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8 Debt Crisis and Adjustment in the Philippines

Robert S. Dohner and Ponciano Intal, Jr.

8.1 Introduction

The last four years have been the most tumultuous period in the postwar history of the Philippines. In August 1983, Benigno Aquino, a popular opposition figure, was assassinated on his return from exile in the United States. That October, the Philippines declared the first of what was to be a series of 90-day moratoriums on principal repayments on its external debt. The rescheduling negotiations were difficult, and it was not until May 1985 that an agreement was signed with the country's private creditors.

In the interim the Philippines carried out a stringent IMF adjustment program which eliminated the current account deficit and restored the rate of inflation to near zero. But the output cost was substantial; between 1983 and 1986 real per capita income fell by 18 percent. In some sections of the country, particularly the sugar growing area of Negros, there was widespread malnutrition. The growing economic plight, along with rising middle class and business opposition to the government, contributed to the February 1986 overthrow of Ferdinand Marcos, a ruler who had been entrenched in the Philippines for 20 years.

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The fledgling democracy led by Corazon Aquino, the wife of the slain opposition leader, started with much goodwill, but severe economic problems, including a debt service burden amounting to almost half of exports. The Philippines, the sole Asian country to declare a moratorium, is often overlooked in discussions of the current less developed country (LDC) debt crisis. Also overlooked is the fact that the country was once widely viewed as one of the successor generation of East Asian tigers. What is remarkable in retrospect is not the debt buildup that took place, nor the fact that the Philippines had to reschedule. Rather it is that what appeared to be rapid economic growth and structural transformation could unravel so quickly during the 1980s, even before the Aquino assassination, the cutoff of external funding, and the adjustment program. Although foreign borrowing pumped the economy up, it failed to establish self-sustaining growth. At the same time, the excesses of the Marcos government weakened the private business sector, leaving the country vulnerable to the shocks of the 1980s.

8.2 Debt Buildup

Ironically, the Philippines began the 1970s with debt rescheduling and an IMF-sponsored stabilization program, the product of fiscal expansion and short-term borrowing during Marcos's first administration. The early 1970s was a period of economic recovery, aided by rising world commodity prices. But the political environment deteriorated at the same time, with increasing protests, kidnappings, and other violence. To restore order, and to prolong his own hold on office beyond the constitutional limit, Marcos declared martial law in September 1972.

Although security threats, some real and some faked, provided the rationale for declaring martial law, the justification for maintaining it quickly became the promise of higher economic growth and greater equality. Marcos initiated a series of reforms, including land reform, and launched a greatly expanded public development investment program. Between 1972 and 1976 public-sector fixed investment rose from 2 percent of GNP to 6.5 percent of GNP. Private investment also grew in this period, as total gross domestic capital formation rose from 22 to 31 percent of GNP (see table 8.1).

Although the oil price shock of 1974 and the subsequent fall in world commodity prices hit the Philippines severely, policymakers maintained their investment strategy. There was ready external financing. The United States supported the Marcos government, and aid flows increased sharply after martial law. The country also began to tap multilateral lending sources, and funds were available from commercial banks. For the remainder of the decade the Philippines maintained a domestic growth rate of 6.5 percent per year, and a current account deficit of about 5 percent of GNP.

Table 8.1 **Philippine Macroeconomic Indicators (percentage of GNP)**

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Real GNP (% change)	5.4	9.3	5.6	5.8	7.4	6.3	5.8	6.9	5.0	3.4	1.9	1.1	−6.8	−3.8	1.5
Investment share GNP	21.6	21.9	26.7	30.6	31.3	29.0	29.1	31.0	30.7	30.7	28.8	27.5	19.2	16.3	14.0
government fixed investment	2.1	2.3	3.4	4.3	6.6	6.9	7.2	7.3	6.9	8.0	7.2	6.1	4.1	3.7	n.a.
National Government budget															
Expenditure	14.4	14.3	11.7	16.0	15.2	14.9	14.8	13.7	14.4	15.8	15.7	14.0	12.7	13.5	17.8
Revenue	12.5	13.2	12.2	14.7	13.5	13.0	13.6	13.5	13.1	11.8	11.4	12.0	10.8	11.6	13.1
Surplus/(deficit)	−2.0	−1.2	0.5	−1.2	−1.8	−1.9	−1.2	−0.2	−1.3	−4.0	−4.3	−2.0	−1.9	−1.9	−4.7
Current account balance	0.1	5.0	−1.2	−5.6	−5.8	−3.6	−4.6	−5.1	−5.4	−5.4	−8.1	−8.1	−3.5	−0.2	3.3
M1 (% change)	24.9	12.3	24.0	14.5	17.1	23.7	13.4	11.2	19.6	4.4	−0.1	38.3	3.5	6.5	19.2
Inflation rate (CPI)	16.6	16.5	34.2	6.8	9.2	9.9	7.3	16.5	17.6	12.4	10.4	10.0	50.3	24.9	0.7

n.a. = not available.

With the rise in the current account deficit the country's foreign debt grew rapidly, nearly tripling between 1974 and 1978 (table 8.2). The public sector did most of the borrowing, and held over 70 percent of the foreign debt of the nonbanking sector by the end of the decade. The Philippines borrowed increasingly from banks, and in the form of loans with floating interest rates. But this was true of all LDC borrowers during the 1970s, and the shifts towards commercial terms and floating rates were less pronounced in the Philippines than in most borrowers. The country's policymakers managed the debt carefully during the 1970s, lengthening maturities, and refinancing when better terms were available. As a result, the debt service ratio (interest and amortization payments as a percentage of exports) increased only slightly, reaching 21 percent by 1980.

In a shift of policy from that of previous postwar governments, the Marcos administration actively encouraged foreign direct investment. But even though direct investment inflows increased sharply after 1972, they played a minor role in total external finance, averaging only 8.6 percent of external borrowing during the 1970s.

