IPP will be shortened and the discretionary power of the BOI will be reduced. Since these measures will apply equally to both domestic and export oriented projects, they are not expected to significantly reduce existing biases against investment mainly for exports.

Pres. Aquino has signed into law the foreign investment legislation passed very recently by Congress. While the law can further be improved, it is a major piece of reform on prior foreign investment law although the implementing rules and regulations (IRR) have not yet been finalized and issued.

4.b Remaining Tasks:

- Revise the IPP to focus on promoting investments in export activities. Streamline EO 226 to provide greater incentives to investments for exports that will complement the recently passed foreign investment law. Since the focus is on the liberalization of foreign investments, it may be timely to review as well EO 226 and the IPP to take into account incentives comptible with the GOP policy to attract foreign investments.

- Reduce/abolish the discretionary powers of the BOI. The BOI should focus more on promotion and marketing instead of regulation. Clipping its regulatory powers translates into further reduction of bureaucratic red tape discouraging a foreign investor's decision to set up business in the country.

- Ratify the Multilateral Investment Guarantee Act (MIGA) Charter. The action to ratify would improve the risk perception of most foreigners who wish to invest and do business in the country.

5. Administrative Reforms for Export Facilitation:

5.a Recent Experience/Status:

The Philippines has been operating several administrative and bonded type schemes to provide exporters with duty free access to their inputs. Critical deficiencies of these schemes are the limited coverage of export products and the significant costs on the exporters covered due to the delays and bureaucratic complexities in the application of these schemes. About 20 percent of exporters and half of nontraditional exports are covered by some form of drawback/exemption scheme.

The schemes are subject to four major constraints. First, many exporters are subject to local "non-availability" requirements which restricts their access to internationally competitive inputs. Second, the "formula of manufacture" used to reconcile imported inputs with exported outputs have not been standardized, making the process time consuming and cumbersome for exporters and implementing agencies. Third, the control mechanisms and agencies are duplicated for much of the drawback/exemption administration. Fourth, indirect exporters are for the most part not covered.

While the GOP has provided a number of programs to assist exporters in the past decade, only a few of them have been successful with limited objectives. However, the GOP has not been able to formulate an effective national strategy nor devise effective administrative mechanisms to implement it. As such, the approach is very ad hoc with no efficient mechanism for responding to exporters' concerns in a systematic way with quick and deliberate action that cuts across interagency bureaucratic hurdles. The functioning of the system is complicated by the multiplicity of government agencies involved in the implementation of the program and the minimal role the private sector has had in the design and delivery of such services.

One of the proposals for congressional deliberation is the Export Omnibus bill. The bill, if approved, would give a high level of priority to exporters and their requirements at the policy level; involve the private sector in a major way in the formulation and fine tuning of export policy, administrative procedures and in the implementation of export support measures; provide an independent source of funding dedicated to export programs in such areas as markeing, design, trade fairs, product prototype development, packaging, trade information and training; and provide the legal basis for executive action to carry out program and policy decisions.

The legislation is expected to remove from the GOP many of the diverse and overlapping export services, consolidate them and transfer them to a professionally managed, private sector oriented trade promotion organization. The legislation would establish the basic policy objectives in such critical areas as export finance, duty free access to imported inputs/equipment and import and export procedures. As such, the proposed Omnibus bill could be an important vehicle in spearheading a more aggressive and comprehensive export policy and support framework.

5.b Remaining Tasks:

- Enact and implement the Export Omnibus Bill to address the shortcomings of the policy/institutional framework in promoting exports and addressing requirements of exporters.

- Streamline the VAT tax credit system and the duty drawback system to extend coverage to all exporters including indirect exporters.

6. Export Financing Issues:

6.a Recent Experience/Status:

Existing systems of export finance in the Philippines are inadequate to promote exports and accelerate export earnings. Many exporters, especially the newer and smaller ones, face great difficulty in obtaining working capital finance for their export activities. Indirect exporters are even worse off. No mechanism, such as domestic L/C, is being used that would enable them to access export finance. Traditional banking practices currently in use do not avail of streamlined disbursement mechanisms to reduce the duration and hence, the costs of export loans. No collateral substitutes were developed to meet the banks' formidable collateral requirements. Nor have transaction-based loan arrangements been employed to increase loan surety.

In summary, the financing constraint of new and small exporters refers mainly to credit access. This constraint is exacerbated by the high cost of money particularly for the smaller exporters. Despite export orders, banks have a tendency to regard these small exporters as nonprime clients since they may lack adequate collateral. Nonprime lending rates are the highest rates charged by banks and nonbank financial institutions.

6.b Remaining Tasks:

- Introduce an expanded preshipment guarantee facility for export loans.

- Introduce parallel financing systems (such as domestic L/C) for domestic input purchases of exporters.

- Create a foreign currency loan scheme to finance the imported inputs of manufactured and other nontraditional exports.

- Develop an independent source of sustainable funds dedicated to export programs in the areas of marketing, design, trade fairs, packaging, trade information, etc.

C. Complementary Policies:

1. Capital Market Development:

1.a Recent Experience/Status:

Like most developing countries, the capital market of the Philippines needs substantial improvement. There is hardly a market for long-term funds, although there exists two stock markets that somehow perform the role of generating long-term equity from the private sector. However, the volume of shares traded in these two stock markets are relatively thin. Only a few large corporations are listed for trading. These stock markets are regulated by the Securities and Exchange Commission (SEC), which does offer some form of protection to investors.

While there exists a number and types of banks (commercial, thrift, rural and development banks) and nonbank financial institutions that provide various financial services, most of their lending activities are short-term. Banking and other financial services are also subject to a host of rules and regulations by the CB that often lead to high intermediation costs. High costs of intermediation drives a wedge between lending rates and deposit rates. The former are higher than what they should be, while the latter are depressed. Foreign equity participation in the banking industry is limited to only 40 percent. Only two foreign banks have been granted a commercial banking license (Citibank and Hong Kong Shanghai Banking Corporation) and with only limited bank branching.

The country may be equipped with basic institutions to channel savings but they can only be effective if there is a substantial flow of savings seeking long term placements in private corporate institutions. The flow is small for various reasons. Private savings as a percentage of GNP is low at 12 percent and much of that savings is generated by and reinvested in family enterprises. Short-term interest rates are high, making it unattractive to lock up money long-term. Most larger investors prefer other outlets, such as real estate and/or family businesses, to which they have a personal connection.

The government securities market developed rapidly in the eighties. Monetary authorities relied on government debt instruments to stabilize the economy, starting with the economic crisis of 1983-85. While an effective tool for carrying out monetary objectives and obtaining funds for deficit financing, government securities are essentially short-term instruments. As a consequence, the share of debt service in the government's budget rose to 40 percent, crowding out economic and social services. The development of the long-term funds market was also held back as more investors preferred the high yielding, short-term government debt instruments.

1.b Remaining Tasks:

- Merge the two stock market exchanges to achieve economies of scale in listing, trading and backview operations.
- Reduce the costs of intermediation.
- Allow greater participation of foreign banks.
- Develop the secondary market for long-term public debt instruments.
- Increase the participation in competitive bidding for government securities.
- Provide small savers access to government securities.

2. Free Entry and Pricing in Interisland Shipping:

2.a Recent Experience/Status:

Maritime transport is considered an important form of cargo transport in the country today. Maritime transport costs can influence investment decisions on plant/factory location as well as markets to serve. In a business enterprise that depends on a strong link-up with capital and natural resources, maritime transport definitely affect profitability.

In 1989-90, in part because of the interisland shipping reforms supported by SDP I, passenger rates other than third class have been freed. Likewise certain cargo rates, such as rates on products requiring refrigeration, have been freed. While formal liberalization of entry into the industry was not achieved because of lack of Congressional approval, MARINA did increase competition on many routes through the decisions of its Board on shipper's requests for route entry.

Progress toward greater competition in shipping must take place on two fronts simultaneously, route entry and pricing. If entry is liberalized but price regulation is maintained, there may hardly be any incentive to provide quality service and cartel pricing could develop among shippers. Two additional elements are the level of port charges, which seem to bear little relation to costs in publicly run harbors and the possible inadequacy of port infrastructure if traffic were to increase.

2.b <u>Remaining Tasks:</u>

- Deregulation of rates for liner services operating the tertiary and development routes and for ferry services.
- Rationalization of pricing formulas for computing cargo rates.
- Reduction of reporting requirements for liner operators.
- Introduction of peak pricing strategy for third class passenger rates.

ANNEX G

POLICY IMPLEMENTATION MATRIX

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SUPPORT FOR DEVELOPMENT PROGRAM II
Policy Implementation Matrix

Overall Goal: Philippine Exports Competitive in World Markets.

	PERFORMANCE INDICATORS	
Policy Objective/Implementation Action	Tranche 2	Tranche 3
A. STRATEGY - Competitive Pricing for Exports and Their Inputs		
1. Market determined foreign exchange rate		Recommendations of the study acted upon, including:
Liberalize foreign exchange transactions and holdings.	Comprehensive study on foreign exchange rules and regulations completed.	- Participation in the foreign exchange market expanded to other banks and non-bank institutions.
	Test run of off-floor trading among commercial banks and review of experience completed.	- Revised accreditation system for foreign exchange brokers and dealers operating.
		Retention limits for exporters of their foreign exchange earnings substantially expanded.
2. Access to inputs at world prices		
Streamline duty drawback and VAT tax credit.	One stop duty drawback center operating effectively.	Length of processing time for 80 percent of completed applications reduced to 60 days or less for at least three months period.
	Procedures for prompt approval of 40 percent of VAT tax credit claims implemented.	Length of processing time for 80 percent of completed applications reduced to 60 days or less for at least three months period.

SUPPORT FOR DEVELOPMENT PROGRAM II
Policy Implementation Matrix

Policy Objective/Implementation Action	PERFORMANCE INDICATORS Tranche 2	Tranche 3
B. STRATEGY - Supportive Environment for Exports		
1. Adequate provision of interisland liner shipping services		
Liberalize cargo rate regulations.	Action plan adopted to liberalize liner cargo rates.	Agricultural commodities reclassified. Cargo fork tariffs widened significantly.
2. Efficient Financial Resource Mobilization		
Lessen interest rate impact of public debt financing through improved management.	Action program for improving the access of small savers to government securities, including possible use of trust units and/or saving bonds, adopted.	Mechanism(s) for the access of small savers to government securities designed.

ANNEX H

ECONOMIC ANALYSIS OF SDP II SUPPORTED REFORMS

SDP II Economic Analysis

1. Background

The goal of SDP II is to make Philippine exports competitive in the world markets. The reforms proposed to be supported under SDP II come under two strategies. The first strategy is competitive pricing for exports and their inputs. The policy objectives of this strategy are market determined foreign exchange rate and access to inputs at world prices. The respective implementation actions are: liberalize foreign exchange market and holdings, and streamline duty drawback and value added tax (VAT) credit on exporters' inputs. The second strategy is supportive environment for exports with the policy objectives of adequate provision of interisland liner shipping services and efficient resource mobilization. The implementation actions are: liberalize shipping rate and route franchising regulations, strengthen VAT administration, and improve public debt management.

The economic analysis attempts to quantify, where possible, the economic impact of the above SDP II reform actions. Of the reforms that could be quantitatively evaluated, the foreign exchange market, VAT and public debt management actions are assessed using a macroeconometric model of the Philippine economy. The other reform actions, i.e., streamlining duty drawback and VAT rebates for exporters' inputs, and interisland shipping reform, are evaluated separately. The next several sections discuss the impact of BOP support and the different reforms. The final section contains an economic appraisal of SDP II.

2. Impact of Balance of Payments Support

The transfer of SDP II funds will increase the inflow of capital and help finance the large current account deficit, which the IMF projects to be 4.5 percent of GNP in 1991 and 3.9 percent of GNP in 1992. Assuming that SDP II funds will amount to $35 million in 1991 and $85 million in 1992, the projected current account deficit will be reduced by approximately 0.1 percent of GNP in 1991 and 0.2 percent of GNP in 1992.

3. Impact of Foreign Exchange Market, VAT and Public Debt Management Reforms

A. Description of the Macroeconometric Model

Impact of these reforms may be assessed in terms of their effects on the economy. Without and with reform action sets of projections are prepared

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using the 1989 version of the Philippine Institute for Development Studies (PIDS) - National Economic and Development Authority (NEDA) annual macroeconometric model.1/

The 1989 version of the PIDS-NEDA model is based on a combination of classical, Keynesian, structuralist and monetarist concepts. The model determines output from the supply side. Aggregate demand also plays an important role in determining output. Supply bottlenecks are taken into account as affecting certain sectors of the economy. Money has a prominent role in determining prices. The mixture of concepts reflects current developing country realities in the structure of the model. For instance, in developing economies, especially those which are agriculture-based, it is more appropriate to highlight the role of aggregate supply in the determination of output to capture the effects of supply bottlenecks. Other institutional constraints are also reflected in the model such as a nonmarket clearing wage arising from persistent unemployment and underemployment. Chronic budget deficits and other macroeconomic imbalances are corrected with appropriate fiscal and monetary policies. Added to this is the effect of policy on economic activity through the influence on aggregate demand.

Interaction of aggregate demand and supply will not necessarily result in full employment equilibrium. In the context of developing economies, it is not imperative that macroeconomic balance be achieved by automatic price adjustments. This immediately rules out the market clearing process inherent in the classical system, noted in the model via the specification of "fixprice" and "flexprice" sectors. The flexprice sector is assumed to have an adjusting price while the fixprice sector is assumed to have an adjusting output level. The former usually pertains to agriculture while the latter to industry.

The model consists of 114 behavioral and structural equations and 53 identities. It is divided into four major blocks: (1) the real sector consisting of production, expenditure, employment, wages and prices, (2) the fiscal sector, (3) the financial sector, and (4) the external sector.

The linkage between the production sector and expenditure sector comes mainly in the form of aggregate expenditure categories appearing as arguments in the demand functions in the production sector. Output as determined then enters into the employment equation. The financial and real sectors interact though the interest rate and through the price variables as some monetary aggregates affect prices. The fiscal sector is essentially exogenous in the basic model, specifically with respect to government expenditures. However, tax revenues are linked to the level of economic activity or output. To the extent that it

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1/ Winifreda M. Constantino, Josef T. Yap, Ronald Q. Butiong and Aleli S. dela Paz, "The PIDS-NEDA Annual Macroeconometric Model Version 1989: A Summary," Working Paper Series No. 90-13, Philippine Institute for Development Studies, 1990.

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is monetized, the government budget deficit serves as the link with the financial sector. The external sector links with the rest of the economy through the financial variables, specifically, net foreign assets. This is in addition to the link between the expenditure/production side, i.e., exports and imports with the current account components.

Because many exogenous variables in the model are policy-oriented, it is particularly suitable for short term policy analysis. It should be noted however, that the statistically estimated structural parameters of the economy, given the model's functional specification, are defined by the estimation period, covering 1968 to 1987 or subperiods thereof. In this respect, simulations of the model are likely to underestimate the level and rate of changes in the structure of the economy.

B. Without SDP II Baseline Scenario

The baseline scenario consists of 62 assumptions (Table 1). The assumptions are based on available information gathered from published and unpublished reports of government agencies and from published studies. Whenever information about certain variables included in the list of assumptions are not available, their past growth patterns are assumed to remain for the next ten years with some adjustments based on an evaluation of the likely growth patterns of the variables. Efforts were made to take into account changes in government policies that affect the values of certain variables included in the list of assumptions. For instance, the assumption on the tariff rates has already incorporated the implementation of the recently launched tariff reform program (Executive Order No. 470).

