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Chapter Author: Robert S. Dohner, Ponciano Intal, Jr.

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7 Debt Crisis and Adjustment

The Philippines went through a particularly wrenching adjustment process in the three years following the declaration of a moratorium in October 1983. This adjustment episode is interesting for a number of reasons. The Philippines had waited until its foreign exchange reserves were almost exhausted before declaring a moratorium and had very little room for maneuver once foreign credit was cut off. Second, the Philippines resisted adjustment policies insisted upon by the IMF, taking over a year to reach a standby agreement and nineteen months to reach a rescheduling agreement with its creditor banks. Third, the program that the Philippines followed was strikingly successful in achieving adjustment, eliminating the current account deficit and domestic inflation by 1986. Finally, much of the discussion between the Philippines and the IMF were reported in the Philippine press, giving a unique insight into the negotiation over adjustment programs.

The crisis and adjustment period may be divided into three phases. The first, from the declaration of the moratorium to mid-1984 is the initial reaction phase. During this period the Philippines was not under an IMF program, although negotiations with the Fund continued for a standby program for 1984 and the Fund did influence some of the policy measures that the Philippines adopted. The second phase of the adjustment process was characterized by a stringent IMF adjustment program. Although the program was signed in December, there were prior conditions that affected Philippine action in the last half of 1984. This second phase ran until the presidential election in February 1986. The last phase started with the negotiation of the nineteenth standby agreement between the Fund and the new Aquino government.

The adjustment phases are determined by the presence or absence of IMF adjustment programs, and with good reason. During these years the relationship between the Fund and the Philippine government changed twice, and sharply in both instances. The Philippines had a relatively lenient IMF program in 1980–81, in which it exceeded targets on domestic credit and net international reserves by a wide margin. The relationship with the Fund began to change in 1982. The unilateral increase in the size of the Philippine industrial rescue fund led the IMF to reject a program for 1982. The seventeenth standby arrangement, which became effective in February 1983, had more restrictive limits on domestic credit and government contributions to public corporations, as well as a limit on short-term nonmonetary debt. However, the Philippines rapidly and substantially exceeded the ceilings on domestic credit and the target for the balance of payments, and the IMF terminated the agreement in the summer of 1983 after only two of the program's four tranches had been drawn (IMF 1984a, 8, 12).

Thus the Philippines declared its moratorium during one of the rare periods in which the country was not under an IMF standby arrangement.

During the early crisis period the Philippines reversed course on policy reforms it had undertaken through IMF and World Bank programs in favor of policies that were familiar, could be implemented rapidly, and were addressed to the critical foreign exchange constraint.

7.1 Trade and Exchange Rate Policy

At the time that the Philippines suspended payments, foreign exchange reserves were extremely low, and the first task of policy was to try to manage international transactions with a minimal level of liquidity. The Philippines almost immediately instituted a foreign exchange control and allocation system. Banks were required to surrender their foreign exchange receipts to a pool at the central bank, from which the central bank made allocations for critical imports. The central bank established an allocation system that gave priority to crude oil imports, raw materials and supplies for export industries, grain imports, raw materials for certain vital domestic industries, and debt servicing for loans from multilateral organizations.

The exchange policy allowed certain imports to take place outside the allocation system. Exporters could import materials on consignment as long as no external financing was required. Firms that were subsidiaries or joint ventures of foreign firms were allowed to pay for raw material imports with equity. In addition, the allocation system allowed imports of goods not on the priority list on a "no dollar" basis, if the importer could come up with the necessary exchange independently. This in fact created a dual exchange rate system, where importers receiving allocations purchased at the official rate, while others financed their imports through the black market at higher rates (table 7.1). It also weakened the exchange surrender system, and by mid-1984 the central bank estimated that it only received about 60 percent of the country's foreign exchange receipts.