In the other direction, capital outflow by Philippine residents, or capital flight, has long been a feature of the economy. A comparison of the total inflow of funds with the financing needs for the current account deficit and reserve accumulation indicates an outflow of about $3.6 billion from 1971 to 1980, or roughly one-third of the increase in total external indebtedness.[1] Capital flight in the Philippines was not nearly so large as in Argentina or Mexico, but was much larger than in Korea or Brazil. Thus foreign direct investment did not add appreciably to the inflow of capital, while capital flight was a substantial drain.

Still, at the end of the 1970s the Philippines was hardly a problem debtor. The country had significantly increased its external indebtedness, but had also raised its export and GNP growth rates. At the end of 1979, the Philippines had a debt/GNP ratio comparable to that of Korea. Its debt service ratio was higher, but was well below that of most Latin American borrowers.

The Philippine economic situation deteriorated rapidly after the second oil price shock in 1980. The government tried to counter the growing domestic recession by raising expenditure, and announced an ambitious program of energy and industrial investment. As a result, the public sector deficit rose sharply, from 2 percent of GNP to 5.5 percent, and the current account deficit widened to 8 percent of GNP (table 8.1, and table 8.5 below).

In contrast to neighboring countries, and to its own experience after the first oil shock, the Philippine economy did not recover under the impetus of increased investment spending. Growth rates dropped each year after 1979 (table 8.1, and table 8.10 below). The dollar value of

Table 8.2 Philippine External Debt (millions of US $)

	1970	1974	1978	1980	1982	1983	1984	1985	1986
Total external debt	2,297	3,755	10,694	17,252	24,677	24,816	25,418	26,252	28,186
Nonmonetary debt	2,088	2,726	8,189	12,318	17,601	19,468	20,211	21,270	25,598
Medium- and long-term	1,779	2,395	6,932	9,770	13,141	15,412	15,926	17,679	22,808
Short-term	309	331	1,257	2,548	4,460	4,056	4,285	3,591	2,790
Monetary sector debt	159	1,029	2,505	4,934	7,076	5,348	5,207	4,982	2,588
Memorandum items									
Debt/GNP (percent)	33.2	25.5	44.5	49.0	62.8	72.7	80.6	82.2	95.2
Debt/exports goods, services	174	106	218	215	308	305	317	332	32.8
Debt service ratio total external debt[a]	29.2	14.6	20.1	20.8	38.1	38.2	43.5	33[b]	33[b]
Short-term as % of total external debt	22.6	36.2	35.2	43.4	46.7	37.9	37.3	32.7	19.1

Sources: Philippine Central Bank, Management of External Debt and Investment Accounts Department (MEDIAD), and Central Bank, Financial Plan Data Center. Unpublished data.

[a]Total interest payments plus amortization of medium- and long-term debt as percentage of exports of goods and services.

[b]After rescheduling.

Philippine exports hit a peak in 1980, and then fell at an average rate of almost 5 percent per year through 1983, the result not only of weak international prices, but also falling commodity export volumes.[2] Slower domestic growth and higher world real interest rates severely affected major domestic firms, many of them highly leveraged. A domestic financial crisis in 1981 brought about the failure of several large firms, many of which were bailed out by the government. Industrial failures continued to proliferate, leaving the Philippine government, and particularly the two major state banks, with nonperforming assets with a book value in the billions of dollars.

Philippine external borrowing accelerated in the early 1980s, and total foreign debt nearly doubled between 1979 and 1982. Borrowing increased under the pressure of a swollen current account deficit, but capital flight also accelerated sharply in the early 1980s, averaging 4.8 percent of GNP in 1981 and 1982. Net foreign direct investment inflows slowed to a trickle, as growing disinvestment offset direct investment inflows.

The cautious borrowing policy of the 1970s disappeared in the early 1980s. The most abrupt change was the increasing use of short-term borrowing. This was particularly true of the public sector, which accounted for two-thirds of the increase in short-term debt outside the monetary sector.[3] Much of the increased borrowing was also done through the monetary sector. The Central Bank borrowed heavily between 1980 and 1982, and encouraged banks to do so by providing swap arrangements.[4] Despite its borrowing, Central Bank reserves fell by $2 billion (two-thirds) from the end of 1980 to mid-1983.[5] As a result, the monetary sector went from a net external asset position at the end of 1979, to a $2.7 billion net liability position by 1982. By 1982 the share of short-term debt, including monetary sector debt, in total debt rose to 47 percent, a much higher share than in other LDC debtors. The Philippines first considered declaring a moratorium in late 1982. When it finally did so in October 1983, its foreign exchange reserves were nearly exhausted.

8.3 The Role of External Shocks

The Philippines's real income position, and its ability to sustain its level of foreign indebtedness, were diminished by the two oil price shocks and the accompanying industrial country recessions. The commodity price increases of 1973 and 1974 temporarily raised Philippine incomes, but between 1972 and 1976 the terms of trade fell by 22 percent, equivalent to an income loss of 4.3 percent of GNP.[6]

The second oil price shock period, 1979 to 1982, had a much more severe effect. The income loss from the change in the terms of trade was larger, equivalent to 6.9 percent of GNP. This time, the terms of trade deterioration was coupled with a rise in real interest rates of almost 12 percentage points, adding another 3.5 percent of GNP to the income loss.[7] Thus the external shock totaled about 10 percent of GNP, which was among the largest for major LDC debtors.

The Philippines faced an additional external problem not shared by other debtors. The terms of trade deterioration was not just a product of the two shock periods, but was more secular in nature. Between 1967 and 1979 (the predebt shock peak), Philippine terms of trade fell by 35 percent. The deterioration was quite steady, interrupted only in 1973–74, and 1977–79; even at the 1974 commodity price peak, Philippine terms of trade were below their 1970 level. It is of course difficult to say what was anticipated and what was unexpected about these movements in the terms of trade, but the required adjustments for the Philippine economy were large.