One crucial variable included in the list of assumptions for the baseline scenario is the nominal exchange rate. The average nominal exchange rate for the period January-July 1991 is assumed to hold for the year. For the subsequent years, it is assumed that the foreign exchange rate movements will still be greatly influenced by the Central Bank. Only a moderate depreciation is therefore to be expected in the next nine years. It should be noted that in the last five years, except 1990, exchange rate depreciation had never gone beyond 5 percent. Thus, in 1992, the nominal exchange rate is expected to depreciate to ₱28.5 per U.S.$1.00. It is further expected to depreciate by 4.9 percent in 1993, 5 percent per year in 1994 and 1995, 3 percent per year in 1996 to 1998, and 1 percent per year in 1999 and 2000.

Addressing macroeconomic imbalance in 1991 and 1992 will be the main concern of the authorities. Hence, reserve requirement is expected to remain at 25 percent. However, improved stability of the economy in 1993 will allow the monetary authorities to reduce the reserve requirement starting that year. The objective here is to bring down the reserve requirement to 16 percent over the years which was part of the original plan of the 1980 financial reforms.

Concomitant with the overall improvement of the economy is the slowing down of the inflation rate. Thus, nominal interest rate on time deposits is expected

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to decline, but not necessarily the real rate. The nominal interest rate on savings deposit is expected to remain the same at 5 percent per annum through the projection period.

The results of this projection exercise are shown in Table 2. The growth of GNP will accelerate from 1.13 percent in 1991 to 7.46 percent in 2000, averaging 5.7 percent per year. The tax effort will hardly change. As a percent of GNP, the budget deficit will fluctuate but will go down to 0.71 percent in 2000. The current account deficit will increase from U.S.$1.8 billion in 1991 to U.S.$3.2 billion in 2000, although as a percent of GNP it will decline from 3.8 percent in 1991 to 2.5 percent in 2000.

C. With SDP II Scenario

1) Assumptions

The assumptions used for the with SDP II foreign exchange market, VAT and public debt management reforms are discussed below. The rest of the assumptions are the same as those of the without SDP II baseline scenario.

The nominal exchange rate for 1991 is assumed to be the same as that of the baseline. For the subsequent year, however, it is assumed that the foreign exchange market will be liberalized in accordance with the SDP II policy implementation matrix. The exchange rate is therefore expected to depreciate to ₱31 per U.S.$1.00 in 1992 approximating the parallel market rate in late 1990. It will further depreciate by 5 percent annually for the years 1993 to 1995, by 3 percent annually for the years 1996 to 1998, and by 1 percent annually for the years 1999 and 2000.

Strengthening VAT administration will mobilize more resources for the government and consequently reduce its budget deficit. Hence more funds, will be made available at lower rates than what may be available for the private business sector, in general, and the export sector, in particular. It is assumed that the baseline scenario already included some amount of VAT collection. It is further assumed that this amount is equivalent to 1.25 percent of nominal GNP. Thus, the actual amount of VAT collection could be derived. To shock the system, a 20 percent growth per year in VAT collection from the Department of Finance's 1992 projected level was obtained. The difference between this and the VAT collection derived from the baseline scenario is then added to the simulation (see Table 3).

Improved public debt management has two components: reduction in the interest rate of Treasury bills and increase in the interest rate on savings deposits. It is very difficult to quantify the effect of this reform action on the interest rate. Given that such improvement in debt management can lead to a reduction in interest rates, it is assumed that the Treasury bill rate will be reduced by 1 percentage point in 1993 to 1995, and by another 1 percentage point in 1996 to 2000 from that of the baseline scenario. The Treasury bill rate in this case is treated as an exogenous variable. The interest rate on savings deposits is assumed to remain at 5 percent in 1991 and 1992. It will increase to 6 percent in 1993 and 1994, 7 percent in 1995, and 8 percent in 1996 to 2000.

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2) Results

Table 4 shows a comparison of the with SDP II scenario relative to the without based on the expected implementation of the three reforms actions, i.e., foreign exchange market liberalization, improved VAT collection and better public debt management.

Tax effort will improve over that of the baseline scenario by 0.89 percent in 1992 and by 18.3 percent in 2000. The budget deficit will be substantially lower than that of the baseline scenario and in fact, a budget surplus is expected starting 1997. Considerable improvement in the external accounts will be realized. In particular, current account deficit will be lower than the baseline scenario by 2.6 percent in 1992 and 29.5 percent in 2000. However, some inflationary pressure will be felt during 1992 to 1996. This will reduce the supply of credit in real terms to the export sector. Thus the level of exports in 1992 to 1995 will be lower than that of the without SDP II scenario. A better result starts to show in 1996. In 2000, the level of real exports will be 2.7 percent higher than that of the baseline scenario.

SDP II will help improve considerably the investment climate. Except for 1992, the level of real investment will be higher than that of the baseline scenario. In 2000, it will be 5.8 percent higher in real terms than that of the baseline scenario. The GNP generated by the with SDP II scenario exhibits a J-curve pattern relative to the baseline scenario. In particular, real GNP will be lower than the baseline scenario during 1992 to 1995. Starting 1996, however, a positive deviation from the baseline scenario will be observed. By 2000, real GNP under the with SDP II scenario will be 2.8 percent higher than that of the without. The J-curve pattern reflects both the cost of structural adjustment and the earlier mentioned limitation of the model in underestimating the pace and level of structural adjustment. It also reflects the historical (stringent) monetary response to inflationary pressures arising from a devaluation and the resulting reduction in the real value of investment funds available to the private sector. This implied monetary policy assumption is changed in the alternative with SDP II scenario below. Additional discussion on structural adjustment costs is provided in Section 6.

The projected structure of the economy with the three reforms in place is shown in Table 5. The share of agriculture will decline from 27.2 percent in 1992 to 21.8 percent in 2000. In contrast, the share of the industry sector will increase from 32.8 percent in 1992 to 39.4 percent in 2000. The composition of demand will also change. In particular, the shares of exports and investment will increase significantly. With the three reforms, industrialization will proceed, anchored on relatively stronger export performance.

Overall, the three policy actions will have a significantly positive effect on the economy in the long run. GNP and GDP levels will be much higher. External and internal balance will improve considerably. Each of the reforms could have been simulated separately and in fact this was done although the results are not shown here. However, there is conceptual basis for a combined simulation of the three reforms. Structural adjustment in the economy is better achieved through a combination of expenditure switching and expenditure changing policies. In the case of the SDP II package, the foreign exchange market reform will result in expenditure switching while the VAT and public debt management reforms will have both expenditure switching and changing effects. The results for the combined case were found to be much better than impacts of the individual reform actions.

D. An Alternative With SDP II Scenario

This scenario uses the same assumptions as in the above with SDP II simulation, except for restoring the real value of credit funds for investment by the private sector. To reflect possible monetary policy response to expected higher inflation rates, liquidity growth is slightly increased and the share of domestic money banks in total liquidity relative to the public sector is increased to restore the real value of available credit for lending by these banks to the private sector.

As shown in Table 6, inflation rate will be slightly higher than in the initial with SDP II case during 1992 to 1996, but will be increasingly lower in the succeeding years. With higher real investment levels, the J-curve pattern relative to the baseline scenario is reduced to three years for GNP and to only two years for GDP from four years for both GNP and GDP under the initial with SDP II scenario. Much higher levels of real GDP and GNP are projected after the end of the J-curve. Improvements in the fiscal and external accounts are also more significant.

4. Impact of Duty Drawback and VAT Rebate Reforms

Since exporters are entitled to duty drawbacks and VAT rebates, the impact on net government revenue would be zero in the long run. More significantly, however, the financial profitability of export activities is expected to improve by streamlining and shortening the duty drawback and VAT rebate processes. Effectively, incentives for exports would be upgraded and exports may be expected to increase in the future.

The benefits of streamlining the duty drawback process may be indicated by the potential financial cost savings and increase in profitability arising from earlier receipt of the duty drawback by the exporter. In the absence of empirical basis that would translate the increase in financial profitability to increased exports and economic income, the financial cost savings could be assumed to be reflective of increased exporter economic income.

The Tariff Commission estimates that in 1990, total duty drawbacks amounted to ₱34.315 million. This is estimated to be around ₱39.5 million in 1991 prices. Assuming that processing time for duty drawbacks is reduced from an average of one year to 60 days, and using a real borrowing rate of 8.05 percent, the estimated financial cost savings (and the increase in profit) of exporters would be ₱2.6 million in 1990.

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Since the above estimates are based on actual duty drawbacks, they are in fact highly understated. Estimates of the potential level of duty drawbacks are provided in Table 7, using the projected value of intermediate inputs for exports under the without SDP II baseline scenario, projected average tariff rates, and the real borrowing rate rather than the time deposit rate to reflect the cost of money. Potential financial cost savings by exporters can be as much as ₱1.4 to 2.4 billion pesos in 1991 prices per year during 1993-2000. Actual financial cost savings in the future expectedly will fall below potential but will be much higher than current performance.

A similar approach could be used to derive results that may be expected from the improvement in processing of VAT rebates to exporters. The VAT division of the Bureau of Internal Revenue estimates that in 1990, the total amount of rebates processed amounted to ₱36.5 million, of which ₱7.5 million were granted and the rest either disallowed or denied. For the same year, the total amount of VAT rebate claims amounted to ₱870 million. Applying the ratio of rebates granted to processed, to total claims would result in total claims granted of ₱178 million or ₱205 million in 1991 prices. Assuming average processing time is reduced from one year to 60 days, and using a real borrowing rate of 8.05 percent, the estimated financial cost savings for exporters could be at least ₱14 million in 1990.

5. Impact of Interisland Shipping Rate and Route Liberalization

This section provides a discussion on two major expected impacts of interisland shipping rate and route liberalization: cost reduction through efficiency gains, and contribution to economic growth of sufficient appropriate shipping services. The readily quantifiable benefits of these reforms, when fully implemented, are estimated to be at least ₱284 million a year.

A. Efficiency Gains and Cost Reduction

One beneficial outcome of policy reforms toward liberalized pricing and entry in the interisland shipping sector may be expected from increased efficiency in the transport of goods and services in the country. The efficiency gains from shipping rate and route liberalization can be derived mainly from travel cost savings, minimization of cargo shut outs, reduction in travel and waiting time, avoidance or reduction in delays in transporting and handling cargos (reduced turnaround time in ports), minimization of weight loss, spoilage, pilferage and spillage of cargos.

Efficiency gains can be illustrated by direct shipment of export products such as bananas direct from Davao to Hong Kong or Singapore and pineapples directly from General Santos City to foreign ports. The elimination of the need for transshipment through Cebu or Manila has greatly encouraged exports from the Davao area. Even if transit freight rates had been liberalized, cost savings from direct shipment of exports are large, approximately ₱7,455-9,560 per 20 foot containers (equivalent to transit rates).

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Fruits and vegetables cargo shut outs at Davao had become a problem during the peak cargo season of September through December. Bananas were either being accommodated in the limited number of available reefer boxes at a much higher charge since its rate deregulation or were being accommodated as break bulk cargo resulting in 80 percent spoilage. Reduction of fruits and vegetables cargo shut outs through route liberalization and encouragement of increased provision of more reefer boxes by shipping operators would translate to huge savings in spoilage costs.

Despite liberalization of shipping rates for livestock, the problem of inadequate hog vans in shipping vessels is seriously contributing to substantial animal weight loss. Cattle from Southern Mindanao are estimated to lose an average of 12 kilograms of weight on their way to Manila and hogs roughly one half to two thirds as much. To reduce costs arising from weight loss during sea transport, further encouragement to shipping operators to invest in hog vans should be made and tied up with plans to introduce more slaughterhouses in cattle and hog growing areas.

A survey of grains shippers done in May 1991 showed substantial spillage and pilferage losses. Southern Agro Export Corporation (SAGREX), which ships corn to both Cebu and Manila, relies heavily on chartering trampers with supplementary service from liner shipping operators. It estimates about 10 percent spillage and pilferage losses from its grain shipments if not containerized and just about 1.5 percent if containerized. Using a 20 foot container containing around 17 to 19 metric tons of bagged corn (equivalent to 350-380 bags) or an average of 18,000 kilograms at the 1991 price of corn of ₱4.40 per kilogram, a saving of 8.5 percent of the shipment would mean that containerized transport of corn is worth a charge increment of approximately ₱6,730. Present total charge now for Davao-Manila is ₱9,000. It is in the best interest of SAGREX to pay higher charges for containerization but it is also in the interest of the shipping liner industry to hold down costs of containerization. The optimal solution appears to be the dual rate system for Class C category. This would mean, on the average, rates paid for containerizing corn and other grains would be 20-25 percent higher than noncontainerized service. This increment would be considerably less than the average incremental value of containerization to the shipper.

The results of a case study done on the Iloilo-Tagbilaran route show that savings to both shippers and passengers for one route could amount to around ₱3 million annually. These savings could be channeled to other productive activities which could generate more output for the local economy. At present, significant traffic of cargo and passenger between Iloilo and Tagbilaran have to pass through Cebu. No liner shipping operator has applied for a route franchise despite MARINA's prescribed rates for the Iloilo-Tagbilaran route. The existing route via Cebu results in unnecessary costs of transport, transfer, and time to both passengers and cargo as well as costs of pilferage and spillage of cargo. Thus, Iloilo shippers are inclined to negotiate with a Cebu based trader who in turn, would be responsible for trading with Bohol traders, rather than engaging business directly with Bohol traders because of additional transport and transfer costs. Bohol consumers bear the burden of unnecessary transport costs.

The direct cost savings to Iloilo rice shippers (Iloilo is a rice surplus province while Bohol is a rice deficient one) of a direct liner service between Iloilo and Tagbilaran include savings in freight and handling costs as well as pilferage and spillage costs. Handling cost savings, i.e. arrastre, stevedoring and wharfage, amount to ₱49.62 per revenue ton. The difference in freight rate between an indirect and a direct service is ₱79.79. Assuming an annual average volume shipment of 2,000 metric tons of rice, savings in freight and handling costs would reach ₱258,820 yearly. In addition, pilferage and spillage will be minimized with a direct route and likewise, the damage to sacks due to the elimination of double handling in Cebu. Pilferage and spillage is estimated to be reduced from 2 to 1 percent. Assuming a pilferage and spillage cost of ₱9.00 per kilogram, savings from reduced pilferage, spillage and damage to sacks could amount to ₱180,000 annually. Therefore, total cost savings of rice cargo directly shipped from Iloilo to Tagbilaran is around ₱440,000 per year.

With regard to passengers, cost savings arising from a direct route between Iloilo and Tagbilaran include the cost difference in fare and time savings benefits. The fare difference is ₱36.50 per Third Class passenger. Time savings benefits are estimated ₱16.80 per Third Class passenger based on the assumed value of time in Western Visayas of ₱2.80 per hour for a total of 6 hours waiting time. Based on actual Philippine Ports Authority traffic figures, passengers who disembarked in Tagbilaran Port totalled 239,240. Assuming that 20 percent of this passenger traffic originated from Iloilo and are all Third Class passengers, then the total cost savings to passengers of direct service would amount to around ₱2.6 million annually.

Taking the total savings of ₱3 million yearly to both shippers and passengers in the potential Iloilo-Tagbilaran route as indicative of benefits which can be derived from other similar developmental routes (28 developmental routes have been identified as of now), estimated grand total savings could reach ₱18 million yearly (covering 6 possible routes) starting in 1993 up to 1995 and ₱84 million annually from 1995 to year 2000 (covering all 28 routes). While this may not be true for all 28 developmental routes due to differences in volume and value of commodity trade as well as level of development of local economy, the case of Iloilo-Tagbilaran is a conservative one since Tagbilaran is not as robust a local economy like those of the other places considered for development routes.