The Philippines had a dual exchange rate system in a more organized and unusual sense. Faced with a black market exchange rate of almost P. 30 per dollar (versus an official rate of P. 14), the Marcos government intervened to oligopolistically organize the foreign exchange black market in the Philippines. In the words of the Minister of Trade and Industry, Roberto Ongpin, who was responsible for the operation:

> the largest and best known Chinese black marketeers were rounded up by the National Intelligence and Security Authority and were told that it was the government's intention to organize a currency stabilization program. The Chinese black marketeers would be permitted to keep their profits from their operations provided that they cooperated with the government by buying and selling foreign exchange at government-dictated rates. . . . In order to maintain discipline, the participants were subject to arrest if they deviated from the established rates. (Ongpin 1986)

Table 7.1 Official and Black Market Exchange Rates (pesos per dollar and ratio)

	Official Exchange Rate	Black Market Premium[a]		Official Exchange Rate	Black Market Premium[a]
1983			*1986*		
January	9.287	1.001	January	19.042	0.953
February	9.464	1.027	February	20.461	0.945
March	9.606	1.074	March	20.781	1.047
April	9.869	1.046	April	20.505	1.073
May	10.032	1.027	May	20.500	1.073
June	10.355	1.070	June	20.552	1.039
July	11.002	1.009	July	20.454	1.015
August	11.002	1.095	August	20.432	0.997
September	11.002	1.168	September	20.509	0.995
October	13.702	1.111	October	20.437	0.999
November	14.002	1.345	November	20.436	0.997
December	14.002	1.350	December	20.491	0.995
1984			*1987*		
January	14.002	1.484	January	20.504	0.995
February	14.002	1.263	February	20.525	0.994
March	14.002	1.094	March	20.563	0.992
April	14.002	1.277	April	20.505	0.982
May	14.002	1.370	May	20.473	0.983
June	17.402	1.195	June	20.456	0.978
July	18.002	1.092	July	20.450	0.978
August	18.002	1.082	August	20.439	0.984
September	18.002	1.077	September	20.601	0.985
October	19.148	0.999	October	20.706	0.984
November	19.959	0.967	November	20.817	0.998
December	19.859	0.984	December	20.815	0.967
1985					
January	18.979	0.937			
February	18.256	0.931			
March	18.478	0.951			
April	18.484	0.982			
May	18.480	0.982			
June	18.473	0.983			
July	18.581	0.977			
August	18.605	0.976			
September	18.616	0.975			
October	18.704	0.970			
November	18.737	0.969			
December	18.896	0.961			

[a]Hong Kong banknote rate divided by the official exchange rate.

This operation was termed the "Binondo Central Bank," named for the area in Manila where most of the black market currency trading was done, and existed from early 1984 until February 1986. Exchange rate guidelines were set by Ongpin, and officers of the National Intelligence and Security

Authority accompanied shipments of currency to Hong Kong. The organization of the black market helped the Philippines narrow the black market premium on the exchange rate in early 1984 and also helped meet IMF conditions later in the year.

To support the exchange rate allocation system, the government also halted the program of import liberalization that had been adopted as a part of the World Bank's structural adjustment loans, and instead imposed additional import restrictions. Taxes on international trade were increased, both to discourage imports and to raise government revenue. An additional 3 percent surtax had been levied on all imports in January 1983. The government raised this surtax to 5 percent in November, later to 8 percent, and then to 10 percent in June 1984. The Philippines also raised taxes on exports of primary commodities to levels that ranged from 6 to 10 percent.[1]

The Philippines had pursued a passive exchange rate policy during the 1980s. The real exchange rate of the peso remained almost constant with respect to the U.S. dollar, as gradual depreciation offset a higher domestic inflation rate. But the real effective exchange rate moved with the U.S. currency and followed the dollar up in the early 1980s, so that by 1982 it had risen 15 percent from its 1978 level. There were two devaluations in 1983, one in June from P. 10.2 to P. 11 per dollar, and a second in October to P. 14. This last devaluation resulted in a real effective depreciation of about 21 percent from the December 1982 level. The effective exchange rate change for traditional exports was somewhat less because of the increase in export taxes. For import commodities not on the priority list the real depreciation was huge; not only were there surcharges on imported commodities, but currency had to be sourced through the black market (table 7.2 and fig. 7.1).