8.4 Philippine Policy and the Debt Crisis

The Philippines was hit more severely by external shocks than most debtor countries. Yet at the same time, the debt crisis that occurred in the Philippines was not simply a result of the second oil price shock and the rise in world real interest rates. The Philippines had developed a borrowing momentum that could not be sustained, and the country would have eventually come to an external crisis even if the shocks of the 1980s had not been there to hurry the process along.

There were two fundamental economic difficulties. First, the Philippines failed to develop self-sustaining growth that would have eased the burden of servicing its external debt. Second, the country failed to shift resources towards the traded goods sector, as was required both by its increasing debt burden and by its declining terms of trade. In more concrete terms, the problems were poor returns from investments, difficulties in mobilizing domestic resources to fund investment, and the maintenance of a trade regime that did not sufficiently encourage exports. In addition, the Marcos government created a political-economic environment that discouraged independent investment, led to capital flight, and eventually crippled much of the productive economy.

8.4.1 Investment

The post-1974 period in the Philippines has been described as one of "debt-driven" growth. Indeed, the economy depended on expanding investment to generate Keynesian output growth. Of the total increment in GDP in the rapid growth period 1974–79, 42 percent came from increased investment expenditure, 28 percent from construction expenditure alone.[8] Despite the rapid rise in investment, and the apparently high levels of capital formation, the Philippines was not successful in translating these additions to the capital stock into economic growth.[9] In comparison to neighboring countries, the Philippines invested more to grow less, and as table 8.3 indicates, this was particularly true during the martial law period. The situation had become much worse by the early 1980s; between 1980 and 1983 the share of investment in GDP averaged over 29 percent, but GDP grew by only 2.6 percent per year.

There is no single explanation for the low return on investment expenditures. In part this was due to a shift towards infrastructure investments with longer gestation and payout periods. The expansion of investment had a particularly large construction component, much of it in public or quasi-public facilities: luxury hotels, cultural centers, and some of the notorious projects of Imelda Marcos such as the villa built entirely of coconut products or the University of Life.

Other investments were hurt by changes in world demand and prices. These include major investments in copper refining, sugar mills, and arguably, the nuclear power plant that the Philippines built.

But more fundamental causes were involved. In the latter half of the 1970s, investment and output growth shifted towards capital-intensive industries, particularly intermediate goods, industries which by definition required large investments per unit of output. This shift was the result of the high degree of tariff protection given to the domestic manufacturing industry coupled with the rapid growth of construction and other investment expenditures. Capital-intensive industries, and capital-intensive methods within industries, were encouraged by an industrial incentive system that greatly cheapened capital, by low real interest rates in the 1970s, and by credit rationing that channeled low

Table 8.3 **Comparative Investment/Growth Rates**

	Investment Rate[a]		GDP Growth Rate		Ratio (ICOR[b])	
	1967–72	1974–80	1967–72	1974–80	1967–72	1974–80
Philippines	20.5	29.5	5.27	6.46	3.88	4.57
Indonesia	12.8	20.0	8.20	7.42	1.56	2.70
Malaysia	18.2	25.8	n.a.	7.26	n.a.	3.55
Thailand	24.3	26.1	6.46	7.48	3.77	3.48
Korea	25.2	29.8	10.0	7.67	2.53	3.89

Sources: Philippines: National Economic and Development Authority (NEDA), *The national income accounts CY 1946–75,* National income series no. 5 (Manila: NEDA, 1978); and *Philippine statistical yearbook 1987.* Others: IMF International Financial Statistics.

[a]Gross domestic capital formation as percentage of GDP.

[b]Incremental capital-output ratio.

n.a. = not available.

cost funds to approved investments. The rapid growth of these industries was responsible for much of the low output response and low employment generation of investment in the Philippines, and for the apparent fall in manufacturing productivity over the decade.[10] And, limited by their high cost to the domestic market, these industries suffered when the investment and construction boom faded in the 1980s.

Favoritism in allocation of loans and government projects and profit skimming on imported capital equipment also reduced the profitability of investment. The Philippines paid more for imported capital equipment than other LDCs, and stories of kickbacks paid by equipment suppliers have begun to emerge.[11] In many of these projects the returns were made simply by the project going forward, and not by the profitable operation of the resulting installation.

The investments made in the 1970s proved particularly vulnerable to the economic slowdown and higher interest rates of the 1980s. Many of the investments ended up in receivership, in the hands of the two state banks and the National Development Company. These nonperforming assets, and their accompanying debt service obligations, form the most difficult fiscal problem the new government faces.

8.4.2 Resource Mobilization

The second weakness of Philippine economic policy was the continued dependence on foreign borrowing to fund domestic investment. To maintain economic growth in the face of external recession, the Philippines increased government expenditure and borrowed abroad in 1975. But the current account deficit never narrowed, and was still about 5 percent of GNP in 1979. By 1982, after the second oil shock, the deficit had risen to over 8 percent of GNP. The current account has both a macroeconomic side, and a microeconomic/resource-allocation side. We discuss the first here, the inability to generate sufficient domestic resources to fund the higher level of investment.

Table 8.4 breaks down investment and savings into public and private components. Private savings rose briefly during the mid-1970s as the economic growth rate accelerated, but trailed off by the end of the decade, leaving a private-sector gap of about 2 percent of GNP.

Public-sector revenue generation might have had the most promise, since the level of taxation in the Philippines has historically been very low in comparison to other LDCs. And, shortly after martial law was declared, there was a significant increase in the national government's revenue share of GNP, due to increased tax compliance, as well as premium duties levied on international trade. However, despite repeated commitments to raise government revenue, and a series of annual tax measures, the revenue share remained about 13 percent for the rest of the decade.[12] The Philippines ran hard just to stay in place.