B. Sufficient and Appropriate Interisland Shipping Services

The rationalization and deregulation of liner shipping cargo rates will contribute to lowering the real costs of interisland shipping, by virtue of the rate flexibility which will be permitted, and the resultant rate competition. The effects which cargo rate rationalization and deregulation will have on shipping costs, however, will be less significant than the effects which this same rationalization and deregulation will likely have on the availability of appropriate liner shipping cargo services. Unrealistically low regulated cargo rates have limited the availability of appropriate capacity for all of those commodities which, until 1989, were

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included in the "basic" commodity category, until livestock were deregulated in November 1990. Milled and unmilled grains and most fruits and vegetables remain in this redefined category up to the present time. Rate regulation (passengers as well as cargo) has also tended to discourage the introduction of services on some low traffic density routes.

The impact of availability of sufficient liner shipping services for several agricultural commodities include the following.

1) Encouragement of Growth in Interisland Trade. When commodity market price differentials between production areas and external areas are significantly greater than the costs of commodity transport from production area to potential markets, then either there is inadequate information on prices and marketing possibilities, or there are transport shortcomings that prevent shipment under appropriate conditions. The price differentials between fruit and vegetable production areas of southern Mindanao and the capital of Manila are quite large. These differentials have been sufficient to permit many fruits and vegetables to bear the costs of air transport, which are three or four times the charges for sea shipment, if only air transport capacity has been available. By deregulating liner shipping cargo rates for these commodities, shipping operators will be able to raise their rates to levels that will induce them, to provide sufficient and appropriate services. The probable results will be that shipments of these commodities will increasingly be made by interisland shipping, rather than by air, with significant cost savings resulting from the modal conversion, and the overall levels of production will rise, partly due to the transport cost savings, but mainly, due to the fact that air transport capacity constraints have also served in the past to limit the levels of fruit and vegetable production.

The market price differentials for a few commodities produced in Southern Mindanao and shipped (to the extent possible) to Manila were, in 1991, between 6 and 35 pesos per kilogram, whereas liner shipping charges were around 40 centavos per kilogram. A conservative estimate would be that, after payment of higher liner charges than current regulated charges, in order to induce operators to provide sufficient, appropriate shipping capacity (mainly ventilated containers), a profit could still be realized by shippers that would average not less than about 6 to 8 pesos per kilogram, or ₱6,000 to ₱8,000 per ton. These commodities would be limited in tonnage terms in comparison to the grains they would be replacing, but shipment levels would not be less than 20,000 tons per annum, and even shipment of this level would produce a net production value benefit on the order of ₱140 million.

2) Encouragement of Agricultural Diversification. Grains may be produced in excess in Mindanao and sugar may be produced in excess in Western Visayas. Diversification out of these commodities is probably desirable to some extent, and perhaps even to a considerable extent. Grains and sugar do not deteriorate rapidly after harvest, however, whereas a number of optional crops are more perishable. Otherwise, desirable strategies for increasing agricultural production value through diversification may fail because of inadequacies of storage facilities and transport that would make it difficult

or impossible to preserve the value of preferred commodities after harvest. By permitting shipping operators to raise their charges for transport of perishable agricultural commodities, cargo rate rationalization and deregulation can be expected to induce the operators to provide the equipment and services which will be required to support agricultural diversification into more perishable commodities.

3) Encouragement of Agro-processing in Production Areas. The dispersion of agro-processing activities out from the current centers of Manila and Cebu, would, most importantly, have implications for the division of gross domestic product among the regions, and could thereby help to slow or even reverse the socially and environmentally undesirable population migration trends to the greater Manila and Cebu areas. In addition, cargo volumes required to support any given level of consumption are reduced, with resultant transport cost savings. By encouraging shipping operators to provide the equipment and services necessary to support such agribusiness undertakings as meat processing and dairying, cargo rate deregulation could give rise to shifts of agro-processing, especially livestock slaughter and processing, in production areas. The latter reform, namely the deregulation of rates for reefer box cargo shipping services, has already taken place in 1990.

There would be other benefits from other commodities and for other routes than only Southern Mindanao - Manila. Also, the rationalization of passenger charges (Third Class passage) as well as cargo would help to bring new services into being. A very conservative if inaccurate estimate of annual benefits deriving from liner shipping rate rationalization would be ₱200 million.

6. SDP II Economic Appraisal

The purpose of this economic appraisal is to demonstrate the worthwhileness of investment of grant funds in SDP II in the standard benefit-cost sense.

Although balance of payments support helps provide the needed financial stability for reform implementation and structural adjustment, the SDP II grant funds are treated as a direct program economic cost for this analysis. SDP II disbursements are assumed to be $35 million in 1991 and $85 million in 1992, adjusted for the shadow price of foreign exchange. The SDP II reforms also have associated and more substantial economic costs arising from the introduction of policy-induced shocks into the system. These adjustment costs will reduce the benefits of the reforms especially in the initial years following reform implementation.

The discussion on the impacts of the SDP II reforms in the previous sections provides basis for the estimation of their economic benefits. Differences in impact assessment methodology do not permit additivity of the benefits from the reforms simulated for their macro impacts to those of other reforms. Also, benefit estimates are not as well derived for the other reforms, i.e., on duty drawback, VAT rebates and interisland shipping. Hence, only the benefits from foreign exchange market, VAT collection, and public debt management reforms are used for this economic appraisal.

The benefits for the three reforms are obtained through the difference in real Gross Domestic Product (GDP) levels between the without and with SDP II simulations earlier discussed. The results are shown in Table 8. It may be noted that real GDP growth will be slower during 1992-1995, and the net benefits will be negative. As mentioned in section 3, this is due mainly to two factors: an implied relatively tight (inflation dampening) monetary policy which reduces the real value of funds available for investment, and structural adjustment costs.

A more accommodating monetary policy, which will partially restore or maintain the real value of credit available for private investment will shorten the adjustment period considerably. Structural adjustment costs arise from the change in relative prices in the economy. These include retooling costs of existing firms, and more importantly, changes in investment patterns and the relatively long gestation periods of new investments accompanied by displacement of other factors of production. However, the length of the adjustment is partly a function of the historically estimated parameters of the model. It is highly probable that structural adjustment will be faster than indicated by the projections. Moreover, the economy will be more stable, with improvements in both balance of payments and fiscal positions beginning in 1992. Additional benefits from the other reform actions not included in the simulations are also expected to occur earlier and offset the costs of adjustment.

Despite the lag in the occurrence of positive benefits and noninclusion of additional and possibly earlier occurring benefits, the projected benefits from the simulations still result in a robust economic internal rate of return (EIRR) of 44 percent. If for instance, under a more pessimistic scenario, where for a variety of reasons the specifics of which are not worthy of speculation at this time, only half the positive benefits are realized beginning in 1996, the EIRR is still a healthy 29 percent.

The other sensitivity analysis conducted simulates the effects of maintaining the real value of credit funds available for private sector investment. The simulation uses the same assumptions as in the base case with SDP II scenario except for the one assumption on credit accommodation. As shown in Table 9, the projections indicate that payoffs from SDP II will be faster, with positive benefits occurring as early as 1994 instead of 1996. This scenario is less likely to materialize than the base case scenario because of the possible fear of heightened inflationary expectations, including possible adverse effects on foreign investment, by the monetary authorities. However, the sensitivity analysis does illustrate that monetary policy accommodation which at least partially restores the real value of private sector credit funds eroded by structural adjustment reforms would significantly reduce structural adjustment costs and increase and accelerate the benefits of the program. The calculated EIRR is a high 73 percent.

Table 1: Baseline Scenario Assumptions
1991-2000

		1991	growth rate (%)	1992	growth rate (%)	1973	growth rate (%)	1994	growth rate (%)	1995	growth rate (%)	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		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	3341	-10.6	3147	-5.8	2964	-5.8	2694	-9.1	2443	-9.3
INCOUT	Income remittances to the rest of the world	321		357	11.2	405	13.4	456	12.6	516	13.2	587	13.8	662	12.8	749	13.1	847	13.1	959	13.2
INCREM	Income remittances from abroad	1300		1590	15.2	1830	15.1	2105	15.0	2420	15.0	2780	14.9	3197	15.0	3677	15.0	4228	15.0	4862	15.0
INTINC	Investment and interest income	396		452	14.1	511	13.1	563	10.2	604	7.3	649	7.5	716	10.3	785	9.6	856	9.0	931	8.8
ITRANS	Inflow of transfers	745		770	3.4	757	-1.7	825	9.0	898	8.8	978	8.9	1034	5.7	1097	6.1	1181	7.7	1269	7.5
MINT	Interest payments	2273		2467	8.5	2634	6.8	2848	8.1	2899	1.8	3008	3.8	3182	5.8	3351	5.3	3519	5.0	3670	4.3
MGOLD	Monetization of gold	240		265	10.4	292	10.2	320	9.6	353	10.3	390	10.5	430	10.3	474	10.2	522	10.1	575	10.2
NINDF	Net direct investment	737		632	-14.2	779	23.3	722	-7.3	824	14.1	959	16.4	1010	5.3	1103	9.2	1185	7.4	1310	10.5
NSHTRM	Net inflows of short-term capital	172		6	-96.5	129	2050.0	166	28.7	213	28.3	263	23.5	333	26.6	421	26.4	526	24.9	664	26.2
OLTLON	Outflows of medium and long term loans	3027		2577	-14.9	2619	1.6	2536	-3.2	1973	-22.2	2013	2.0	1866	-7.3	1758	-5.8	1630	-7.3	1498	-8.1
ONTINM	Other non-merchandize trade inflows	3307		3436	3.9	3576	4.1	3789	6.0	3976	4.9	4028	1.3	4191	4.0	4363	4.1	4541	4.1	4728	4.1
ONTOUM	Other non-merchandize trade outflows	1072		1187	10.7	1255	5.7	1389	10.7	1550	11.6	1744	12.5	1922	10.2	2114	10.0	2347	11.0	2605	11.0
REVADJ	Revaluation Adjustment	309		188	-39.2	169	-10.1	31	-81.7	31	0.0	22	-29.0	22	0.0	22	0.0	22	0.0	22	0.0
UNREM	Unremitted arrears	0		0		0		0		0		0		0		0		0		0	
OTRANS	Outflow of transfers	5		5	0.0	8	60.0	8	0.0	8	0.0	8	0.0	8	0.0	8	0.0	8	0.0	8	0.0

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Table 1: Baseline Scenario Assumptions
1991-2000

		1991	growth rate (%)	1992	growth rate (%)	1993	growth rate (%)	1994	growth rate (%)	1995	growth rate (%)	1996	growth rate (%)	1997	growth rate (%)	1998	growth rate (%)	1999	growth rate (%)	2000	growth rate (%)
2. Others																					
ER	Exchange rate	27.08		28.5	2.2	29.9	4.9	31.4	5.0	32.97	5.0	33.96	3.0	34.90	3.0	36.03	3.0	36.39	1.0	36.75	1.0
GNPUS	Real US GNP 2/	3508.80		3624.67	3.3	3726.16	2.8	3837.95	3.0	3953.09	3.0	4071.60	3.0	4193.83	3.0	4319.65	3.0	4449.23	3.0	4502.71	3.0
MPIF	Dollar import price index for fuel products 2/	719.71		799.6	11.1	839.58	5.0	879.00	4.8	959.95	9.1	1039.62	8.3	1001.2	4.0	1124.45	4.0	1169.43	4.0	1216.21	4.0
MPIIF	Dollar import price index for non-fuel products 1/	207.122		215.925	4.3	225.706	4.5	234.96	4.1	244.405	4.0	255.55	4.6	267.3	4.6	279.6	4.6	292.46	4.6	305.92	4.6
PID	Dollar export price growth rate 1/	220.67		229.91	4.2	239.66	4.2	249.32	4.0	256.98	3.1	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/	379624		394009	4.0	413365	4.7	432793	4.7	452269	4.5	472621	4.5	493009	4.5	516114	4.5	539339	4.5	563609	4.5
IIPJAP	Index of industrial production of Japan 2/	130.114		135.319	4.0	141.679	4.7	148.338	4.7	155.013	4.5	161.909	4.5	169.279	4.5	176.896	4.5	184.856	4.5	193.175	4.5
T1	Average tariff for imports of fuel products	21.0		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		16.79	-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

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Table 1: Baseline Scenario Assumptions
1991-2000

		1991	growth rate (%)	1992	growth rate (%)	1993	growth rate (%)	1994	growth rate (%)	1995	growth rate (%)	1996	growth rate (%)	1997	growth rate (%)	1998	growth rate (%)	1999	growth rate (%)	2000	growth rate (%)
B. Production/Expenditures																					
CINV	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/	3353.94		3437	2.5	3523	2.5	3611	2.5	3702	2.5	3794	2.5	3889	2.5	3986	2.5	4006	2.5	4108	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	2362.95		2599.24	10.0	2859.16	10.0	3145.08	10.0	3459.59	10.0	3805.55	10.0	4186.1	10.0	4604.71	10.0	5065.19	10.0	5571.71	10.0
WLAGRI	Legislated wages for agriculture	77.01		84.711	10.0	88.947	5.0	93.394	5.0	98.064	5.0	102.967	5.0	108.116	5.0	113.521	5.0	119.197	5.0	125.157	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
ISRUS	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	3453.76	1.0	3488.3	1.0	3506	0.5	3523	0.5	3541	0.5	3559	0.5
FERIC	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	1021.09	3.0	1051.73	3.0	1083.28	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	0.65	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

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Table I: Baseline Scenario Assumptions
1991-2000

		1991	growth rate (%)	1992	growth rate (%)	1993	growth rate (%)	1994	growth rate (%)	1995	growth rate (%)	1996	growth rate (%)	1997	growth rate (%)	1998	growth rate (%)	1999	growth rate (%)	2000	growth rate (%)
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
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		74700	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
OPUPOI	Operating expenditures, obligation	91096		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
OPEXPI	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	170015	4.0	170672	4.6
EXTFIN	External financing of the deficit	23000		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	4.1	117727	4.9	124900	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	71.05	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

Table 1: Baseline Scenario Assumptions
1991-2000

		1991	growth rate (%)	1992	growth rate (%)	1993	growth rate (%)	1994	growth rate (%)	1995	growth rate (%)	1996	growth rate (%)	1997	growth rate (%)	1998	growth rate (%)	1999	growth rate (%)	2000	growth rate (%)
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	27117.1		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: ICS[illegible]
3/ Average level
4/ Same growth as non-oil price growth rate
5/ Medium assumptions