Table 7.2 **Real Effective Exchange Rates**

	Dec 82	June 83	Dec 83	June 84	Dec 84	June 85	Dec 85	June 86
Official exchange rate	9.171	11.002	14.002	18.002	19.760	18.465	19.032	20.580
Philippine CPI	177.6	184.4	223.9	275.2	337.7	351.3	356.8	351.4
Partners WPI ($)	124.39	124.80	124.76	124.71	123.90	123.08	130.46	137.84
Black market premium	1.035	1.020	1.350	1.195	0.984	0.983	0.961	1.026
Import tariffs	1.31	1.32	1.34	1.39	1.39	1.34	1.34	1.34
Traditional export taxes[a]	0.960	0.960	0.943	0.879	0.943	0.943	0.943	0.943
Nontraditional export taxes	0.997	0.997	0.996	0.996	0.996	0.996	0.996	0.996
Traditional exports	100.0	115.9	119.3	116.4	110.9	98.9	106.4	123.5
Nontraditional exports	100.0	115.9	121.3	126.9	112.8	100.6	108.2	125.6
Importables	100.0	115.1	162.1	155.6	113.9	97.8	102.9	127.4

Source: Lamberte et al. (1985), table IV.3, updated by the authors.

[a]Traditional export taxes include .3(18–14)/18 for economic stabilization tax

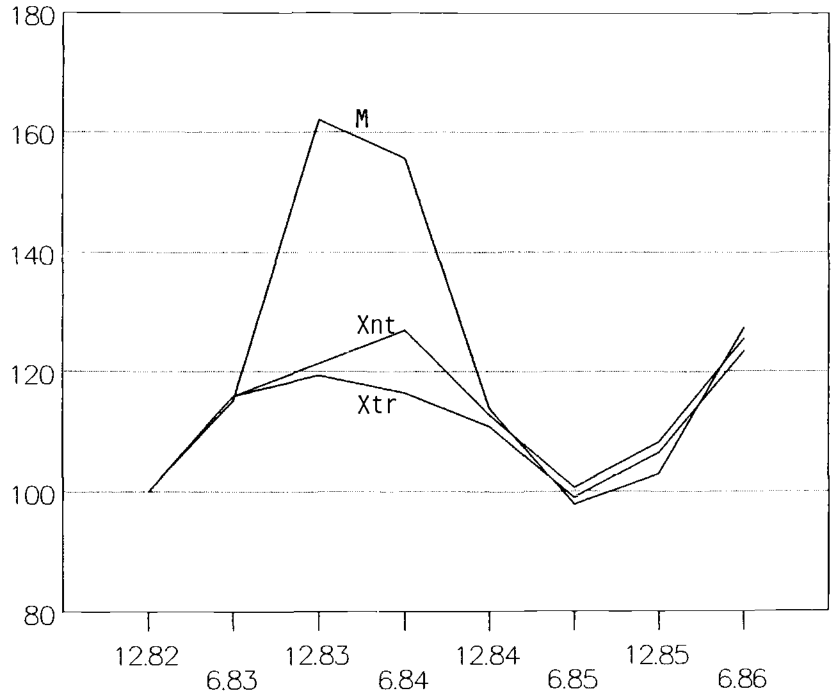

Fig. 7.1 Real effective exchange rates (December 1982 = 100)
Note: M = importables; Xnt = nontraditional exports; and Xtr = traditional exports.

7.2 Government Budget

In 1981 and 1982 the consolidated public sector budget deficit reached 5.5 percent of GNP, with the deficit of the national government over 4 percent of GNP. This marked the peak of Philippine budget deficits, and the following year saw a significant narrowing of the deficit of the public sector.

Revenues were increased by the import surcharge, the additional taxes on exports, and increased excise taxes on petroleum and other products. The result was a rise in the revenue share of GNP to 12.0 percent in 1983 from 11.4 percent in 1982. National government expenditures fell by 8 percent in real terms during 1983. Nonwage, noninterest expenditures (primarily operations and maintenance expenditures) were reduced by 13 percent in real terms, and the capital expenditure of the national government was trimmed. But the biggest decline came in equity transfers and net lending to government corporations, which fell from 3.5 percent of GNP in 1982 to 2.1 percent in 1983. As a result of these expenditure cuts and the increased revenue effort, the deficit of the national government fell to 2 percent of GNP for 1983.