Table 8.4 Savings/Investment Balances (percentage of GNP)

	1976	1978	1980	1982	1983	1984	1985
Private sector							
Investment	24.73	21.88	23.73	21.61	21.43	15.05	12.57
Savings	23.56	20.77	20.75	18.02	16.57	12.33	13.95
Personal	10.88	8.44	5.98	3.25	1.97	−0.80	−0.53
Corporate[a]	3.09	2.87	5.49	4.44	4.27	2.67	3.50
Depreciation[b]	9.59	9.47	9.28	10.33	10.33	10.46	10.98
Surplus (deficit)	−1.17	−1.12	−2.99	−3.59	−4.87	−2.72	1.38
Public sector							
Investment	6.56	7.20	6.94	7.16	6.09	4.11	3.69
Savings	1.82	3.93	4.98	3.20	4.00	4.02	3.37
Surplus (deficit)	−4.73	−3.27	−1.96	−3.96	−2.09	−0.08	−0.33
Net foreign resources/ current account	5.90	4.31	4.95	7.55	6.96	2.75	−1.05

Source: Philippines, NEDA, National Accounts section.
[a]Includes saving by government-owned corporations.
[b]Includes statistical discrepancy.

The country depended heavily on indirect taxes and taxes on international trade, taxes which had low elasticity. Some of the rise in the revenue share had been transitory, particularly additional export taxes levied on windfall prices that disappeared after 1975. Finally, the government eroded the corporate tax base during the decade by granting a large number of incentives and exemptions. The Marcos government, which needed to solidify its position by granting tax exemptions, was not strong enough politically to increase overall tax rates and collections.

The domestic recession lowered the government's tax collections in the early 1980s. In addition, changes in the way taxes were calculated reduced income tax collections, as did increasing evasion. As a result, the share of national government revenue in GNP fell by 2 percent between 1979 and 1982. This occurred at the same time that the national government and publicly owned corporations increased their investment to offset the recession, and the consolidated public-sector deficit rose sharply to over 5 percent of GNP by 1982 (table 8.5). Private savings slumped in 1982, the product of falling per capita income and expectations of a future exchange rate depreciation. So in spite of a fall in private-sector investment, the resource gap of the private sector also increased.

8.4.3 Trade Policy and Exchange Regime

As described above, the two oil price shocks were dramatic episodes in what has been a pronounced secular deterioration in the Philippine terms of trade. At the same time, the debt service obligations of the Philippines steadily rose as a result of the increased use of foreign

Table 8.5 Public-Sector Balances (percentage of GNP)

	1980	1981	1982	1983	1984	1985	1986
National government							
Revenue	13.1	11.8	11.4	12.0	10.8	11.6	13.0
Expenditure	14.4	15.8	15.7	14.0	12.7	13.5	17.6
Current	9.3	8.7	9.2	9.1	8.1	9.3	10.9
Capital	5.1	7.1	6.4	4.9	4.5	4.2	6.7
equity, net lending	2.0	3.0	3.5	2.1	2.7	2.7	4.5
Surplus (deficit)	−1.3	−4.0	−4.3	−2.0	−1.9	−1.9	−4.6
Local government							
Surplus (deficit)	0.0	0.1	0.1	0.1	0.0	0.0	0.0
Social security							
Surplus (deficit)	0.8	0.8	0.9	0.8	0.6	0.8	0.8
Government corporations							
Investment	4.5	5.4	5.0	4.9	3.1	2.7	1.5[b]
Cash generation	0.1	0.0	−0.1	0.7	0.5	0.7	0.0[b]
Transfers from national government	2.0	2.8	3.0	2.1	1.1	0.9	1.9[b]
Surplus (deficit)[a]	−2.5	−2.7	−2.1	−2.1	−1.5	−1.1	0.9[b]
Consolidated non-financial public Sector							
Investment	8.2	10.4	9.0	8.2	6.9	6.6	n.a.
Surplus (deficit)	−3.0	−5.7	−5.4	−3.2	−2.8	−2.2	−3.7

[a]After transfers from the national government.
[b]Figures for 1986 refer to 14 major nonfinancial government corporations.
n.a. = not available.

capital. Both of these required a shift in Philippine productive resources towards traded goods industries. This did not occur during the period leading up to the debt crisis. Despite the rapid growth in nontraditional manufactures exports, and the transformation in the Philippine export mix, the share of exports in total output increased only modestly and arguably fell on a net basis.

Relative price movements signal resource shifts, and table 8.6 presents several measures relevant to the traded goods sector in the Philippines. Despite some variation, the price measures tell much the same story. The real depreciation that took place during the 1970 stabilization program was sustained until the middle of the decade. After that point there was a gradual but persistent fall in the relative price of tradable goods and a decline in Philippine export competitiveness. This is most clearly seen in the relative price of tradable to nontradable goods, which declined by about 9 percent from its level at the beginning of the decade. The real exchange rate (Philippine prices relative to those of its trading partners) varies over a wider range, but shows a decline from the mid-1970s.[13] The one competitiveness measure that shows a continued improvement is the real wage rate, which was an important factor in

Table 8.6 Philippines Relative Price Indexes

	(1) PTraded/ PNonTraded	(2) REER	(3) Terms of Trade	(4) PExports/ PGDP	(5) Manufacturing Real Wage
1967	85	73	127	94	
1968	88	73	123	95	108
1969	92	74	121	90	107
1970	97	109	119	118	103
1971	100	107	111	109	105
1972	100	100	100	100	100
1973	110	108	113	125	87
1974	115	96	115	159	77
1975	112	104	88	125	86
1976	107	102	78	102	81
1977	105	101	71	95	86
1978	102	108	79	98	85
1979	101	101	87	105	85
1980	97	99	69	96	91
1981	93	96	60	90	n.a.
1982	91	91	59	74	n.a.
1983	93	109	61	91	n.a.
1984	103	109	60	101	n.a.
1985	101	96	56	83	n.a.
1986	93	117	65	87	n.a.