Table 2

Baseline Scenario

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP (% change)										
Personal Consumption	4.44	6.09	5.88	5.73	5.55	6.16	5.92	6.20	6.33	6.2282
Government Consumption	1.61	2.37	5.95	5.51	5.83	6.63	6.25	5.85	5.71	6.02
Gross Domestic Capital Formation	3.34	10.20	12.95	14.36	13.35	12.20	10.41	10.02	10.24	10.57
Durable Equipment	1.41	9.28	13.29	14.37	13.75	11.95	10.62	10.40	10.22	10.11
Private Construction	-0.17	8.28	9.55	12.53	12.32	12.40	11.33	10.92	11.71	12.74
Public Construction	3.90	10.40	12.74	11.68	10.53	10.25	5.28	4.52	5.61	6.66
Exports	6.38	7.13	9.44	9.15	9.60	9.35	8.70	8.66	7.92	7.91
Exports of Goods	4.76	8.01	10.50	10.21	10.77	10.59	9.05	9.14	8.45	8.36
Garments	[illegible]	7.27	9.01	9.79	10.59	11.17	11.23	11.27	11.69	10.95
Semiconductors	9.31	7.68	9.07	9.14	11.06	9.29	10.30	11.31	9.41	9.30
Coconut products	-1.51	3.20	3.38	3.79	4.25	3.31	2.70	3.58	3.62	3.44
Other agricultural products	1.93	2.91	-6.13	7.66	7.42	7.01	7.11	8.09	6.84	8.78
Other manufactured goods	2.64	9.86	15.54	11.59	11.04	12.24	5.73	6.82	6.08	5.91
Other goods	3.63	9.15	13.00	11.62	11.72	11.45	9.15	8.29	7.52	7.63
Exports of Non-factor Services	12.44	4.09	5.61	5.14	4.96	4.18	7.15	6.46	5.49	5.75
Imports	1.80	11.31	6.80	9.04	10.32	11.02	10.46	10.28	10.57	9.78
Imports of Goods	3.24	10.60	6.78	8.97	10.27	11.00	10.53	10.38	10.69	9.85
Fuel products	4.66	10.24	4.37	7.45	8.86	10.92	8.57	9.29	10.31	9.74
Machinery	2.43	11.73	6.81	11.39	12.72	12.55	11.44	12.04	12.06	9.98
Basic metals	3.22	8.10	6.73	8.56	11.00	11.01	8.92	10.78	10.02	10.07
Cereals	9.88	20.65	7.09	3.57	2.45	2.43	2.40	2.60	2.85	3.15
Chemicals	3.36	12.34	8.65	10.70	12.32	13.55	12.73	11.52	11.68	10.60
Textile yarns	5.48	18.21	12.31	10.03	11.09	15.69	13.52	12.03	12.78	9.85
Other imports	2.54	8.30	6.77	8.46	9.95	11.08	11.30	10.25	10.71	10.5[illegible]
Imports of Non-factor Services	-25.26	29.82	7.16	10.79	11.36	11.37	8.92	8.23	7.95	8.1[illegible]
Gross National Product	1.13	4.35	5.98	6.17	5.72	6.29	6.21	6.66	7.01	7.46
Gross Domestic Product	1.25	4.32	5.95	6.17	5.54	6.18	6.18	6.51	6.92	7.39
B. Production (% change)										
Value-added in Agriculture	2.08	3.56	4.20	4.49	3.78	3.90	5.02	5.67	4.96	4.46
Crops	0.47	2.53	3.83	4.50	3.42	3.41	4.60	5.10	4.71	4.75
Livestock and Poultry	4.98	5.97	4.62	4.27	4.27	5.83	7.29	7.92	6.63	5.24
Fishery	3.58	4.01	5.18	5.21	4.56	3.18	3.63	4.73	3.73	2.81
Value-added in Industry	0.76	5.04	7.47	7.77	6.86	8.12	7.72	7.87	8.92	10.06
Manufacturing	1.03	4.79	6.76	7.41	6.64	7.98	8.21	8.33	9.32	10.31
Food	0.56	4.04	4.95	6.30	5.42	5.28	8.36	8.00	7.82	8.33
Semiconductors	3.37	5.54	8.69	8.64	9.10	9.04	9.67	9.81	10.16	9.32
Garments	7.13	5.73	6.47	6.20	6.43	5.31	6.29	9.87	10.54	10.78
Other manufacturing	-0.08	5.20	8.17	8.42	7.26	10.69	8.07	8.02	10.23	12.17
Construction	0.22	8.36	13.91	12.03	10.22	12.22	7.93	7.76	9.20	11.24
Mining and Quarrying	0.75	2.81	5.04	5.16	5.72	4.61	3.91	3.86	4.77	6.40
Electricity, gas, & water	-1.36	1.99	2.23	2.58	0.60	-0.58	2.24	3.80	4.27	3.43
Value-added in Services	1.10	4.26	5.87	5.95	5.56	5.97	5.55	5.82	6.33	6.68

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Table 2

Baseline Scenario

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
C. Prices, Employment										
Consumer Price Index (% change)	16.55	8.57	9.30	7.82	8.87	7.84	9.53	10.36	9.02	8.07
Wages of Unskilled Workers (% change)	13.25	7.44	2.85	2.17	3.81	2.16	5.67	6.21	6.90	5.75
Full-time unemployment rate	23.73	25.38	26.16	26.44	26.80	27.03	27.05	26.60	26.13	25.9
D. External Accounts										
Balance of Payments (mil $)	1261.52	1010.71	1819.96	1304.60	1333.99	862.73	869.00	930.76	372.95	344.15
Current Account (mil $)	-1776.48	-1825.29	-1716.14	-1809.80	-1650.26	-2099.92	-2207.10	-2295.79	-2946.50	-3172.25
Current Account Ratio	-3.84	-3.50	-3.01	-2.91	-2.72	-2.78	-2.60	-2.37	-2.64	-2.47
E. Monetary Accounts										
Total Liquidity (% change)	13.61	15.07	12.49	14.15	15.15	18.95	17.17	17.81	16.16	13.65
Money Supply (% change)	12.78	14.93	13.98	13.69	14.04	13.64	15.29	16.63	15.72	15.34
90 day T-Bill rate	23.18	20.97	19.95	18.21	17.23	16.56	16.11	15.75	15.77	15.86
F. Fiscal Accounts										
Budget Deficit (mil P)	40899.43	36958.48	44193.62	47752.83	44094.93	54825.53	48626.11	46522.88	29167.82	33535.30
Deficit Ratio	3.17	2.49	2.59	2.45	1.97	2.14	1.64	1.33	0.72	0.71
Revenue Effort	15.89	15.62	15.55	15.96	16.01	15.65	15.56	15.10	15.11	14.69
Tax Effort	13.99	14.00	14.12	14.62	14.75	14.53	14.54	14.17	14.23	13.87
Revenues (% change)	15.11	13.33	14.33	17.23	15.14	11.85	15.46	13.97	16.52	12.76
Taxes (% change)	21.07	16.61	16.80	19.20	16.62	13.17	16.75	14.88	17.40	13.31
G. Other Values										
Nominal GNP	1289132	1486831	1707200	1949709	2238659	2561012	2973934	3492974	4067643	4716893

Table 3. Assumption on VAT Collections
(in million pesos)

Year	Nominal GNP	Implied VAT Collection[1]	VAT Collection with 20% growth[2]	Incremental VAT Collection[3]
1991	1289132	17000	-	-
1992	1486831	18585	-	-
1993	1707200	21340	25175	3835
1994	1949709	24371	30209	5838
1995	2238658	27983	36252	8269
1996	2561012	32013	43502	11489
1997	2973934	37174	52202	15028
1998	3492974	43662	62643	18972
1999	4067643	50846	75172	24326
2000	4716898	58961	90206	31245

1/ 1.25 percent of nominal GNP.

2/ The DOF projections were used for 1991 and 1992. The 20 percent growth was applied to the DOF 1992 projected VAT collection.

3/ This was added to the variable OTHAX in the model.

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Table 4

Combined Effects
Percent deviation from baseline
with SCP II base case scenario

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP										
Personal Consumption	0.00	-0.03	-0.01	-0.01	-0.03	0.02	0.08	0.15	0.25	0.37
Government Consumption	0.00	-1.56	-2.80	-3.66	-4.12	-4.18	-3.83	-3.09	-1.92	-0.30
Gross Domestic Capital Formation	0.00	-0.34	0.24	0.73	1.19	2.10	[illegible]	3.81	4.77	5.95
Exports	0.00	0.40	-0.20	-0.35	-0.24	0.08	0.54	1.12	1.85	2.71
Exports of Goods	0.00	-0.62	-0.82	-0.82	-0.62	-0.21	0.33	0.99	1.82	2.78
Imports	0.00	-0.61	-1.06	-1.26	-1.31	-1.20	-1.03	-0.83	-0.54	-0.20
Imports of Goods	0.00	-0.86	-1.27	-1.45	-1.48	-1.35	-1.16	-0.95	-0.63	-0.27
Gross National Product	0.00	-0.29	-0.33	-0.27	-0.14	0.21	0.67	1.30	1.96	2.80
Gross Domestic Product	0.00	-0.23	-0.25	-0.20	-0.06	0.28	0.73	1.23	1.92	2.73
B. Production										
Value-added in Agriculture	0.00	0.60	1.02	1.05	0.73	0.06	-0.89	-2.13	-3.50	-4.97
Value-added in Industry	0.00	-0.92	-1.14	-0.96	-0.38	0.74	2.16	3.70	5.60	7.51
Value-added in Services	0.00	-0.22	-0.36	-0.38	-0.29	0.02	0.48	1.07	1.83	2.78
C. Prices, Employment										
Consumer Price Index	0.00	3.11	3.71	3.71	3.20	2.20	0.55	-0.82	-2.85	-5.30
Wages of Unskilled Workers	0.00	1.59	2.50	2.90	2.80	2.25	1.22	-0.22	-2.09	-4.45
D. External Accounts										
Balance of Payments	0.00	4.76	4.57	9.07	12.61	26.82	37.01	50.64	178.31	271.00
Current Account	0.00	2.63	4.85	6.54	9.09	11.01	14.66	20.43	22.53	29.49
E. Monetary Accounts										
Total Liquidity	0.00	0.42	0.64	-0.82	-2.62	-5.39	-8.06	-11.26	-14.95	-18.87
90 day T-Bill rate	0.00	0.00	-5.26	-5.85	-6.21	-12.50	-12.89	-13.23	-13.54	-13.77
F. Fiscal Accounts										
Budget Deficit	0.00	-20.75	-31.22	-43.69	-67.05	-72.18	-105.50	-139.45	-276.71	-297.27
Revenue Effort	0.00	0.60	1.86	3.25	5.11	7.32	9.42	11.74	14.12	17.33
Tax Effort	0.00	0.89	2.24	3.69	5.65	7.94	10.11	12.51	14.96	18.29

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Table 5

Combined Effect
Percent share of GDP and GNP components

		1992	1995	2000
A.	Gross National Product	100.00	100.00	100.00
	Personal Consumption	80.09	79.43	75.51
	Government Consumption	9.16	8.86	8.69
	Gross Domestic Capital Formation	17.83	22.24	27.11
	Exports	28.69	31.33	34.03
	Exports of Goods	22.24	25.18	28.26
	Garments	4.56	5.08	6.13
	Semiconductors	4.45	4.93	5.64
	Coconut products	1.35	1.27	1.05
	Other agricultural products	0.79	0.72	0.74
	Other manufactured goods	2.49	3.00	3.31
	Other goods	8.36	9.90	11.06
	Exports of Non-factor Services	6.45	6.15	5.77
	Imports	36.35	38.93	45.33
	Imports of Goods	34.70	37.14	43.43
	Fuel products	1.87	1.93	2.18
	Machinery	10.79	12.21	15.10
	Basic metals	1.62	1.76	2.04
	Cereals	2.98	2.84	2.30
	Chemicals	0.70	0.79	1.01
	Textile yarns	0.43	0.50	0.64
	Other imports	16.32	17.11	20.15
	Imports of Non-factor Services	1.65	1.79	1.90
B.	Gross Domestic Product	100.00	100.00	100.00
	Agriculture	27.20	25.88	21.78
	Industry	32.80	34.32	39.36
	Manufacturing	24.77	25.51	29.22
	Construction	4.63	5.58	7.29
	Mining and Quarrying	1.42	1.39	1.50
	Electricity, gas, & water	1.98	1.84	1.35
	Value-added in Services	40.00	39.60	38.87

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Table 6

Combined Effects
Percent deviation from baseline
with SDP II Alternative Scenario

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
A. Expenditures on GDP										
Personal Consumption	0.00	-0.01	0.02	0.04	0.04	0.12	0.21	0.30	0.43	0.59
Government Consumption	0.00	-1.61	-2.93	-3.85	-4.33	-4.35	-3.93	-3.06	-1.71	0.15
Gross Domestic Capital Formation	0.00	-0.17	0.59	1.27	1.88	2.92	3.69	4.81	5.80	6.91
Exports	0.00	1.28	0.52	0.47	0.47	0.75	1.13	1.65	2.28	3.13
Exports of Goods	0.00	0.51	0.09	0.20	0.26	0.60	1.03	1.61	2.31	3.24
Imports	0.00	-0.52	-0.92	-1.07	-1.09	-0.96	-0.78	-0.57	-0.28	0.07
Imports of Goods	0.00	-0.75	-1.12	-1.24	-1.24	-1.09	-0.89	-0.67	-0.35	0.02
Gross National Product	0.00	-0.13	-0.15	-0.04	0.13	0.55	1.06	1.74	2.45	3.34
Gross Domestic Product	0.00	-0.06	-0.09	0.03	0.22	0.52	1.13	1.67	2.41	3.29
B. Production										
Value-added in Agriculture	0.00	0.78	1.30	1.41	1.09	0.36	-0.70	-2.08	-3.63	-5.26
Value-added in Industry	0.00	-0.77	-1.11	-0.83	-0.16	1.12	2.70	4.43	6.49	8.57
Value-added in Services	0.00	-0.05	-0.16	-0.13	-0.01	0.35	0.85	1.50	2.32	3.34
C. Prices, Employment										
Consumer Price Index	0.00	3.26	4.01	4.03	3.44	2.28	0.73	-1.16	-3.46	-6.18
Wages of Unskilled Workers	0.00	1.67	2.69	3.15	3.03	2.39	1.19	-0.45	-2.58	-5.22
D. External Accounts										
Balance of Payments	0.00	15.31	9.41	17.30	19.63	37.37	45.92	57.96	188.81	281.10
Current Account	0.00	8.47	9.98	12.47	14.15	15.35	19.19	23.38	23.86	30.59
E. Monetary Accounts										
Total Liquidity	0.00	1.25	1.47	-0.03	-2.18	-5.34	-8.40	-11.96	-16.14	-20.36
90 day T-Bill rate	0.00	0.00	-5.26	-5.85	-6.21	-12.50	-12.89	-13.23	-13.54	-13.77
F. Fiscal Accounts										
Budget Deficit	0.00	-21.95	-33.05	-46.01	-69.93	-74.53	-107.92	-141.43	-278.09	-296.51
Revenue Effort	0.00	0.48	1.68	3.04	4.92	7.19	9.37	11.80	14.34	17.76
Tax Effort	0.00	0.79	2.07	3.50	5.47	7.82	10.07	12.58	15.19	18.73

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Table 7
Financial Cost Savings from Improved Duty Drawback System in Real Terms
(1991 prices)

Year	Average Tariff (%)1/	Value of Imported Intermediate Inputs (P M)2/	Duty Drawback (P M)3/	Real Borrowing Rate(%)4/	Interest Cost on Duty Drawback(P M). without SDP II 5/	with SDP II 6/	Net Savings7/
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1991	13.38	143179	19157	8.05	1542	257	1285
1992	12.27	158409	19437	13.80	2682	447	2235
1993	11.96	168416	20143	12.07	2431	405	2026
1994	11.66	183276	21370	11.81	2524	421	2103
1995	11.04	202087	22310	9.78	2182	364	1818
1996	9.20	224610	20664	10.14	2095	349	1746
1997	9.20	248502	22862	7.95	1818	303	1515
1998	9.20	274646	25267	6.81	1721	287	1434
1999	9.20	304564	28020	8.17	2289	382	1908
2000	9.20	335486	30865	9.21	2843	474	2369

1/ Refers to the average tariff for all imported intermediate inputs (i.e., all imports except imports of fuel products, electrical supplies, machinery and transport) per EO 470.