The deficits of the public corporations were more difficult to control. Despite the deferral of five of the Major Industrial Projects during the year, investment expenditures by public corporations stayed at 5 percent of GNP, even as the national government was reducing its contributions to public enterprises. Part of the resulting financing requirement was met through internal funds. Cash generation of the public corporations rose during the year because of higher charges on public services, but also because the National Power Corporation ran up external arrears toward the end of the year. However, the borrowing requirement of the public corporate sector remained at 2.1 percent of GNP. Almost the entire deficit was financed through foreign borrowing.[2]

Only at the end of the year did the Finance Ministry exert more direct control over the operations of the nonfinancial corporate sector. Tariffs and taxes were raised on water, power, petroleum products, and transportation, and the investment programs of the corporations were substantially reduced. In addition, the government imposed more effective ceilings on foreign borrowing by corporations, including short-term borrowing.

7.3 Monetary Policy

Monetary policy also became more restrictive at the end of 1982, and this continued through the first half of 1983. Reserve money in June 1983 was only 2 percent higher than it had been in June 1982.[3] During 1983 the central bank took further actions to limit the growth of reserve money and to reduce the money multiplier. The Philippines completed its financial liberalization in January 1983 when the last limits on short-term interest rates were removed. At the same time, the central bank announced limits on drawings from the subsidized rediscount windows and for the first time tied the rates of those rediscounts to market interest rates.[4] The central bank raised reserve requirements from 18 to 23 percent during the last half of the year, reversing the decline in reserve requirements that had taken place under the financial liberalization program.

Despite these efforts, there was massive growth in the monetary base in the last half of 1983. From June to December of that year reserve money increased by 72 percent to a level of P. 28 billion (table 7.3). The increase in reserve requirements and greater public holding of currency restrained the growth of the money supply, but M1 still increased by 40 percent over the course of 1983. As a result of this explosion in money, the central bank largely accommodated the devaluations that took place during 1983. In December market interest rates were only two percentage points over their June levels and inflation was running at 50 percent.

Four factors accounted for the rise in reserve money over the latter part of 1983. The first was an increase in central bank credit to the national

Table 7.3 Factors Affecting Reserve Money[a] (in billions of pesos)

	1982	1983				1984				1985		1986		
	Dec	Mar	Jun	Sept	Dec	Mar	Jun	Sept	Dec	Jun	Dec	Mar	Jun	Dec
Reserve money	18.6	17.2	16.1	17.6	27.7	24.8	27.1	28.7	34.2	31.6	38.0	40.4	38.0	50.0
Net foreign assets	−35.5	−37.4	−45.1	−52.9	−44.7	−45.0	−49.2	−51.8	−47.0	−45.4	−80.1	−81.1	−78.8	−86.9
Net domestic assets	54.1	54.6	61.2	70.5	72.4	69.8	76.3	80.5	81.2	77.0	118.1	121.5	116.8	136.9
Credit to public sector	8.0	8.0	8.3	9.6	12.5	13.9	15.7	13.6	11.0	14.7	20.9	28.1	17.6	12.9
National government	9.9	9.7	9.0	9.5	12.0	14.2	16.1	14.0	11.4	13.6	16.3	23.6	12.8	8.7
Assistance to financial institutions	3.1	3.5	3.0	2.7	5.0	3.8	6.7	13.4	10.9	12.5	13.7	19.1	13.9	13.7
Regular rediscounting	15.9	15.8	13.1	12.1	12.2	11.1	10.6	9.6	8.4	7.3	8.3	9.0	8.5	6.9
CB securities, RPs, RRPs	−4.6	−4.7	−4.7	−4.4	−4.4	−10.9	−9.9	−11.9	−13.9	−37.3	−32.2	−49.5	−46.9	−29.9
Other items net	31.7	32.0	41.5	50.5	47.1	51.9	53.2	55.8	64.8	79.8	107.4	114.8	123.7	133.3
Swap differential	1.2	1.7	2.6	3.5	8.0	9.8	11.9	18.2	22.0	15.3	14.2	14.2	13.7	13.2
Forward cover differential	3.8	4.7	6.1	7.8	8.8	9.4	10.4	12.4	14.1	17.9	21.7	21.8	22.1	22.4

Source: IMF (1984b; 1985c; 1986b; 1988b).

Note: RPs are repurchase agreements and RRPs are reverse repurchase agreements.