Notes:

1. Traded goods prices are a weighted average of gross value-added (GVA) deflators for agriculture and forestry, mining, and tradable manufactures. Nontraded prices are a weighted average of GVA deflators for construction, electricity and gas, and services. Weights are 1972 value addeds.
2. Dollar wholesale prices in major Philippine markets divided by dollar prices in the Philippines. Markets are the United States, Japan, Germany, the Netherlands, and Korea. An increase in the index is a real depreciation.
3. Export unit value divided by import unit value.
4. GVA deflators from national accounts.
5. Basic manufacturing wage divided by GDP deflator. Wage series discontinued in 1981.

n.a. = not available.

the growth of manufactures exports from the Philippines during the decade.

Philippine trade and industrial performance have been determined by a system of protection initiated in 1950. To deal with external imbalance, the Philippine government began licensing imports, in amounts determined by essentiality of the product. The incentives created for domestic production of these goods led to rapid industrialization and growth during much of the decade, but the growth rate had slowed appreciably by 1959.

The Philippines carried out a liberalization program in 1960–62, depreciating the exchange rate and removing import controls. However the intention was never to alter the protective system, and tariffs were raised to counteract the effect of ending import licensing. The liberalization did not succeed in producing more rapid growth, nor in developing manufactures exports. Modest import controls were reintroduced at the end of the 1960s as the balance of payments worsened, and were extended further during the 1970s.

The disappointing economic performance of the 1960s blunted the challenge to the structure of import protection. Policy turned toward industrial promotion through incentives legislation (1967) and narrow export promotion through investment incentives and duty free imported inputs (1970.) As a result, three streams of trade policy developed in the 1970s. First, import-substituting manufacturing continued to have heavy tariff protection. This was supplemented with non-tariff barriers and industrial incentives in the latter part of the decade.

Second, manufactures exports, especially apparel, footwear, and electronic components, grew rapidly in the 1970s under the impetus of the 1970 depreciation, falling real wages, and duty free imports of materials. However no provision was made to compensate exporters for the high cost of domestic procurement. As a result almost all inputs were imported, margins of domestic value added were very thin, and export growth was heavily dependent on export processing zones and bonded warehouses.

Third, the Philippines increased the taxation of traditional export commodities, particularly agricultural commodities. Temporary export taxes were introduced after the devaluation in 1970, but were later made permanent, and supplemented with windfall duties in 1974. The two most important export crops, coconuts and sugar, were monopolized under government sanction, and a substantial levy was placed on coconut (copra) producers.[14] As a result of the increasing effective taxation, traditional exports stagnated during the 1970s and then fell during the early 1980s.

Philippine export performance is highly mixed. Nontraditional manufactures exports grew rapidly, and increased their share of total exports from 6 percent in 1970 to 60 percent by 1980. But the overall growth of exports was insufficient given the high investment, high foreign-borrowing strategy the country pursued. The share of merchandise exports in GDP was nearly the same at the end of the decade as it was at the beginning (table 8.7.) This was in sharp contrast to neighboring countries, where significant increases in exports took place.

Furthermore, the export/GDP share overstates the Philippine position. The very rapid growth of nontraditional exports shifted the structure of Philippine exports towards goods with higher import requirements

Table 8.7 **Export Shares in GDP**

	1970	1974	1976	1978	1980	1982	1984
Percentage shares merchandise exports to GDP							
Philippines	15.1	18.6	14.2	14.2	16.4	12.6	16.7
Malaysia	41.3	43.8	47.5	46.7	54.0	44.6	48.3
Thailand	10.5	18.1	17.9	17.5	19.3	18.6	20.2
Philippines memo items							
Exports net of consignment imports	15.1	17.7	12.6	12.4	14.0	10.3	12.5
Service exports[a]	2.6	3.5	3.0	4.6	4.7	5.9	6.3

Sources: Philippines: Central Bank, *Annual report: Statistical bulletin,* 1985, table 6.55, and unpublished balance-of-payments data. Others: Asian Development Bank, *Key Indicators of Developing Member Countries,* 1986.

[a]Net of interest receipts and U.S. base rental.

and lower domestic value added. The result was to increase the import component of the country's exports, lowering the net foreign exchange generation of the traded goods sector. A rough correction for this effect is shown in table 8.7 where consignment imports for the garment and semiconductor industries are netted out of Philippine exports. The result is a narrowing export/GDP ratio over the decade.[15]

The structure of protection bears much of the responsibility for the slow rate of output growth and low returns on investment described above, as well as the insufficient growth of exports. Despite the rapid growth of labor-intensive exports, Philippine manufacturing remained capital intensive, with low productivity growth *and* low employment generation.[16] What the Philippines did in the 1970s, through investment incentives and import protection, amounted in fact to a strategy of secondary import substitution concentrating on intermediate goods. This strategy saw some success, particularly under the impetus of increased domestic investment and construction, but by 1978 had reached its zenith. The manufacturing growth rate declined continuously starting in that year, and the industries promoted in the 1970s suffered huge output declines in the 1980s (table 8.8).

The major break in trade policy came in 1981, when the Philippines started an import decontrol and tariff reduction program under a World Bank Structural Adjustment Loan. This came at a time when what the Philippines desperately needed was a substantial devaluation and expenditure reduction. The program was soon superceded by import controls adopted during the crisis in 1983, although it reduced revenue collections, and probably increased the output declines that took place in domestic manufacturing.

Table 8.8 **Real GDP by Industrial Origin (percentage change)**

	1983–85	1986
GDP market prices	−9.6	1.1
Agriculture	5.6	3.7
Industry	−19.9	−2.7
Mining	−10.1	−11.9
Manufacturing	−14.2	0.8
Construction	−44.8	−20.6
Services	−9.8	2.3
Total manufacturing	−14.2	0.8
Misc. manufactures	32.0	0.2
Basic metals	13.8	−4.9
Publishing	7.3	10.5
Beverages	3.7	−7.9
Leather	1.5	−11.6
Footwear	−0.5	13.6
Electrical machinery	−4.0	19.6
Food	−6.9	0.9
Rubber	−13.0	3.2
Tobacco	−15.5	−23.0
Petroleum products	−17.2	0.3
Furniture	−23.2	10.1
Wood and cork	−23.9	−27.6
Paper	−26.0	8.9
Chemicals	−26.7	−7.0
Textiles	−29.5	21.4
Nonmetal minerals	−35.3	0.5
Metal products	−35.5	−2.8
Nonelectrical machinery	−50.1	4.9
Transport equipment	−81.9	−4.4

Source: Philippines, NEDA, "The national income accounts of the Philippines," mimeo (August 1987).