2/ This refers only to that part of imported intermediate inputs used for exports. It is assumed that 50 percent of the total imported intermediate inputs will be used for the production of exportables. Total imported intermediate inputs for the period 1991-2000 were estimated by multiplying the projected total imports by 64 percent since the share of imported intermediate inputs for the period 1967-1990 averaged 64 percent.

3/ Obtained by multiplying column (2) by (1).

4/ This is the real borrowing rate for exporters which is assumed to be the same as the rate on secured loans. During the 1986-1990, the nominal interest rate on secured loans was on the average higher than the 91-day Treasury bill rate by 1.42 percentage points. This is added to the projected nominal Treasury bill rate obtained by the model without SDP II in place to arrive at the nominal borrowing rate. The real borrowing rate shown in column (4) is obtained by subtracting the projected inflation rate from the nominal borrowing rate.

5/ Obtained by multiplying column (3) by (4). It is assumed that the length of processing time on claims of duty drawback averages 12 months.

6/ Obtained by multiplying column (5) by .167 on the assumption that the the length of processing time for duty drawback claims is reduced to 2 months.

7/ Difference between columns (5) and (6).

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Table 8. SDP II Economic Appraisal
Base Case and Sensitivity Analysis on 50 Percent Reduction in Positive Benefits

Foreign Exchange Market, VAT and Debt Management Reforms

Change in Gross Domestic Product (million pesos, 1991 prices)

	without SDP II Level	without SDP II Growth (%)	with SDP II Level	with SDP II Growth (%)	Incremental GDP Level	Incremental GDP Growth (%)
1990	1226252		1226252			
1991	1241580	1.25	1241580	1.25	0	-0.00
1992	1295216	4.32	1292237	4.08	-2979	-0.24
1993	1372282	5.95	1368851	5.93	-3431	-0.02
1994	1456951	6.17	1454038	6.22	-2914	0.05
1995	1537667	5.54	1536744	5.69	-923	0.15
1996	1632694	6.18	1637266	6.54	4572	0.36
1997	1733595	6.18	1746250	6.66	12655	0.48
1998	1846452	6.51	1869163	7.04	22711	0.53
1999	1974226	6.92	2012132	7.65	37905	0.73
2000	2119924	7.38	2177798	8.23	57874	0.85

(in million pesos, 1991 prices)

	Benefits	SDP II Economic Cost	Net Cash Flow	Sensitivity: Net Cash Flow (with half the positive benefits)
1991	0	1176	-1176	-1176
1992	-2979	2856	-5835	-5835
1993	-3431		-3431	-3431
1994	-2914		-2914	-2914
1995	-923		-923	-923
1996	4572		4572	2286
1997	12655		12655	6328
1998	22711		22711	11356
1999	37905		37905	18953
2000	57874		57874	28937
Economic Internal Rate of Return (%)			44.23	28.70

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Table 9. SDP II Economic Appraisal
Sensitivity Analysis (with Direct Credit Accommodation)

Foreign Exchange Market, VAT and Debt Management Reforms

Change in Gross Domestic Product (million pesos, 1991 prices)

	without SDP II		with SDP II		Incremental GDP	
	Level	Growth (%)	Level	Growth (%)	Level	Growth (%)
1990	1226252		1226252			
1991	1241580	1.25	1241580	1.25	0	-0.00
1992	1295216	4.32	1294439	4.26	-777	-0.06
1993	1372282	5.95	1371184	5.93	-1098	-0.02
1994	1456951	6.17	1457389	6.29	437	0.12
1995	1537667	5.54	1541049	5.74	3383	0.20
1996	1632694	6.18	1642817	6.60	10123	0.42
1997	1733595	6.18	1753184	6.72	19590	0.54
1998	1846452	6.51	1877288	7.08	30836	0.57
1999	1974226	6.92	2021805	7.70	47579	0.78
2000	2119924	7.38	2189458	8.29	69534	0.91

(in million pesos, 1991 prices)

	Benefits	SDP II Economic Cost	Net Cash Flow
1991	0	1176	-1176
1992	-777	2856	-3633
1993	-1098		-1098
1994	437		437
1995	3383		3383
1996	10123		10123
1997	19590		19590
1998	30836		30836
1999	47579		47579
2000	69534		69534

Economic Internal Rate of Return (%) 72.68

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ANNEX I

ADMINISTRATIVE AND IMPLEMENTATION ISSUES

ADMINISTRATION AND IMPLEMENTATION ISSUES

I. Constraints on Policy Implementation:

This annex examines the feasibility of effective implementation according to schedule, identifies the factors and issues that may pose a hindrance to smooth policy implementation, and suggests how to deal with these problems. Overall, the constraints to an efficient and effective implementation of the policy reform agenda lie in government weaknesses as exemplified by weak capabilities of responsible agencies, lack of qualified technical staff, inadequate budgetary resources to establish a computerized monitoring and evaluation system, intra-agency bickerings and stifling bureaucratic procedures.

In addition, there is wide-spread perception of endemic corruption among some of the key implementing agencies. A tendency toward interventionism and over-management by others are further key impediments to smooth policy change implementation.

A. Internal Constraints:

1. Overview:

The report by the USAID consultants (from the Implementing Policy Change project) on their meetings and interviews yielded a strong impression that there is a deep-seated interest in policy reform in general, and particularly in accomplishing some of the reforms represented in the Support for Development Program (SDP) II Policy Implementation Matrix, on the part of some key Government of the Philippines (GOP) actors, as well as on the part of many of the private sector stakeholders who will be most affected. A key issue seems to be how much management of the economy is right and necessary. Reservations about liberalization are particularly strong, from what we have been able to observe, in the Central Bank (CB), which will bear most of the burden of any mistakes. Also raised was the issue on the the potential probity of the private sector if allowed to deal more broadly in public debt instruments, for example.

Management has often been synonymous with protectionism. While it is said by some that the official position of the Department of Trade and Industry (DTI), formerly very protectionist in stance, has now changed, others indicate that this is still an entity where the nationalist/protectionist stance is most alive and well. The Board of Investment (BOI), also a former bastion of import substitution and capital intensive development, has also apparently come out in favor of export competitiveness and less intervention.

Despite a proliferation of intra- and inter-agency committees, taskforces, and working groups of various kinds, it appears that operational issues and implementation constraints, though recognized at higher levels, are not easily alleviated. Here, as elsewhere, inter-agency collaboration at the implementation level is more difficult to achieve than at the planning stage and the policy-making level. There are indications that intra-agency collaboration and communication among units is difficult to achieve as well.

The overall strictures on growth of the public sector establishment mean that almost all the agencies that will be involved with SDP II implementation are seriously understaffed. The Bureau of Internal Revenue (BIR) and Bureau of Customs (BOC) may be the two agencies most hard-pressed in staffing terms as compared to the urgency/significance of their revenue generating mandates. A recent Salary Standardization Act has attempted to introduce coherence into GOP salary grids. However, one result is said to be that government salaries are not sufficient to attract and maintain the best qualified personnel at highest levels, while at lower levels, due to high overall educational attainment, a considerable proportion of staff are overqualified and undermotivated, as for example in the BIR.

One legacy of the Marcos-Aquino transition is that the vast majority of senior civil servants left government during that transition, whether voluntarily or involuntarily. No one seems to be able to predict with any certainty whether this will happen during the next transition or not. Meanwhile, in some agencies, senior positions go unfilled for months and even years, while in others, senior people are already talking of leaving, or positioning themselves to leave to participate in electioneering, or to avoid being asked to leave after the elections.

Some staff training opportunities exist, especially in National Economic Development Authority (NEDA) and in the higher reaches of operating departments. However, it is unclear the extent to which training opportunities address training needs; not yet assessed is whether trainees are able, on return to their parent organizations, to innovate and apply their new skills. While some in-house on the job training takes place in some of the line organizations which will be involved in SDP II implementation, it is also not clear what the quality of that training has been, and/or what relationship there may be between this sort of training and performance, then evaluation of performance and promotion.

2. Competitive Pricing for Exports and their Inputs:

2.a Need to Change Foreign Exchange Market Behavior:

The policy reforms proposed in the Matrix will have to be supported by changes in the behavior of the key actors in the foreign exchange sector if the overall policy objective of competitive pricing for exports and their inputs is to be achieved. SDP II should include a component that will facilitate the transformation of the market from one that is tightly controlled by the Central Bank through on-floor trading and "jaw-boning" into one in which the role of the CB is to ensure competitive behavior by dealers and to intervene only in emergencies.

Two major GOP constraints are the long standing policy of the CB to protect the exchange rate from fluctuations and the nature of its relationship with the Bankers' Association of the Philippines (BAP). Even after the policy reforms proposed in the Matrix, such as off-floor trading, or any additional liberalization measures, have been agreed upon, the overall policy objective will not be achieved if the CB continues to intervene in the market or jaw-bone to "protect" an overvalued rate and a small but influential group of commercial banks find it in their interests to succumb to this pressure.

The situation is now improving. The CB has agreed to the introduction of off-floor trading in the near future. New rules have been drafted and circulated to BAP.

The delay in the introduction of off-floor trading has been caused by disagreements over what should be the allowable "open foreign exchange position." The CB rightly want to make sure that the commercial banks do not hold excessive foreign exchange and do not overextend their foreign liabilities. The rules that the CB originally proposed take into consideration foreign exchange assets and liabilities payable at some future time. The commercial bankers, through BAP, would prefer to be allowed to hold as much foreign exchange as required so long as their foreign exchange positions do not exceed a specified proportion of the bank's capitalization or net worth. It can be reasonably assumed that, with help from the proposed study (to be funded by USAID within the program) to determine the limit of banks' forex holdings, discussions between the CB and BAP will resolve this issues and off-floor trading will begin, possibly very soon. A target date by the end of the year has been mentioned by both the main parties concerned.

In the meantime, the Governor of the Central Bank announced that the CB had reached an agreement with the BAP to adopt the "textbook approach" to the determination of the foreign exchange position of the banks (press reports on August 17). Under this approach the foreign exchange position of a bank is based on its "unimpaired capital". This approach is used in many other countries, including Singapore, Thailand and Malaysia. However, the issue of defining the limits remains.

Some problems may remain even after full agreement on the textbook approach. The market may be somewhat illiquid if the "25 per cent of capital" rule is applied. A study will be required of the so-called "open position" of the commercial banks before trading can begin. Some training of traders on operating procedures and rules and some trial runs will also be required.

The current situation is in some ways a good one for introducing policies that will lead to market determined foreign exchange rates. Some risks are less than usual. The CB's international reserves are over 50 per cent higher than a year ago. Overall foreign reserves are at record levels. The reduction of the import levy, which will raise demand for imports and put pressure on the rate, will contribute further to increasing export competitiveness.

Some significant underlying concerns will remain. As indicated above, the CB might still act to maintain an overvalued exchange rate. The first set of concerns are about the policy goals that now drive the CB; the second, the way in which the CB now operates and the way it will need to operate in a more open, competitive environment. Each will be discussed below.

2.b <u>Central Bank in a Open Foreign Exchange Market:</u>

2.b.1 <u>Central Bank Goals:</u>

The CB has tended to act to maintain the peso/dollar rate and has resisted the downward pressure on the peso. Unfortunately, this has harmed exporters by overpricing their goods and by making capital expensive. Interest rates have had to be held at relatively high levels to attract dollars to maintain the high exchange rate as well as to fund the fiscal deficit.

There are a number of reasons why the CB has followed this policy.

First of all, there is a lack of confidence in the market that any official rate can be maintained. This has lead to the holding of precautionary balances that are not related to the underlying volume of trade. When this happens the CB feels that the banks are keeping the peso/dollar rate lower than it should be. The CB therefore tries to create the impression that they will resist downward pressure on the rate and maintain particular rates for long periods.

A devaluation would increase the CB's losses on debts it has been forced to assume by the National Government. Relatively high proportions of the CB's liabilities are in dollars and its assets in pesos. There are proposals to move these debts to the National Government. The CB is aware that a devaluation would probably result in increased unemployment, since prices will tend to rise and output fall, until the export industries had increased capacity sufficiently to respond to the new overseas prices for its products. It is not very appealing to say in the lead-up to an election that in the long run employment growth will depend most of all on improved export incentives.

In the short run, the high interest rates that are necessary to protect the overvalued exchange rate and which do so much long term damage to the economy, are much less painful than the few thousand jobs that will be lost to a devaluation. The experience of the mid-1980s was not a good one for the CB. At that time the banks were allowed to hold on to foreign exchange. When there was a foreign exchange crisis, the CB had to buy the foreign exchange from them and subject future flows to tight controls.

The CB finds it difficult to agree to minimal intervention because it believes that the banks do not behave competitively. There is at least some evidence to support this view. Many banks still do not have the broad-based ownership that might make them act in a more competitive manner. They are able to maintain quite high spreads between deposit and lending rates, generally higher than any other ASEAN country in recent years. However it should be noted that the CB did itself encourage the formation of BAP partly so that it could communicate its policies to the banks with minimal effort. The CB's own rules on capital requirements have restricted entry and therefore competition.

The CB does not like the way in which the banks compete in the foreign exchange market. They compete for other banks' customers, importers and exporters, when they need foreign exchange, rather than buy and sell foreign exchange among themselves. The banks earn their money from the letters of credit and other commissions they earn from the newly "pirated" clients.

It is easy for the CB or the banks to move the rate in such a thin market. The on-floor trades represent only a few per cent of all foreign exchange transactions, and yet they determine the price for all official transactions.

It will be difficult to achieve a market determined rate if the present interbank market structure and resulting bank behavior are unchanged and the CB can continue to intervene through purchases or jawboning to maintain an overvalued rate. Changes in behavior are required by both the CB and the banks. Of course, if the rate were actually market determined, some of the motivation for the banks to act as they do would be eliminated.

2.b.2 New Mission for the Central Bank:

To prepare the CB to manage the exchange rate in a more open environment, there need to be two strong policy commitments by the CB:

1. To aim for a market determined foreign exchange rate; and

2. To encourage new entrants into the foreign exchange markets.

The first policy commitment provides an off-floor trading will result in more competitive exports. The second meets the CB's own concerns about oligopolistic behavior by the banks.

The new entrants could be Offshore Banking Units (OBUs) and non-bank financial institutions--dealers and brokers.
Adding more information to the system, brokers would act as intermediaries between dealers, reducing the transaction costs of the banks and other dealer and smoothing changes in the rate.

Regulatory changes would be required to permit the entry of OBUs. Their tax rates are lower than those of domestic banks. Another problem is that the inflow of capital would tend to push the inflation rate up, making exports less competitive. The high capitalization requirement (P3 million) is a deterrent to many potential entrants. The CB fears irresponsible behavior by new, small banks. In reality, the larger banks have caused the more serious problems.

There used to be a network of dealers. Their reintroduction would broaden the market. The introduction of brokers would also help. Brokers interact with buyers and sellers, and by improving the flow of information, bring about transactions that are close to

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the market rate. It might also be possible to allow the manufacturers themselves to deal in the market, by selling to each other in off-floor trading. However, if care is not taken with licensing standards, and the CB's controls in support of those standards, destabilizing speculation may take place. Another possibility might be to develop a network of dealers who can trade with the banks but are not allowed to trade in the wholesale interbank market. The market would become even more active if trades could be made in cash dollars. It is not now possible to open an account in cash dollars; checks have to be used.

To encourage the attainment of these new missions, there may have to be changes in the Monetary Board. A basic problem with promoting a goal of a market-determined exchange rate is that many members of the current Monetary Board have an incentive to keep the exchange rate overvalued.