[a]Monetary authorities basis—includes Treasury IMF accounts. Foreign assets and liabilities converted into pesos at constant exchange rate of P. 18.002 per U.S. dollar.

government, which rose by 3 billion pesos (45 percent of the government's annual deficit). The other sources of monetary expansion were less conventional. The largest increase in reserve money came from the losses incurred on outstanding swap and forward cover contracts when the exchange rate depreciated. These losses added P. 8 billion to domestic assets, equivalent to two-thirds of the increase in reserve money, although a substantial portion of these losses was blocked to their recipients by the central bank. Additional growth in reserve money came from the accumulation of external payments arrears. The buildup of arrears blunted the contractionary effect of reserves outflow, and this was not offset by the collection of peso deposits on amounts in arrears.

The external crisis weakened confidence in the already fragile financial system of the Philippines, particularly in nonbank financial institutions. The central bank expanded emergency loans to financial institutions by 2 billion pesos during the last half of 1983, most of it to thrift banks, which added to the growth of reserve money during the last part of the year.

7.4 Domestic Inflation and Price Intervention Policy

The domestic inflation rate accelerated dramatically during the last half of 1983, fueled by devaluation, the institution of import controls, money supply growth, and consumer hoarding of commodities such as rice and cooking oil. By the beginning of 1984 consumer prices were rising at a rate of 60 percent per year, and this rate persisted throughout 1984 (fig. 7.2). The Philippine government had set domestic price ceilings for rice, sugar, and a number of other consumer commodities since the beginning of the martial law period.[5] In addition, the government regulated prices for transportation and domestic sales of petroleum products.[6] These prices were adjusted at frequent intervals after June 1983 to reflect higher import and domestic costs, but the discrete nature of the price ceiling adjustments led to anticipatory buying and shortages of consumer items during 1983 and 1984, and an acceleration of the consumer price index at the time each adjustment was made.

Philippine actions in the initial crisis period increased the difficulty that the country had in adjusting to the cutoff of foreign funds. The very low level of foreign exchange reserves available to the country dominated initial policy, leading to exchange and tax policies that discriminated against exports. The government had difficulty reducing the deficit due to its ineffective control over public corporations. But the loss of control over the money supply in the last half of 1983 was the most damaging. The effect of the 1983 devaluation was lost through price level increases, and by mid-1984 inflation was proceeding at Latin American rates.

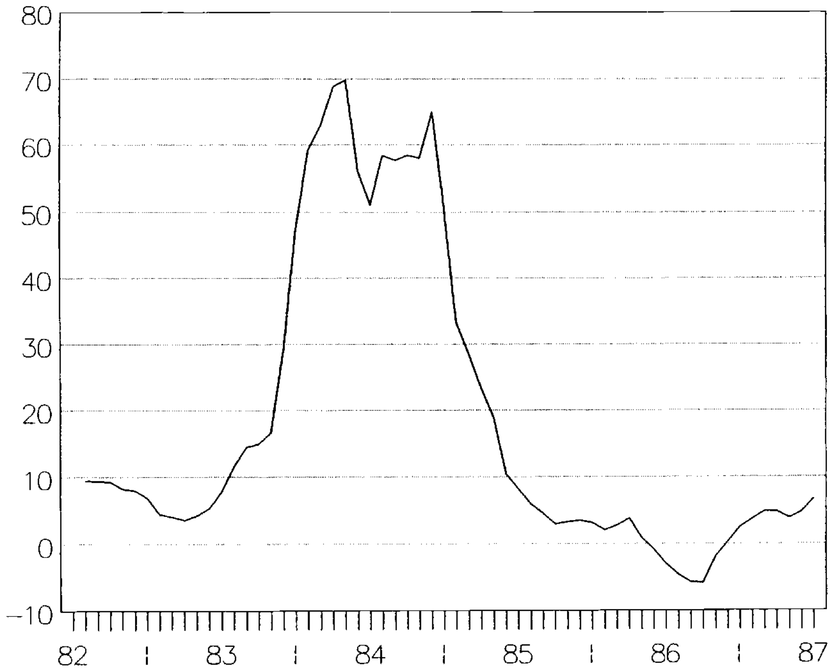

Fig. 7.2 Philippine inflation
Note: CPI percentage change over previous six months, annualized.