8.4.4 The Martial Law Business Environment: "Crony Capitalism"

The last contributor to the debt crisis in the Philippines was a more general change in the business environment that occurred under martial law. The change had its roots in the Philippine political system, and the challenge that martial law presented.

Politics in the Philippines has traditionally been dominated by a group of wealthy families, who exercised political control in local areas and competed among themselves for the presidency. Although from a well-to-do family, Marcos was not really of this group. When Marcos declared martial law in 1972, suspended the Constitution, and dissolved Congress, he put himself directly in opposition to the traditional oligarchs. In order to solidify the position of the martial law regime Marcos did two things. The first was to centralize political power and government functions in the national government in Manila, and greatly expand the national government and military role. The second response was to create a countervailing elite: his own family, his wife's, and a group of Marcos associates, or, as they were called, cronies.

To do so, Marcos used the power of the state to dispense and accumulate wealth. Public works contracts, government procurement, industrial incentives, and inexpensive credit were all channeled to Marcos supporters, including the military, to cement loyalty, and through kickbacks, to enrich Marcos himself. None of this, except the inclusion of the military, was unusual in Philippine politics; "What are we here for?" asked one former Philippine president when questioned about graft in his administration. What was unusual was the scale on which this took place under martial law. This was made possible by the greatly expanded level of public investment in the 1970s, financed by foreign borrowing. It was also supported by the preference of external creditors for public guarantees, which further concentrated the flow of financial resources through the state.

But Marcos's use of state power went beyond simple graft. The most important part of the wealth accumulation was done through the creation of monopolies, either through direct intervention to control an industry, or through the grant of exemptions or exclusive privileges to favored individuals. The government intervened directly in food marketing, the fertilizer industry, labor export, gambling, and, through the Cultural Center of the Philippines, in pornographic film distribution. Monopolies were created in the two most important export crops, sugar and coconuts. Run by two Marcos cronies, these generated billions of pesos of revenue. In addition, presidential decrees gave tariff and tax exemptions or exclusive import rights to particular firms, granting effective monopolies. Among the industries affected were livestock and television imports, peroxide, sugar milling equipment, and cigarette filter production.

Outright expropriation was done only at the outset of martial law. Later, less visible pressure was brought to bear on profitable firms to sell out to Marcos family members, or to cronies. The cronies built business empires, based on very high financial leveraging. They were willing to take large financial risks due to their implicit government backing, an assumption that proved correct in the 1980s when the government rescued many crony firms.

These actions took a significant toll on the behavior of the private sector not associated with the Marcos government. Businessmen became less willing to invest and expand in the Philippines for fear of attracting attention, and instead moved their money outside the country. In order to protect themselves from the cronies and from their own government, firms invited foreign joint venture participation, reasoning that Marcos or his associates would be reluctant to move against a firm with foreign ownership. Political opposition among the business class began to surface in 1980, grew after the corporate bailouts of 1981, and became widespread after the Aquino assassination.

By the end of the 1970s, corruption in the Philippines was large enough to have macroeconomic consequences. The effects went beyond the drain of funds through corruption. Increasing government interventions, monopolization, and grants of exclusive privilege sapped the efficiency of the economy, lowered the profitability of investments that were undertaken, and increased the vulnerability of the Philippines to the financial crises of the early 1980s. Crony capitalism provides much of the explanation for the deterioration of economic growth and asset portfolios in the 1980s, and was the first thing that the new Aquino government sought to diminish.

Power and wealth were mixed motives for Marcos's actions from the beginning. Furthermore, there were some successes of the martial law administration; not all of its actions can be characterized as plunder and theft. But, in the latter part of the 1970s the balance began to tilt, and the accumulation of wealth became the predominant motive. And this in turn severely limited the willingness and ability of the government to react to the approaching economic crisis.

8.4.5 Crisis and Adjustment

The Marcos government first tried to counter the domestic recession, but it came under increasing pressure from its external creditors, including the IMF and World Bank, from its own statutory limitation on external debt, and from its increasing difficulty in generating counterpart funds to match foreign project inflows. The Philippines changed its policy course during 1982, cutting national government expenditure and dramatically slowing the growth of the money supply. But by this time the drain on reserves and the drying up of short-term capital had already begun, and the moratorium, finally declared on 15 October 1983, had become inevitable.

Three things had a critical effect on the adjustment period that followed. First, the Philippines had almost exhausted its foreign exchange reserves when the moratorium was declared. The severe liquidity constraint decisively influenced the trade and exchange rate policy the country adopted during the crisis. The second factor was a massive increase in base money that occurred in the last half of 1983, which largely accommodated the devaluations that took place in June and October.[17] By the beginning of 1984 the inflation rate was over 60 percent. The final factor was the almost complete dissembling of the portfolios of the state-owned financial institutions. By 1984 and 1985, government aid to these institutions absorbed almost 2 percent of GNP.

Under pressure from the severe shortage of foreign exchange, the Philippine government reverted to trade and exchange rate policy which had characterized much of the postwar period. Banks were required to surrender foreign exchange holdings to the Central Bank, which in turn allocated the supply to priority uses. Taxes on traditional exports were raised, and the fall in their export volume continued. The government effectively created a multiple exchange rate system by allowing importers to obtain foreign currency on the black market. This greatly increased the import premium, and meant a continuing shortage of foreign exchange at the Central Bank, even for priority allocations. Non-traditional manufactures exports increased, but not by enough to prevent an overall decline in export volumes. The current account deficit was reduced, but this was brought about by a dramatic fall in imports, particularly capital goods imports.