2.b.3 Central Bank Monitoring and Other Operations:

There will be many more transactions in the wholesale foreign exchange market once off-floor trading gets underway and the number of actors increases. The CB will have to be able to monitor these transactions on a continuous basis in order to make effective interventions at minimal cost when required to maintain stability and to ensure competitive behavior. Continuous monitoring does not necessarily mean continuous intervention. The team was told by CB staff that their objective should not be to intervene in order to fine tune the exchange rate but to respond to external and internal crises that might cause panic in foreign exchange markets. The CB should intervene less than it does now, but those interventions should be better informed.

One problem is that the CB does not yet have monitoring systems that can cope with large numbers of transactions. One banker told the team that the CB was at an "informational disadvantage". The installation of the CB's Management Information System (MIS) has been held up by its inability to hire enough systems experts and programmers, mainly due to the low salaries that the CB can pay. Part of the monitoring responsibility lies with the Department of Economic Research. This department has some very highly qualified staff; some of the current staff have graduate degrees from the best Filipino and foreign universities. However, the CB has had difficulty in keeping such high quality staff.

Staffing is a serious problem at the CB as a whole. There is a need to attract and retain MBAs, economists, accountants, lawyers, bankers, computer specialists, and others who have been trained in the latest banking techniques and policies. This will only be possible if the rapid promotion of such highly skilled and experienced people is facilitated. Entry from the outside to senior positions should also be possible. At the moment only the Governor himself is appointed. Legislation is now being prepared to establish a more independent CB under which it will be possible to appoint senior staff, rather than have to promote from below. The CB stressed the measurement side of training as being particularly important. For example, it takes two months to produce information on the deposit liabilities of the banks.

The CB has set up a bankwide reorganization committee to deal with some of these problems. The committee has decided, for example, to separate the statistics and economics sections of the Department of Economic Research. This will give each a stronger focus and improve the quality of monitoring and economic research. Some progress will be made with the salary issue by promoting some senior staff into vacant higher positions.

2.b.4 Other Forex Management Issues:

Better paid, better qualified and better equipped staff will not by themselves ensure the achievement of the CB's new foreign exchange goal. New management strategies that are basically developmental will be required that are well understood, and therefore can be effectively implemented, by all the staff active in establishing and maintaining competitive foreign exchange rates. The staff will have to be motivated in terms of those missions rather than the conservative stabilization and control goals that have been dominant in the CB since it was first established.

The banks and the new entrants will not only have to work out a new set of relationships with the CB and each other, but they will have to learn and hone new skills. A training program is recommended for representatives of all exchange market participants. Part of the training would be to help the banks understand the CB's new rules and definitions. Some of the larger banks now have training programs for traders. There should be study tours to countries that have more open foreign exchange markets. More will need to be learned about swaps, forwards, futures, hedges, and bid/sell trading. Rules will have to be agreed on how to confirm deals, lot sizes and so on.

As a higher proportion of the trade is in currencies other than the dollar, now about 60 per cent, dealers will have learn how to monitor and respond to movements in many currencies. There should be peso/dollar service. The much higher level of transactions and players in the market will necessitate that everyone be on-line. Many of the banks already subscribe to a number of computerized information systems. Dealers will have to learn more about the techniques for pricing of foreign exchange, for example, those based on interest differentials.

3. Access to Inputs at World Prices:

3. Streamline Duty Drawback System:

This policy area is one of the most complex in terms of administrative and institutional actors and actions. On the surface, it would seem to be a simple matter to carry out the actions that constitute the performance indicators--to have the new "one-Stop Shop" for duty drawback operating effectively by May 1992, and to increase the number of standard formulas of manufacture (SFM's) that are used to determine what the duty drawback allowance is, and apply them to a total of 500 export items out of 6000 possible items.

However, to do this involves the following organizations directly: The Department of Trade and Industry, including the Board of Export Trade Promotion (BETP), the Board of Investment (BOI), the Bureau of Customs (BOC), the Bureau of Internal Revenue (BIR)--although the latter has refused to cooperate in the one-stop shop--the Department of Science and Technology (DOST), including the Institute of Technical Design and Innovation (ITDI), which establishes the formulas on the basis of actual investigation and analysis, the Commission on Audit (COA), which has to audit all transactions and drawbacks on a post-audit basis under the present system, and the Philippine Chamber of Commerce and Industry (PCCI), which has been trying to force the government's hand on this matter by paying for the systems study that is presently being carried out by the University of the Philippines (UP).

Basically, the duty drawback system is to be streamlined in two ways. First, the exporter client--through its broker--will be able to take all its documentation to one facility, where that documentation will be processed. It is in this sense that it is a "one-stop" shop. There are SDP II peformance targets to process applications within 60 days, once all the documentation has been presented, and the application is thus considered complete. This will be an improvement over the present situation in which it may literally take years to get the duty drawback credit--which should be distinguished from the tax credit refund, which is in the hands of the BIR, and is a separate matter and system.

There is an existing facility presently available at the port, but it is too small, is in poor shape, and the new facility will be better for the staff and, and is thought to be more conveniently located for the clients. It is being designed by the same UP Engineering Department that did the initial feasibility study, including a "methods engineering" approach to ensure that it can operate efficiently. World Bank funding is expected to be provided for increased staffing, physical facilities and some systems improvements.

One important issue on the duty drawback system reform that should included is decentralization. If the system to be established works well, then it can be replicated outside Metro Manila, and on the islands which do the most production for export.

The second streamlining effort concerns the formulas on the basis of which the drawback is calculated. This can be on the basis of the actual content of the item to be exported--how much wool, leather, thread, dye, etc. was actually used in the manufacture of the item, and of that, how much was imported and thus subject to duty. Alternatively, this can be done on the basis of a generic formula, which is really an average for that sort of item. The policy reform actions inluded in the Matrix are supposed to be taken around generic formulas. At present, there are some 150 of these, which are determined by the ITDI, but are certified by the BOI--they are items that are manufactured by firms that come under the aegis of the BOI. There is a handbook of these Standard Formula of Manufacture (SFM), which is supposed to be updated periodically. The last formal update appears to have been done in 1986, but other informants said that it is a continuous process.

A formula can be allocated either by item (that is, by tariff lines), or by firm. When the standard is allocated to the firm, it done in terms of the bonded warehouse system. This is not part of the "one-stop" system being contemplated. One of the key technical issues is whether exporters will agree to have one generic formula, for example, for leather shoes, or will insist on having one for high heeled shoes, sandals, boots, etc. The same is true for garments--long-sleeved dresses, evening dresses, short-sleeved dresses, and so forth.

Whereas ideally, the ITDI could establish averages and then apply them uniformly, there are trade conventions, including those of the GATT, that will constrain how this is actually done. Subsidies are not allowed, so that an average that is too high can be considered a subsidy for some exporters, and might therefore become subject to counterveiling duties in the importing country. Therefore, the DTI must ensure that the averages applied are at the lower end of the scale. This will still benefit the smaller and medium exporters, who do not have the staff or the cash flow to wait around to have their own individual actual SFMs determined. However, the larger firms will still use actual standards, since they have the staff and the funds to wait out the system to get the real duty drawback.

A major issue, in addition to the basis for calculation of the SFM, is the documentation required to submit a complete application. Typically, one of the main delays in dealing with the BOC in general, and with duty drawback in particular, is said by all concerned to be the risk that a key paper will be "lost" or "misplaced" until a bribe is paid to the official who is supposed to have received it. Alternatively, the broker returns from the port to the client and says that he can't file the application because there is yet another paper required, and the client, who doesn't know the rules, pays the broker more money and spends more time, to get the real or fictional paper so as to complete the application. These transaction costs are very high, especially for the smaller exporters.

This is why an aspect of the "One-Stop Shop" streamlining will be adviced to the clients who file applications on exactly what documentation is required to file the application to begin with, and then a letter indicating what documents may still be missing once the application has been reviewed. This is supposed to take care of the problem of repeatedly "missing" or "misplaced" documents. A similar approach is being taken with information provided to taxpayers by the BIR and has apparently met with some success.

Only when a system is very simple can corruption be controlled. Apparently, there was a World Bank-funded study that concluded that exemption would be the simplest and best system in the duty area for facilitating exports, but the BOC was opposed, believing that this would be too open to abuse. Even allowing for typical obstructionism of such agencies, and a possible desire to keep the corruption going, it is also apparently true that the bonded warehouse system was abused in the past, leading to a Senate investigation of the DTI. Thus, even those who would like to reform the system more radically are "gun-shy"about doing so.

One of the most significant observations both about duty drawback and VAT, is that the private sector is at least as much to blame for the level of collusion and corruption as the GOP staff who are supposed to be enforcing the revenue generation statutes and codes--the staffs of BIR and BOC. Apparently, for every improvement in the system, or each liberalizing step, there are at least some private sector "clients" that flagrantly abuse it. So, bureaucrats who are supposed to give at least the appearance of performing, and who are risk averse anyway, are unlikely to support liberalizing trends--honest ones because they know they will be abused, and dishonest ones, because they will have less leverage.

It has been observed that a reforming head of an agency can only last for a limited time--until he becomes corrupt himself, or until those forces that have profitted from previous corruption "intrugue" him out of office. Thus, while changes in leadership have short-term positive results, they are usually not completely successful and don't lead to sustained changes.

Even absent corruption and collusion in duty and tax evasion by the private sector, it may be seen from this brief discussion that actually getting the streamlined duty drawbak system going, and meeting the policy reform targets by the appropriate dates, will require the concerted and efficient efforts of a rather large number of organizations and agencies which have few incentives to collaborate quickly or effectively. Another key constraint is the fact that there is apparently no funding yet for the computer hardware required for the new system.

One of the most constraining of the institutional actors involved in the duty drawback scheme is the Commission on Audit, mandated by the Constitution to have a completely separate identity from the rest of the GOP. Like the BOC, the COA maintains a strong control and regulatory posture given its nature and mandate. It only believes in post-audit, is largely unautomated, and like most regulatory and collection bodies of its type, is relatively comfortable with delivery horizons that extend to years rather than months, as for duty-drawback for example. The COA representative in the duty drawback system seemed supportive but as might be expected, emphasized all the most usual bureaucratic requirements for documentation and stressed staffing and computer system obstacles to much more rapid action.

There seems to be a great deal of pressure to open the new "Shop", and there are a number of senior officials competing to get the credit for promulgating the regulations that will govern its operation. However, the private sector groups involved are trying to delay its inauguration until the study by UP has been completed, and the regulations carefully formulated. This is in the hope that short-term political gains will not be placed above long-term systems success, which otherwise would be likely, especially in this election year.

4. <u>Adequate Provision of Inter-Island Liner Shipping Services:</u>

Although the proposed policy reforms will meet resistance from some shipping industry groups, it should be possible to implement them reasonably quickly since they have been developed over a considerable period of time in close collaboration with MARINA and the Shippers' Council (SHIPPERCON). There is substantial GOP ownership of the reforms since they had their origin in the Government's own Presidential Task Force.

In common with other parts of SDP II, the objective is to increase competition by liberalizing prices and entry. The implementation strategy is to use one set of reforms as a carrot to induce the industry to accept the other set. The widening of the tariff forks, which will in effect allow rates to rise on routes where rates are so low that shipping lines have little incentive to offer services, will encourage the industry to accept the route liberalization, the objective of which is to make services more competitive.

The rates for many agricultural commodities in particular are so low that in some instances no shipping services at all are offered and some produce actually has to be sent by air. This transportation constraint is limiting agricultural production in some locations. On other routes there is a need to encourage more competition because monopolistic and oligopolistic practices have resulted in rates that may be too high for some commodities.

Some of the existing problems with the sector, which are potential sources of implementation problems for these policy reforms, lie in the non-competitive behavior of some of the key shipping lines. Three shipping lines are much larger than any others; there is a second tier of four that are much larger than those below them. Full rate and route entry liberalization has not been recommended because it is feared that the larger shipping lines may enter new routes and drive out existing smaller companies with aggressive pricing. It is a sellers' market at the moment. Full, immediate liberalization would simply drive up the rates.

An important role for the public sector will be maintain high levels of competition on the routes with the denser traffic flows by encouraging new entrants from among the smaller shipping lines. MARINA will also have to make sure that low volume routes continue to be served by licensing shipping lines to operate on the more profitable routes only if they undertake to serve some minor outports.

The Interisland Liner Shipping Rate Rationalization Study Draft Final Report (Nathan Associates Inc., 1991) recommends that a number of studies be carried out to prepare for the implementation of the policy reforms. The most critical ones are the Liner Shipping Route Study, which would help with the liberalization of the route network, and the MARINA/SHIPPERCON Study, which would examine the two agencies' institutional development needs. Studies are also recommended on container transport, the transport of agricultural products, passenger accommodation, training and safety.

The report recognizes that both organizations will have to change to meet the challenges of the reforms that will liberalize the sector. MARINA is now essentially a regulatory organization. As the route and rate structures are liberalized, the importance of the regulatory role will diminish. The consultants suggest that MARINA become more development oriented. In the future MARINA should monitor the performance of the industry, identify problems and lobby for their correction. According to the consultants, there are some problems that can already be identified as candidates for MARINA's attention: open pilotage, integrated clearance offices in the ports, cargo handling and cargo clearance.

The consultants recommend that SHIPPERCON become a much more effective protector of the shippers who now suffer so much from the existing rate and route structure. The consultants conclude that the organization is not as effective as it might be at lobbying for better services and standards. Since SHIPPERCON has few offices, it is not as accessible to shippers as it might be.

The proposed institutional study will address many of these issues. It is important that the study be carried out in a very collaborative and participatory manner (as the Interisland Study was). Both organizations will need to redefine their missions and explore fully what those new missions mean for their operations, interrelationships and staffing. Management and staff should collaborate closely with the consultants in defining the reorientation of their organizations so that when the agreed recommendations have to be implemented there is a broad-based understanding within the organization of their implications. This will ease the transition.

In order to facilitate the implementation of the rate and route liberalization itself, MARINA will have to work closely with the shipping industry to explain the need for the changes and demonstrate that in the long run the changes will be for the benefit of the industry as a whole.

MARINA has said that it anticipates considerable opposition to the reforms. Many of the liberalization measures are not now in the interests of the larger shipping lines which dominate the industry. They will gain nothing from encouraging new competitors for their services. In the short run the package of higher tariffs (or the possibility of higher tariffs) and freer entry into all or most routes will be seen to be beneficial to most. In the longer run, the freer entry will tend to bring down rates, as monopolistic profits are competed away.

Although the Government can carry out the critical policy reforms without legislation, those feeling that they might suffer from the reforms will exert their influence through the Congress. MARINA's best hope for heading off that opposition is first of all to convince major shipowners that they will gain in the long run and secondly to mobilize support from the shippers and the smaller shipowners. In the long run all should benefit because the reforms should themselves generate trade and enlarge the markets for interisland shipping services. However MARINA does believe that in some cases legal action may be required to implement the route liberalization.

Care will have to be taken in phasing in the policy reforms. It might be best to announce that the changes in rates and routes liberalization will begin in, say, six months and allow the industry to prepare itself through new investment which would respond to the anticipates tariff flexibility.

The proposed Liner Route Shipping Study will help to articulate some of these implementation issues. It should also lay out some options on how to mobilize a critical mass of support for the reforms. The key will probably be to help the smaller shipowners, the shippers and the political leadership of some of the regions that need better services to make their case in the political arena.

MARINA will need a good management information system (MIS) to be able to monitor the performance of the system. The current system is very weak. Presently, the quality of the staff is capable of meeting the agency's new mission but that many will require substantial training. He did not think that MARINA needed many additional staff or staff with different basic qualifications. For example, the economic staff have MAs, which is the right basic qualification.