7.5 An IMF Standby Agreement

7.5.1 Negotiations

Negotiations between the Philippines and the International Monetary Fund for a new standby to replace the cancelled 1983 agreement were disrupted by the Aquino assassination in August, but resumed in September. Events moved rapidly in October. A devaluation was one of the conditions of the Fund which the Philippines carried out on October 5. On October 17 the Philippines declared a moratorium on principal repayments on its external debt, and a ten-bank advisory group was formed, headed by Manufacturer's Hanover. On November 10 the Philippines submitted a letter of intent to the IMF. The program contained in the letter of intent was approved by the Fund's managing director and sent to the Fund's executive board for approval. Unable to rush the approval process forward, the Philippines applied to the United States for a bridge loan until disbursements from the IMF program came through, but the U.S. demurred, insisting that it too would wait for the executive board's approval.

The IMF program and the rescheduling negotiations were derailed by the discovery in early December of the Philippine reserves overstatement. The banks broke off negotiations on rescheduling, and the IMF immediately sent a team to Manila to examine the books of the central bank, shelving the agreement that had been reached. While the practice of padding reserve figures was not unusual among LDCs, it had a devastating effect on the relations between the Philippines and both the IMF and the country's creditor banks.

The amounts involved were large; the overstatement had run as high as $1.1 billion, or 50 percent of stated international reserves. But the effect was far greater, because it cast doubt on the integrity and honesty of the Philippine technocrats, a group that the IMF had considered allies in promoting policy reforms in the Philippines. Jaime Laya, the central bank governor, was most directly affected, but the reputations of all of the technocrats were tarnished, with the possible exception of Cesar Virata, the finance minister. Negotiations became much more testy, and nearly every factual submission by Philippine negotiators was subject to question. The IMF insisted on an outside audit of the books of the central bank which was performed by Sycip, Gorres, and Velayo, a large, local accounting firm. The IMF and the World Bank sent teams during 1984 to examine Philippine economic statistics. The negotiating banks informed Finance Minister Virata that they would rather not see Governor Laya at the table when negotiations resumed. Laya was appointed minister of education, culture, and sports in January, and Jose Fernandez, head of the Far East Bank, was appointed governor of the central bank.

The negotiations on a new standby agreement were prolonged and difficult, and it was not until December 1984 that a new agreement with the IMF was signed. During that time the Philippines had to extend the original ninety-day moratorium several times since agreement with the banks hinged on an agreement with the Fund. Reaching an agreement with the IMF was a critical matter. The Philippines had to deal with an extreme shortage of foreign exchange after the moratorium was declared. Reserves were low, and the centralization of foreign exchange receipts that the central bank had tried to establish was not very successful. The dollar pool that the central bank created had a balance of only $800 million in the first week of January, of which $455 million was earmarked for oil imports. Even importers of goods on the priority list were having trouble getting allocations from the central bank. As the negotiations with the Fund wore on, the Philippines finally arranged additional financing from other sources: the U.S. Export Import Bank and the Commodity Credit Corporation provided additional funds early in 1984, as did the Asian Development Bank. In all, the Philippines was able to raise $370 million from these agencies.

This time the IMF took a much tougher stand than it had in previous standby consultations. Negotiations took place not only on the content of the program, but also on the prior actions that the Philippines would have to take before the IMF would agree to a program. What the Fund particularly wanted was a reduction in the money supply after the huge increase of the last part of 1983. At this time the inflation rate was already running at 60 percent per year, and the Fund worried that the Philippines would develop a high inflation–devaluation cycle similar to that of many Latin American countries. The IMF originally set as a target a reduction of reserve money from P. 28 billion at the end of December 1983 to P. 23 billion by the end of March.[7]

The central bank had some success in reducing liquidity through open market operations in the first quarter of 1984, although some of the reduction was seasonal. Outstanding central bank securities and reverse repurchase agreements increased by P. 6.5 billion during the quarter (see table 7.3). However, parliamentary elections were held on May 14, and advances to the government, largely used to finance the election, increased sharply in the second quarter, reversing the gains the central bank had previously made. The central bank also increased its emergency loans to financial institutions during the quarter.

The fragility of the financial system was an obstacle to liquidity reduction during much of the year. The system had been battered by the Dewey Dee crisis in 1981 and by the prolonged domestic recession. When reserve requirements were raised by five percentage points in the last half of 1983, reserve deficiencies rose to over 20 percent of required reserves. Half of the reserve deficiencies were those of the government-owned PNB. These were erased early in 1984 when the central bank allowed PNB to exchange uncollectible promissory notes issued by sugar mills for bonds issued by the newly created Philippine Sugar Corporation, and then made those bonds eligible as reserves.