Under IMF pressure, the Philippines devalued further in 1984, reduced export taxes, and abandoned the exchange surrender requirement, unifying the exchange rate. But the Fund was further concerned with inflation, and the huge growth in the money supply that had taken place. In a highly unusual step, the IMF demanded a reduction in the *level* of the money supply as a precondition for an agreement, and the program that the Philippines and the Fund finally agreed on had stringent monetary growth restrictions. The Central Bank met the precondition, and met most of the monetary targets, primarily through the sale of Central Bank bills, with interest rates at times over 40 percent.

Evaluating monetary policy during this period is difficult. Reported interest rates lagged behind the inflation rate, so that real interest rates only turned positive in 1985. However, the real money supply fell by 30 percent during 1984, to the lowest level of the decade. In addition, there was a decisive shift of what bank credit there was to the public sector; real credit to the private sector fell by 49 percent between 1983 and 1985.

The program was highly successful at meeting the external targets and in reducing the rate of inflation. The Philippines eliminated all payments arrears by the end of 1985, and had virtually eliminated the current account deficit. The noninterest current account balance increased by nearly 10 percent of GNP in a three-year period (table 8.9).

The inflation rate fell as rapidly as it had risen. Although six-month changes in the CPI remained at rates above 50 percent for all of 1984, by May 1985 the inflation rate was below 10 percent per year. For all of 1985 (December–December) the rate was below 6 percent, the lowest since the 1960s, and prices actually declined slightly in 1986.

Table 8.9 **Philippine Noninterest Current Account ($ million)**

	1982	1983	1984	1985	1986
Balance	−1575	−1139	741	1875	1892
% of GNP	−4.0	−3.3	2.4	5.9	6.4

Source: Philippine Central Bank.

The output cost of the stabilization was high. Per capita incomes fell by 15 percent from 1983 to 1985, with a further 3 percent fall in 1986. Total investment expenditure fell by 50 percent. The manufacturing sector was particularly hard hit, with the largest losses posted by the industries that had been protected during the 1970s (see table 8.8). The credit squeeze had a drastic effect, forcing many firms to the wall. It was this reduction of output and the attendant compression of imports that was responsible for achieving external balance so quickly. Over the course of the program there was little change in the balance of incentives for traded goods, and a 4 percent reduction in the volume of exports.

A substantial output cost was also paid for reducing inflation so quickly, and the emphasis in the IMF program on reducing monetary growth appears misplaced. Reducing inflation in the Philippines has never been as difficult as in many Latin American countries, for the Philippines lacks the institutional features that give inflation momentum. Unionization is very low, and indexation virtually absent. The Philippines has repeatedly exhibited substantial real wage declines after devaluations and the same occurred between 1983 and 1986. But the credit stringency that was imposed by the monetary policy, and the shift in credit towards the public sector to support the losses of the two state banks, had a severe effect on domestic business and financial institutions. The Philippines has been traumatized by six years of financial upheaval, and it will take some time to restore confidence.

Despite the high output cost, the Philippines did achieve a successful and rapid stabilization between 1983 and 1985, and the new government started with the considerable advantage that those stabilization costs had already been paid. Arguably, the program was instrumental in bringing about the change in government, and the end to the abuses of the crony period. And yet, stabilization has not been the real problem for the Philippines; the Philippine economy is relatively easy to stabilize. It is the achievement of sustained economic growth that has proved more elusive, and the problems here are more microeconomic and resource allocational than they are macroeconomic in nature.

In the end, the Philippine debt crisis is largely a microeconomic story. Foreign debt and the domestic investment it funded were used to mask the problems of a sluggish and overprotected manufacturing sector, increasing taxation of agricultural exports, and the vitiation of the domestic economy through cronyism. It is true that the second oil shock and the following interest rate shock accelerated the Philippine crisis. In addition, Philippine policymakers made their own problems worse by failing to respond to the external shock, by betting heavily against devaluation through the issuance of swap and forward contracts, and by waiting so long to declare a moratorium. But the fundamental difficulties would not have been avoided through a more favorable external environment or better short-run macro management. By failing to make fundamental resource allocation adjustments when external financing was available, the Philippines made its problems far more difficult in the 1980s.

8.5 The Aquino Government

The popular revulsion against the excesses of the Marcos administration has placed the Aquino government in a unique position. The new government has dismantled the monopolies in coconuts and sugar, and has committed itself to less market interference and equal application of the law. While it is unrealistic to suppose that corruption will disappear from Philippine political life, it is likely to be drastically reduced in scale; Mrs. Aquino has already dismissed two cabinet members for graft, despite their close association with her husband. The government has also enacted a comprehensive tax reform that reduces exceptions and will increase the responsiveness of the tax system.

The Aquino government faces the problem that has plagued the Philippines since independence: how to achieve self-sustaining output, wage, and employment growth. The new government has continued the trade liberalization program that was interrupted by the debt crisis, although against heavy domestic opposition. And it has encouraged activity in the rural sector and reduced the discrimination against traditional export goods.

But the world economy is far less hospitable than it was in the 1960s and 1970s, and the debt accumulation and array of nonperforming assets are a heavy burden of the past. Economic recovery and growth in the Philippines will require a high degree of political determination, as well as a fraction of the external funds that were available to build the martial law regime.