A further institutional change may be required. The consultants believe that the Shipping and Ports Advisory Council (SPAC) is not as effective as it might be. SPAC was set up by the Presidential Task Force. It could become more representative. The private sector members are members by name rather than by organization, for example. The Secretary of Transportation can in practice choose to be advised by SPAC, or not. Its meetings are characterized by what were said to be "endless debates". The consultants recommended that it be given clearer objectives and by-laws and that its advice be taken more seriously by the executive.

5. Efficient Financial Resoure Mobilization:

5.a. Constrain National Budget Deficit by Strengthening Value Added Tax (VAT) Administration:

The Bureau of Internal Revenue, which is as a revenue generating bureaucracy is always under the gun to perform, seems to be making progress, at least in the VAT division, in moving toward increased collection efforts. Senior decision-makers indicate at the policy level that they support measures to increase export competitiveness--e.g., by facilitating the faster processing of tax credits for components of exports.

BIR has been the recipient of considerable donor assistance in the past, and has been reorganized several times. Earlier plans to endow BIR with a new and presumeably more highly-motivated cadre of VAT personnel have apparently been scrapped. This plan would have filled vacancies with "clean" outsiders. Instead, through force of circumstance, these vacancies have been filled from within, by persons whose effectiveness is said to be open to question. The assumption is that even if they are not dishonest, they are not motivated to do much in the collections area, since they are over-qualified and are given few incentives.

In an environment and in specific sectors where corruption and payoffs have been the rule in the past, significant and enduring difficulties are created for the efficiency of agency as a whole, and for and individual performance. As one interviewee outside BIR quipped, it is sometimes doubtful whether the BIR actually wants to increase its capability, since then it would have less of an excuse not to collect taxes.

The VAT target under SDP I was the only one with which there was substantial difficulty, and release of funds from the last tranche was delayed as a result. In part, this seems to have derived from a genuine misunderstanding of the wording of the target. Other evidence would, however, suggest that the BIR was over-reporting progress and under-reporting problems in meeting the target.

Under the SDP II Policy Matrix, the target is now being expressed as a ratio of VAT collections to GNP, so as to get the sense of the reform across with a reasonably measureable target, but one about which there can be some negotiation or change if it appears unlikely to be met.

Many of the VAT problems are related to staffing; others relate to the need for more supervisory time for existing supervisors, to better tools for VAT agents, to the matter of computerization, and access to computers and computer training--and appropriate software--by VAT agents. The operational head of the Division has a very good appreciation of the limitations of the present system, and has some concerns about whether the new "Operation Suyod", which implies expanding the VAT taxpayer base, can really be effectively implemented nationwide with the present staff and at a realistic cost given the likely benefit.

A two-pronged approach to the problem of corruption and collusion in assessment and collections is being taken--a PR and information campaign for the taxpayers, and the elimination of room for maneuver for the VAT agents, through the development and dissemination of a new manual which will cover every possible case and issue. There is also the possibility that a large VAT payers unit will be established, since it is a very few companies that pay the majority of VAT (38 are the biggest payers).

Regarding the New Payment Control System (NPCS) which is being piloted in six areas, things seemed more positive, and expansion to all 97 districts seemed less problematic. But here, the need expressed was for better training for VAT and for BIR staff in implementing the system after the pilot experience was assessed.

This is a liberalizing system, which is based on self-reporting. BIR is also using self-reporting in its tax credit scheme for exporters--50% of the credit is given when the application is received, and the rest (adjusted) is given after the return has been reviewed. This is what is being suggested by some for the duty drawback system, but so far, the BOC and COA have not agreed to follow this model.

The BIR's senior management are in close touch with the PCCI as representatives of their clientele, and are also trying to work with the Development Academy of the Philippines (DAP) on a series of five "change management projects", some of which will affect VAT. ABD is funding the implementation of the Information Systems Plan, the forumulation of which was a performance indicator under SDP I. This is intended to have immediate benefits for VAT in that it will--in conjunction with the new Tax Identification Number (TIN) system--allow the development of a clean database of VAT payers. This, then, will provide a secure baseline for the VAT division to work from in trying to achieve its targets.

Key constraints for the VAT targets being achieved are the broader question of political will on the part of the GOP to develop and enforce anti-corruption measures, and on the part of large private sector VAT payers to pay their real taxes, and creative measures within BIR to motivate staff to do a better job. The latter matter should be addressed positively, in terms of increased incentives, and also in terms of increased sanctions against poor and corrupt performance. Some steps in these directions have already been taken.

5.b <u>Lower Interest Rate Impact of Public Debt Management:</u>

The policy reform actions in the proposed policy matrix of SDP II under this policy objective is likely to suffer from implementation problems, at least on the basis of present information. For some, if not most, of the actions proposed under this heading there is too much uncertainty to expect more than studies and preparatory activities during SDP II.

Improved public debt management is one approach towards lessening the interest rate impact of public debt financing. To do this, the preparation of an action program for developing a secondary market for long term public debt instruments and a more open market for government securities are proposed. There are also proposals for the design and implementation of small saver schemes that would channel savings into government securities. In the first year or so of SDP II, various studies and preparatory activities would be carried out. Initial steps in implementing long term debt instruments, a clearing and settlement system, and savings schemes would be taken prior to Tranche 3.

The net effect of all of these measures would be to lower interest rates and reduce the overall public sector deficit. That would in turn mean that more investment funds would be available for exporters, and other potential investors, since there would be less "crowding out" by the public sector, and the rates at which the exporters borrow would be lower.

Since there is shortly to be a study on Public Sector Debt Management, the IPC team focused on the savings aspects of the implementation actions.

5.b.1 Central Bank and Competition:

Anticipated are problems caused by the relationship between the Central Bank, on the basis of its current mission, and the larger banks. As with foreign exchange, whichever instruments and mechanisms are introduced, the fact remains that few of the parties concerned do not have as strong incentives as they should to bring interest rates down.

The high interest rates required to maintain the overvalued exchange rate actually tend to reinforce the relationship between the CB and the banks. Higher interest rates mean higher earnings for the banks since past experience has shown that lending rates can more easily be moved upwards than deposit rates have to be to attract funds.

Most of those who do save with banks are apparently not as interested as they might be in real, positive interest rates since the deposit rates are often less than the rate of inflation. It might be they have no option but to accept negative rates since competition among the banks with the larger branch networks is so weak. Frequent reference was made to the oligopolistic practices of the banks keeping down deposit rates.

This situation will only change if entry rules are liberalized. Many experts think that the capital requirements for entry into the banking sector are too high. There is also a very limited number of government security dealers allowed to trade in government securities. The Central Bank still feels that entry should be limited since it worries about its own capacity to control the market and about the risks of financial institutions failing.

Again, as with foreign exchange trading, the key to overcoming these concerns is for the Central Bank to have far more effective monitoring systems and for the Central Bank's managers to feel confident that some of their fears of uncompetitive behavior on the part of the Banks will be overcome if new entrants are permitted.

5.b.2 Savings Mobilization:

The savings proposal in the SDP II policy matrix have two purposes: to give real, positive interest rates to small savers and therefore increase savings in the formal sector, which would in turn improve financial intermediation; and, by channeling those savings into government securities, add to the supply of savings and thus reduce the interest rates.

This would help exporters who wish to invest. It would also of course be helpful if more savings were mobilized, for public or privates uses. Financial intermediation measured by M3/GNP at around 20 per cent is exceptionally low; the proportion for Thailand is almost 60 per cent.

New savings schemes have not proved easy to implement. The "Premyo Savings Bond", which was introduced in 1974 was not a great success. Although it was sold in low denominations, most of the buyers were the commercial banks, and most of the purchases were made in Manila. There were few sales in the secondary market. As soon as the Premyo ceased to have reserve eligibility, the banks unloaded their holdings, which amounted to about 70 per cent of the total issue. The Monetary Board decided to redeem all outstanding bonds in 1987.

Although the experience of the Premyo Bond was not good, it might still be worth considering a similar instrument now to offer positive interest rates to small savers and to mobilize more funds for the government at relatively low cost. The pool of savings is now higher than when the Premyo bond was launched. A much higher proportion of total bank deposits are now in the form of savings accounts than was the case 5 years ago.

Banks that do not now have branch networks would find a savings bond a good way to win new customers; those same banks are now having to buy funds at high rates of interest. From the government's point of view, and in the long run, it is worth incurring some higher than normal transactions costs to encourage the savings habit. The savings rate in the Philippines is a very low 13 per cent, well below the average for lower middle income countries.

One important implementation constraint with the savings bond is the lack of effective retail outlets. Some experts feel that the existing commercial banks that do have extensive branch networks will not promote the bond aggressively since it would tend to compete with their own deposit mobilization programs. And of course they do not want competition to push up deposit rates.

In some countries, such as Sri Lanka, postal savings banks might be considered as an outlet. In the Philippines, this is not a feasible option since the postal savings bank's financial operations have long since declined to ineffectiveness. Customers could be reached directly by whichever GOP agency is given responsibility for the scheme, but that would add to the public sector bureaucracy.

Unit trusts or mutual funds specializing in government securities have also been proposed for consideration as part of the policy matrix. It has been suggested that the GOP encourage its own banks to activate their trust departments and that the Central Bank authorize the thrifts and eventually the rural banks to perform trust operations. There are many good models for unit trusts specializing in government securities. Most of the Continental European based unit trusts do in fact specialize in government securities (in contrast to Britain's which tend to specialize in equities). These unit trusts have performed very well in recent years.

One problem is that any new savings scheme takes considerable time to research, develop and implement, typically longer than the duration of SDP II. The first step is to explore the interest of the existing institutions. Since financial institutions tend to be conservative and reluctant to move in new directions, few will exhibit much enthusiasm and many will have difficulty in understanding how they might benefit from the scheme. A close working relationship will have to be established with a few of these institutions simply to learn enough about what might work to move on to the next step, market research.

Market research into new savings schemes can only meaningfully be carried out if some practical options can be presented to potential customers. Great care will have to be taken in designing the survey instruments since potential clients tend to react positively to offers of new products. Questions have to be framed so that the cost and benefits of options can be assessed. In this case reference has to be made to alternative uses of household earnings. Further, it has to be clear whether or not the savings would be incremental, not just reallocated from another savings scheme.

Once there is clear information on which scheme, or which form of which scheme, might be most marketable, some banks have to be persuaded to pilot the scheme. It is probable that it will be found that the transactions costs will be very high for any scheme that is aimed at small savers. The banks may well lobby for government subsidies to cover some of the transactions costs. It may however be possible to persuade the banks that it is in their long term interests to accept some losses in the early years to establish a long term market position.

It would probably be wise to limit SDP II activities under this heading to collaborative studies with the Central Bank, the commercial bank and other financial institutions, market research, and the introduction of pilot schemes. It might be that, based upon these preparatory activities, a major theme of SDP III could be savings mobilization.

B. External Constraints: Socio-Political Analysis

At the beginning of August, the socio-political situation as seen from Metro Manila, was in something of a pre-election campaign lull. Attention appeared to be focusing primarily on the bases negotiation, and whether or not the Senate will ratify it, as well as on the aftermath of the Mt. Pinatubo erruption, and the ensuing social and economic displacement.

Meanwhile, however, there were a number of issues pending in Congress or recently dealt with by Congress which have direct bearing on the content and macroeconomic environment of the proposed SDP II policy reform matrix. Some of these will have a direct impact on SDP II policy reform implementation, and some are therefore included in the Matrix itself.

By the third week in August, when negotiations on the content of the policy reform Matrix for SDP II were considerably more advanced, the bases agreement had still not been ratified, and pre-electoral campaigns were beginning to heat up. "Presidentiables" were beginning to be put forward by their potential backers, or to announce their candidacies, and the print and television media were very much taken up with their respective stances and resignations from a major political party and other parties.

Statements about foreign debt, domestic deficits, and other key issues relevant to the context of policy reform, including the rates for shipping on certain routes, were very prominant in the news as the budget was announced, and candidates and "proto-candidates" began to select issues. Corruption was another key issue being addressed in Congressional hearings, and there were rumors that changes would be made at Customs.

There is thus an apparently generalized concern with macroeconomic stability, and a growing awareness of the relative weakness of the Philippine economic performance vis a vis that of others in the ASEAN region. There is a considerable amount of important national symbolism involved in the base negotiations. But there are also important economic issues underlying the bases agreement and the results of the negotiations--and whether the Treaty is ratified or not--will impact not so much on the security situation of the Philippines as on its foreign exchange and international and domestic debt positions, employment, and growth.

In general, there there seems to be support in government, in Congress and in the private sector, for more liberal economic policies that would support the SDP II goal of increasing export competitiveness. Even some of those in Congress and in the private sector who were in the past most nationalist and most in favor of a protectionist approach are, apparently, embracing a more open-market approach generally, and especially to foreign exchange management. Some of these appear to be doing so out of enlightened self-interest, while some others have the benefit of better economic analysis at their disposal.

Despite this description of increased openness to reforms, there is also concern expressed daily in the press, and apparently in the Congress, that the government is going too far in terms of its support for open economic approaches, that this will be to the detriment of local industry and even to local exporters according to some, and that protectionism is still necessary, and proper. Recent legislation has been passed, for example (the Foreign Investment Code), which liberalizes foreign investment potential in export-oriented industries.

A Congressman has petitioned the Supreme Court to overturn this legislation, arguing that it is harmful to export promotion, as well as to the economy as a whole. Offshore banking operations in the Philippines are also being liberalized, but there is considerable reaction against this as well, partly on nationalistic grounds, but partly, presumeably, because this will tend to increase competetiveness in what has been a banking sector dominated by a few strong family-run banks that have profitted significantly from a relative lack of competition.

Lobbying efforts appear to be strong on both sides of these issues. In terms of liberalizing capital markets, and specifically trying to get the SEC to be more responsive to the needs of the private sector, there is a private sector group called **Financial Executives Association of the Philippines (FINEX)**, which has been created with impetus from the DOF. This group might be of some assistance in developing the plan for the secondary government securities market.

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The **Bankers Association of the Philippines** (BAP) is also apparently quite an active participant in dialogue with the Central Bank and the DOF about exchange rate policy, issues such as off-floor trading, interest rate and public debt instruments. To what extent they are ipso facto a force for liberalization is not clear, and they are said to be wary of the CB in its regulatory hat, especially as regards the limited number of forward trades they are presently doing, since this may have a questionable impact on the way they and their clients are reporting income and foreign exchange holdings.

The **Philippine Chamber of Commerce and Industry** (PCCI) is officially on record as strongly supporting increased foreign exchange liberalization and other reforms that would support increased export competitiveness. Apparently, even some of its key members who, in past, have been in favor of--and profitted heavily from--protected industry approaches, are espousing an export-led oriented growth policy, again in part because they themselves are increasingly involved in the export side of the equation.

Various other business-related associations have similarly announced their support for more liberalized economic and fiscal policies, and at least some of these organizations are making proactive suggestions to government.

The Commissioner of the Customs, for example, has set up a body through which he can interact better with his clients--the **Customs Industry Consultative Council (CICC)**. This is the venue for the private sector to propose ideas and identify problems. They submit their plans to the committee, and then this p-rovides them with a way to "thrash them out". This would be the appropriate venue for trying to solve the duty-drawback implementation problem with the exporters, for example. The Philippines is also involved in the **Customs Cooperation Council**--one for ASEAN and one worldwide, which gives them the opportunity to see other models.