The central bank had made large emergency loans to thrift banks and investment houses during the last part of 1983. In 1984 emergency loans and overdrafts to commercial banks and DBP increased sharply (table 7.4). In July, a run on the Banco Filipino, the country's largest savings bank, forced the bank to close its doors.[8] At this point the central bank had extended almost one billion pesos to Banco Filipino. The central bank at first refused to supply additional emergency assistance but, after a presidential directive, extended an additional P. 3 billion to the savings bank. In negotiations with the IMF, Virata and Fernandez argued that further reductions in the money supply would create more extreme difficulties in the financial system.

There were other issues that were important in the negotiations on prior action for a standby program. The Fund wanted a further devaluation of the peso to restore the erosion of real exchange rates that had taken place since the previous devaluation, and a floating of the exchange rate to allow the resumption of bank foreign exchange trading and the narrowing of the black market premium. The Fund also wanted further cuts in the investment

Table 7.4 **Central Bank Emergency Loans to Financial Institutions (in millions of pesos)**

	1982	1983		1984		1985		1986	
	Dec	Jun	Dec	Jun	Dec	Mar	Dec	Mar	Sept
Emergency loans	3,137	3,051	3,787	3,432	3,732	3,950	3,996	3,961	3,874
Commercial banks	3,074	2,989	2,753	1,397	1,565	1,839	1,942	1,919	1,871
Thrift banks	25	25	226	234	358	285	248	245	236
Finance companies	32	28	205	283	288	306	302	297	306
Investment houses	—	—	396	499	497	497	486	482	443
Rural banks	—	9	7	7	12	11	6	6	6
Special government banks	6	—	200	1,012	1,012	1,012	1,012	1,012	1,012
Overdrafts	2	2	1,170	3,219	7,189	8,255	9,752	15,181	9,960
Commercial banks	2	2	487	2,524	3,444	4,416	6,009	11,443	6,247
Thrift banks	—	—	252	480	3,530	3,625	3,530	3,525	3,500
Finance companies	—	—	29	9	9	8	8	8	8
Investment houses	—	—	402	206	206	206	205	205	205
Total	3,139	3,053	4,957	6,651	10,921	12,205	13,748	19,142	13,834

Source: IMF (1985c), table 47, and the central bank, *Quarterly Economic and Financial Report*, September 1986.

programs of the state-owned corporations, an increase in taxes, and a shifting of tax burdens away from international trade and toward domestic transactions.

On June 5 the central bank devalued the peso to a level of P. 18 per dollar, and at the same time instituted two additional trade taxes. The first was a 10 percent tax on foreign exchange for nonmerchandise transactions. The second was a windfall tax on traditional exports, called the economic stabilization tax.[9] The effect of the two taxes was to establish a multiple exchange rate system. Nontraditional exports and merchandise imports for which exchange was allocated took place at P. 18 per dollar, nonmerchandise imports at P. 19.80 per dollar, and traditional exports at an effective rate of P. 16.80. These additional measures became further sources of disagreement between the IMF and the Philippines, and their removal became a prior condition of the agreement.

In September and October 1984 the Philippines took a number of actions that paved the way for an eventual agreement with the Fund. The economic stabilization tax on exports, imposed along with the June devaluation, was removed on September 22. In September the central bank also allowed commercial banks to retain half of their foreign exchange receipts, and the exchange allocation system was abolished in October. The import surcharge was reduced to 5 percent, and the 10 percent excise tax on foreign exchange for nonmerchandise imports was replaced by a uniform 1 percent tax on all foreign exchange transactions. Finally, on October 15 the exchange rate was allowed to float.

In August and October the Philippine government increased taxes on petroleum products and crude oil, coke and coal, and other products subject to excise taxes. Interest exemptions were removed and, in a major victory for the Fund, the Philippine government agreed to remove tax and tariff exemptions from government-owned corporations and to reduce the tax exemptions given to manufacturing firms under BOI incentives. The estimated impact of these measures on the 1984 budget was P. 2.6 billion, or 0.5 percent of GNP.