Appendix

Table 8.10 Real GNP by Expenditure Shares and by Industrial Origin (percentage changes)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Personal consumption	5.8	4.9	4.8	5.0	5.3	5.2	4.8	4.5	4.0	3.1	2.9	1.0	0.2	0.9
Government consumption	11.8	14.7	7.7	2.1	0.9	3.0	3.7	3.7	3.7	6.4	−3.9	−6.1	−0.6	4.2
Gross domestic investment	10.9	22.9	23.5	15.4	−0.1	8.6	11.2	4.4	2.3	−3.5	−4.7	−36.7	−20.7	−8.3
Fixed investment	3.4	19.2	31.6	15.0	1.9	8.4	11.7	6.9	3.5	0.6	−2.8	−28.1	−23.1	−14.8
Exports	14.2	−10.7	1.5	18.6	16.5	3.8	6.8	13.4	1.2	−2.6	6.9	11.6	−7.2	21.8
Less: imports	4.0	16.3	6.2	1.0	6.4	12.9	16.4	3.3	−2.7	3.5	−1.6	−5.3	−23.0	25.4
GDP	8.5	5.0	6.4	8.0	6.1	5.5	6.3	5.2	3.9	2.9	0.9	−5.7	−4.0	1.1
GNP	9.3	5.6	5.8	7.4	6.3	5.8	6.9	5.0	3.4	1.9	1.1	−6.8	−3.8	1.5
GDP by industrial origin														
Agriculture	6.1	2.6	4.3	8.0	5.0	4.1	4.5	4.7	4.0	3.1	−2.1	2.3	3.2	3.7
Industry	12.4	5.6	8.7	10.4	8.4	6.1	8.0	4.7	4.5	2.1	0.7	−10.5	−10.5	−2.7
Mining	4.0	0.2	3.0	3.2	16.8	3.8	18.0	4.8	−2.7	−7.3	−2.5	−10.7	0.7	−11.9
Manufacturing	14.0	4.7	3.5	5.7	7.5	7.3	5.4	4.2	3.4	2.4	2.3	−7.1	−7.6	0.8
Construction	8.6	12.8	44.2	33.3	9.6	2.8	13.7	5.6	9.7	3.2	−4.8	−23.7	−27.6	−20.6
Services	7.0	6.2	5.9	6.0	4.9	5.9	5.8	6.2	3.4	3.5	3.6	−6.7	−3.3	2.3

Source: Philippines, NEDA, "The national income accounts of the Philippines," various issues.

Notes

1. This does not cover capital flight through export underinvoicing or import overinvoicing, which has also characterized the Philippines.

2. In contrast to other countries in this study, exports of services make up a significant part (one-third) of total Philippine exports. These include not only the rental on U.S. military bases, but also the supply of overseas workers, and construction services as well. Dollar earnings from exports of goods and services stayed roughly constant from 1980 to 1984.

3. Short-term debt was not covered in IMF programs, nor were revolving credits (the vast majority of short-term debt) included in the Philippine statutory debt limitation.

4. In a swap arrangement a bank would borrow abroad in foreign currency, and then exchange the proceeds with the Central Bank for pesos. The Central Bank agreed to sell foreign currency to the bank at a set exchange rate in the future, so the bank could pay back the loan.

5. This was unknown at the time, for the Central Bank was systematically overstating its reserves, by amounts of as much as a billion dollars.

6. Throughout, we measure terms of trade effects as the amount of additional exports needed to maintain an import level. Import prices rose 28.7 percent relative to export prices. This, times an import share in GNP of 15.0 percent, equals 4.3 percent. The terms of trade income loss in this case excludes the transitory income gain of 1973 and 1974.

7. The starting point for the terms of trade calculation was the year 1978. Between 1978 and 1982 import prices rose 33.1 percent relative to Philippine export prices; this times the 1979 import share of GNP of 20.8 percent equals 6.89 percent. The average interest rate paid on Philippine external debt rose from 5.21 percent in 1979 to 8.73 percent in 1982. Rates of export price inflation used to calculate the real interest rate were 5.20 percent (the 1975–79 average) and −2.96 percent (the 1979–85 average). The change in the real interest rate was multiplied by the share of gross external debt, less foreign assets of the monetary system, in the average 1979–80 GNP. These types of calculations are highly sensitive to the endpoints. The endpoints were chosen as reasonable approximations, and produce neither the highest nor the lowest income changes possible.

8. Net exports added a negative 3 percent to the GDP increment over the same period.

9. There is some question about the true level of capital formation and savings in the Philippines, in part engendered by the low resultant growth rate. Studies of the World Bank's International Comparisons Project indicate a significantly lower value for the Philippine investment share.

10. Richard Hooley (1985) has estimated a decline in total factor productivity of Philippine manufacturing of 2 percent per year in the latter half of the 1970s. Factor productivity improved within most industries, but interindustry shifts were responsible for the overall decline.

11. A particularly egregious example is the Bataan nuclear power plant, built by Westinghouse, at a cost three times that of a similar plant built by Westinghouse in Pusan, Korea.

12. A rise in government revenue was a major goal of the IMF's Extended Finance Facility for the Philippines (1976–79). A revenue share of 17 percent was also part of the Philippines' 1974–77 Development Plan.

13. The Philippines had what amounted to a de facto real peg against the dollar until 1983, riding the dollar down in 1978 and then up between 1980 and 1982.

14. Two further developments affected the supply of traditional exports. Conservation legislation reduced the legal exports of logs, which had accounted for 27 percent of exports in 1970, to near zero by the end of the decade, and the suspension of U.S. sugar quotas in 1974 deprived the Philippines of a highly lucrative market. The increasing taxation of export agriculture was to some degree offset by substantial investments in irrigation for domestic grain, and the Philippines briefly became a rice exporter during the 1970s.

15. One area where the Philippines did have considerable export success was in the service sector. Philippine overseas construction and contract labor services grew substantially during the decade, boosting the service export share from 2.5 to 6 percent of GDP. Ironically, this is an indication that Philippine factors of production, particularly labor, were more productive outside the country than within.

16. The peak share of manufacturing in employment was reached in 1956.

17. A major source of the monetary expansion was losses that the Central Bank suffered on a large volume of outstanding forward contracts and swap agreements. These had been issued as a form of patronage, and as a way of borrowing reserves.

Reference

Hooley, Richard. 1985. *Productivity growth in Philippine manufacturing: Retrospect and prospects*. Monograph no. 9. Manila: Philippine Institute for Development Studies.

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