There are monthly workshops facilitated by the PCCI with the Bureau of Internal Revenue (BIR) to discuss tax policy and tax administration. These appear to be more successful at actually influencing BIR policy and behavior than are the CICC meetings. Customs seems to be regarded as the most intractable agency likely to be involved in SDP II policy reform implementation, with the exception of the Commission on Audit (COA).

Less known are the views of organized labor, smaller and medium-sized exporters, energy suppliers, and other representatives of the transport sector than those involved in inter-island shipping, about the policy reform areas under discussion for SDP II. What a hypothetical "man in the street" in Metro Manila, let alone in a provincial capital or in the country side would think about protectionism versus market-orientation, isolationationism versus regionalism, is simply not known.

There are other issues such as the energy sector, and labor, as well as productivity, and improved product design and market development, which impinge strongly on the supportive environment for export competitiveness that SDP II seeks to foster. These, however, are either being addressed under other A.I.D. programs and projects, or by other donor organizations, or both.

The main constraining factor in the socio-political environment that will affect implementation of reforms under SDP II is the election and its aftermath. The shift of attention away from daily business and toward positioning for the election and the transition to follow it has begun. According to one observer, this process will last for 400 days of the SDP II LOP. Even those who remain in place who have been involved in the negotiations of the Policy Matrix may be responding to new "political masters" when implementation is underway; many of them may have left by the time the second tranche is to be released.

This is one reason why the Mission and some of the GOP actors concerned had hoped to "front-load" the Matrix, pushing key reform actions to the first or second tranche periods. However, as negotiations continued, it became apparent that for some key policy areas, such as public debt management, and even foreign exchange liberalization, not enough was yet known about how to carry out the spirit of the reforms to do so quickly.

Both parties to the negotiation of the SDP II policy matrix are aware that moving too quickly on the basis of imperfect knowledge is more dangerous than not moving until after the elections. Some observers predicted that such key moves as increasing VAT collections, or designing new instruments for small savers, are unlikely to take place before the elections.

Realism thus dictates a system for monitoring and evaluation that will allow for reasonable and well-founded mid-course corrections to the targets in the Matrix, so long as there is a demonstrable trend toward accomplishing the agreed reforms under what will clearly be somewhat turbulent political conditions.

II. Assessment of Institutional Needs:

A. Resource, Policy Studies and Training Requirements:

1. Technical Skills/Qualifications Requirements:

A good number of the implementing agencies of the SDP II policy reform matrix have to contend with an aging technical staff, many of whom belong to the old school of fixed exchange rate regime and/or protectionism. The survey and assessment of available and required technical skills and staff qualifications among the GOP agencies likely to be involved in the implementation of SDP II yielded the following general impressions:

a. Focus the scope and intensity of training and development needs on the managerial strata below the policy making levels. These would include supervisory management, whose technical specialization is relatively narrow and whose principal task is to ensure policy execution, and middle management (embracing a broad range of managerial positions at diverse degrees of specialization) whose focus is on tactical considerations, with some participation in strategic planning and management.

b. Raise a "critical mass" of reform-oriented managers and supervisors (both in operations and research) in the Central Bank and other institutions having a management philosophy that stresses management of the economy in policy making. This is one way of breaking down the orthodoxy within these insitutions.

c. Develop other skills and qualifications that may not lead to any immediate improvement of performance but will critical to future performance under an institution whose objectives are more developmental. Examples of these skills are competence in econometric modelling and forecasting.

Institution-related findings are as follows:

a. Bureau of Internal Revenue-Value Added Tax Division:

The presence of a considerable number of CPAs and accountant-lawyers in the BIR and in the VAT division in particular, is often seen as giving BIR a distinct professional edge, since such revenue examiners are expected to be adept at both tax calculations and tax laws; clients would have more confidence in their expertise. But in fact most of the CPA-lawyers are overqualified and as a result, undermotivated.

The upshot of having overqualified personnel is the tendency to continuously maintain high entry requirements for jobs, giving rise to a queuing process in which those with lesser qualifications often fall by the wayside. This "job rationing by credentialization" results in resource misallocation and appears to bring about motivation difficulties, since many of these revenue officers are by force of circumstance performing functions not commensurate to their level of education.

The VAT division has a critical shortage of computer staff. It has only 2 programmers, both adept in operating systems and computer languages, representing just 1 percent of the division's total work force. The more glaring inadequacy is the absence of a centrally developed and uniform VAT-related software and recent initiatives at the regional levels to develop their own computer applications packages, while commendable, tend to result in incompatibilities among regional systems, exacerbating the already poor state of communication and computer link-ups.

Lack of computer hardware is likewise a serious problem, although the problem lies not so much in uneven distribution of personal computers among regional offices but in computer underuse for VAT purposes and extensive time sharing with collection and withholding functions.

An equally important need is to put more emphasis on the development of "soft skills" required for managing people effectively in environments where the content of the work is changing. For VAT specifically, expansion of coverage and the transition from pilot to nationwide program would bring about a painful adjustment process, which would tax BIR's internal capacity. A strategic "change management" program would assist BIR in developing a flexible capacity to respond to its ever expanding revenue role in a developmental context.

The VAT division has little time for more policy-analytic type of activities (e.g. tax forecasting) because much more time is being concentrated on resolving administrative bottlenecks and maintaining antiquated systems and procedures. The obverse understaffing is the organization of the division into few sectiosn. A section chief supervises about 40 people, way above the ideal ratio of 1 supervisor to 10 personnel. The outcome is an overburdened managerial layer and a poor authority delegation structure.

b. Bureau of Customs:

The duty drawback unit clearly suffers from both manpower and computer lack. The recent hiring of nine examiners somewhat alleviated manpower constraints but the more important issue that saddles the duty drawback operations is the long-delayed transition from manual to computer-based accounting and bookkeeping. Even the start-up phase of the one-stop shop would not be accompanied by a shift to automation, an obvious missed opportunity to "piggyback" an important innovation in a new system.

The BOC managers of the duty drawback center in the future, must develop a sense of "ownership" of the system. Department of Trade and Industry-International Trade Group (DTI-ITG), through the Bureau of Export and Trade Promotion (BETP), plays firstly a facilitating role and secondly, a managerial role that ranges from the needs assessment of the center to procurement of computer hardware and software for use of BOC in managing the system and effective operations of the center. This setup, however, leaves BOC as a mere spectator in the process although it is supposed to be the chief implementor of the new system.

Training of BOC staff ranging from familiarization of the rules and procedures of the one stop shop to the use of the computers will be needed to facilitate processing of completed documents for duty drawbacks. Observation tours and trips for senior managers in other developing countries where similar institutions are successfully operating to the benefit of their exporters are also well advised.

c. Central Bank:

Policy research and evaluation in the Central Bank is hampered by the lack of manpower with specialized skills at a very advanced level. Compared with premire government monetary institutions in Southeast Asia, the Central Bank has no doctorate degree holders and few experts with masteral degrees. Advanced analytical skills are virtually important in econometric modelling and simulation in issues on export competitiveness (e.g., subsidies, import liberalization and exchange rate depreciation and devaluation).

Specialized training abroad is being proposed by the CB's Economic Research Division on such critical fields as econometric forecasting, external debt management, treasury and currency management and innovations in the financial system. Because of the CB's critical need for analytical policy research, it may be necessary in the short run, while waiting for the results of a long-term training and development program to open a "facility" that will permit the CB to tap the policy-analytic services of say, the UP School of Economics and Center for Research and Communication (CRC).

The CB has experienced a high staff turnover rate in recent years. Many of its technical manpower have moved over to more lucrative jobs in private financial institutions, in the process crippling CB's policy analysis and evaluation capacity. A lean policy research staff is unable to respond quickly to demands for policy-analytic information.

Partly due to resource constraints, overall measures have not been implemented to modernize systems and procedures and, at least within the Treasury Department, to install a reliable system of information gathering and analysis in relation to foreign exchange market trends and developments.

For a financial institution needing to respond promptly to requests for basic and analytical information, the CB is seriously undercomputerized. The estimated average computer-person ratio within the bank is 10:1, which is significantly below the ideal ratio of 3:1.

d. Department of Finance-Domestic Operations Group:

The department does not have the luxury of freeing up in-house staff for policy studies on the development of the capital markets. On top of its internal constraints, the performance indicators under the responsibility of the department require a tedious process of private sector-public sector dialogue, coordination and cooperation.

Expected to be an implementation issue is the workable partnership with the Central Bank's Government Securities' Department in implementing the policy reform actions. Although the CB department is supportive of the efforts of the Finance department at improved public debt management, the CB is quite cautious in translating policy into action, partly on account of its poor state of automation, but mainly because of the CB's differences with the Finance Department in terms of the type of instruments to be used.

The Finance Department believes that the development of a secondary market for long-term securities is a "policy execution" problem since a broad-based consensus already exists on how a secondary market ought to work, given the market imperfections in the Philippines. The greater need is "policy engineering"--how to put it together. On the other hand, the development of alternative instruments for small savers and channeling them into government securities is a policy design problem and the more important task is to assemble a technical team, with external professional help, that can undertake the study of the various options of mobilizing small savings.

2. <u>Training Issues:</u>

Three technical assistance and training issues merit comment. First, there seems to be a clear preference for disciplines that stress the use of mathematical languages. Policy analysts trained in economics, operations research, public finance and systems engineering are seen to typically approach policy analysis in a more systematic way.

Second, there is demand for analysts who can work in agency settings where decision-making requires prompt and immediate analytical results. Policy analysts who can respond to time pressures in a rapid fashion are favored. Lastly, analytic activities of the specialized king (e.g. benefit-cost analysis) are seen to be the domain of middle-level technical staff, in direct support of top-level management working on large and complex policy areas.

Several institutions, such as the DTI, BOC and CB, have developed in-house training and organizational development capacity. This approach is based on a sort of "packaging" and "standardization" of training needs, and includes sectoral training and special ad hoc programs. There is nothing wrong with this approach, since it is more cost-effective to provide a "total" program to a group than to redesign it for a select group. It is also a deliberate attempt to link training to overall organizational goals, out of a perception that training is a necessity for organizational survival.

However, the training packages coming out of in-house institutes are limited to "familiarization sessions" for new or newly-promoted employees, short-term technical workshops, and popular courses for external clients. The CB Institute, for example, confines its offerings to CB employees to orientation courses, supervisory development courses, with a sprinkling of "public offerings" on project feasibility study preparation, rural bank financing and credit evaluation. Within the DTI, the Human Resources Development Services (HRDS) handles trainingfor those involved in frontline serviceswhile the Philippine Trade and Technology Center (PTTC) offers trade facilitation services and training for exporters.

This king of in-house training capacity should be beefed up to handle low to medium-level familiarization and specialization needs, such as technical retooling for VAT personnel and "client relations" skills for frontline BOC duty drawback staff. But constraints on resources (facilities, faculty and consultants) would inhibit any further development of these institutes into highly technical bodies, with capacities to undertake policy research and train technical staff on forecasting and evaluation methods. For specialized technical needs, it may be more cost-effective to sponsor individuals to study in well-established research/training institutions.

The policy and institutional environment needs to be enhanced through the immediate infusion of urgently needed technical assistance and policy analysis skills as well as a longer-term package of strategic, value-reorienting organizational reforms. This may be started through a "flagship" training and development program that cuts across various management levels but specifically aimed at strengthening the policy and evaluation capacity of appropriate units in each agency in order to maintain the momentum of the policy reforms.

These skills enhancement activities can be implemented in isolation from generic organizational goals as long as each contributes to the raising of the general level of policy evaluation skills in the export sector.

Organizational development of a more structural nature is strongly recommended to wean entire agencies away from traditional thinking and toward a more market-oriented and developmental perspective. The latter typically requires capability-building measures that involve questions of agency mission.

C. Coordination and Communication Issues:

Since successful and timely implementation of policy change would require the commitment, at times, of various government agencies, a case can be made for improving coordination and communication within and across a widely diversified structure of government agencies. Suggestions for periodic workshops presided over by either NEDA or DOF, will help clear up implementation bottlenecks and improve interagency cooperation. It is crucial that the monitoring process be designed within a clear and consistent framework of coordination that takes account of the particular circumstances of the GOP agencies.

Towards this end, providing computer hardware and training to the DOF, NEDA, CB and other involved agencies would greatly improve the monitoring process withint each agency and thus, improve conditions for inter-agency cooperation. Networking the agencies will go further in providing a more macro-view of the reforms undertaken and compel uniformity in the use of analytic methodologies. In general, the government must continue to improve the orchestration of policy reforms by further strengthening the links between NEDA-DOF-CB on the one hand and the line agencies, on the other and by increasing the capabilities of the latter.

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ANNEX J

INITIAL ENVIRONMENTAL EXAMINATION

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EXAMINATION OF THE NATURE, SCOPE AND MAGNITUDE OF THE ENVIRONMENTAL IMPACT

A. Description of the Project

The Support for Development Program II (SDP II) aims to contribute to private sector led, sustainable economic growth in the Philippines by supporting the implementation of significant policy reform actions by the Government of the Philippines (GOP). The program will help the GOP meet its external financing requirements by providing balance of payments (BOP) support on a grant basis. This support will encourage the implementation of reforms leading to an improved policy and institutional environment for the private sector and more open and competitive markets. The GOP will use $115 million of the grant to service official debt owed to the U.S. Government or multilateral institutions. $5 million of the grant will be set aside to cover technical assistance, studies, monitoring, audit and evaluation services. Since this is a performance-based BOP support program, local currencies will not be generated under the program and, therefore, no tracking or programming of local currency is required.

SDP II will support GOP reforms to liberalize the foreign exchange market, streamline refunds of customs duties and value added tax (VAT) to exporters, liberalize rates and franchising of inter-island shipping, strengthen VAT administration and public debt management. The planned BOP support will be disbursed in three tranches: the first tranche upon satisfaction of initial conditions precedent, including agreement on studies necessary to achievement of performance indicators for later tranches; the second and third tranches, when the indicators in the attached policy implementation matrix are achieved.

Other SDP II activities will be $5 million for audit, monitoring and evaluation of the policy reform activities and for technical assistance and studies to further the policy reform process. No significant environmental effects are expected from these activities.

B. Recommended Environmental Action

The project consists exclusively of a cash transfer, technical assistance, studies and monitoring, audit and evaluation. No construction or other activities which could have an adverse environmental impact will be undertaken. All project activities are eligible and recommended for categorical exclusion pursuant to the provisions of 22 CFR 216.2 (c)(2)(i) and 22 CFR 216.2 (c)(2)(ix) which provide for a categorical exclusion in such situations.

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INITIAL ENVIRONMENTAL EXAMINATION

A. COUNTRY: Republic of the Philippines

B. ACTIVITY: SUPPORT FOR DEVELOPMENT PROGRAM II (492-0450)

C. TOTAL A.I.D. FUNDING: $60,000,000 (ESF Grant)

D. LIFE OF PROGRAM: September 1991 - September 30, 1994

E. STATEMENT PREPARED BY:

CAMERON L. PIPPITT
Office of Development Resources Management
USAID/Philippines

F. ENVIRONMENTAL ACTION RECOMMENDED: Categorical Exclusion

G. USAID ENVIRONMENTAL OFFICER'S CONCURRENCE:

KEVIN A. RUSHING
Office of Natural Resources, Agriculture and Decentralization

H. USAID/PHILIPPINES DIRECTOR'S DECISION:

APPROVED: Richard E. Johnson

DISAPPROVED: ____________

DATE: 9/9/91

I. APRE ENVIRONMENTAL OFFICER'S DECISION:

APPROVED: ____________

DISAPPROVED: ____________

DATE: ____________

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