In March the Monetary Board gave the central bank permission to sell short-term, non-reserve-eligible notes. The central bank aggressively marketed these bills, called "Jobo bills" after the nickname of the central bank governor, starting in mid-August, at rates that exceeded 40 percent. Jobo bills were purchased by banks as a safe alternative to domestic loans and by the nonbank public. Through the sale of these securities, the central bank succeeded in reducing reserve money by approximately 12 percent between early August and the end of October, clearing the way for an agreement with the Fund. A letter of intent was submitted October 31, and the standby arrangement was approved by the executive board of the IMF on 14 December 1984.

7.5.2 The Adjustment Program

The standby arrangement worked out with the IMF was exceptionally stringent. The agreement was for $650 million, spread over eighteen months and divided into seven tranches. Program reviews were set for each quarter, and some of the conditions covering the remainder of the program were to be set at later reviews. The IMF agreement cleared the way for rescheduling agreements with the commercial banks and with official creditors, but the program itself brought little additional funding. The initial drawings under the agreement were to be used to clear up arrears that the Philippines had accumulated.

The program and the assumptions on which it was based are outlined in tables 7.5 and 7.6. The most immediate indication of the severity of the adjustment program is given by the GNP assumptions. The expected drop in GNP for 1984 was 6 percent, with zero growth assumed in 1985, implying a fall in per capita income of 11 percent over two years. In fact, these turned out to be too optimistic; real output fell in both years, leading to a 15 percent reduction in per capita income from 1983 to 1985.

The monetary targets proved to be the most difficult to meet. The targeted measure was reserve money, currency plus bank reserves.[10] The reserve money figure had already reached a peak of P. 34 billion by early August 1984, and the December 1984 ceiling required a substantial reduction. The growth of reserve money was to be limited to 23 percent over the course of 1985. The monetary targets also included substantial reductions in banking system credit to the public sector, ruling out monetary financing of the government deficit during 1985.

Table 7.5 **Philippines 1985–86 Standby Program Performance Criteria**

	31 December 1984		31 March 1985		31 December 1985		31 March 1986	
	Ceiling	Actual	Ceiling	Actual	Ceiling	Actual	Ceiling	Actual
Money and credit (billion pesos)								
Reserve money	32.0	34.2	31.0	30.5	39.5	38.0	38.9	40.4
Net banking system credit to national government	17.9	17.0	17.9	19.0	13.0	12.4		10.0
Bank credit to public sector	27.4	25.6	27.7	29.0	20.7	19.2		14.2
Central bank credit to PNB	5.0	5.0	5.1	5.1	5.3	5.0	5.3	8.2
External payments (million US$)								
Net international reserves (floor)	−4,719	−3,886	−4,351	−4,150	−1,910	−1,841	−1,615	−1,512
External payments arrears	2,744	2,690	3,161	2,642	0	0	0	0
Short-term external debt	9,649	9,998	9,649	9,757	9,649	9,458	9,649	9,088
New borrowing approvals								
1–12 years maturity	1,800	512			2,255	1,232	2,255	1,246
1–5 years maturity	300	177			400	250	400	251
Public sector (billion pesos)								
Combined deficit, 13 monitored public corporations	13.0	11.6	2.4	0.9				

Source: IMF (1984a; 1985a; 1986a) and Montes (1987).

Table 7.6 Philippines 1985–86 Standby Program Assumptions

	1983	1984		1985		1986	
	Actual	Projected	Actual	Projected	Actual	Projected	Actual
External objectives							
Current account deficit							
(US$ billion)	2.8	1.5	1.1	1.1	0.1	0.5	−1.0
(percent of GNP)	8.1	5.2	3.5	4.1	0.2	2.3	−3.5
Exports (percent change $ value)	−0.3	5.9	7.7	10.0	−14.1	11.0	4.6
Imports (percent change $ value)	−2.3	−22.7	−18.9	−1.6	−15.8	3.4	−1.3
Trade balance (US$ billion)	−2.5	−0.5	−0.7	0.1	−0.5	0.6	−0.2
Savings and investment							
Gross domestic investment	27.5	22.0	19.2	22.5	16.3	23.0	15.4
Total savings	27.5	22.0	19.2	22.5	16.3	23.0	15.4
Gross national savings	19.4	16.8	15.7	18.4	16.1	20.7	18.9
Foreign savings	8.1	5.2	3.5	4.1	0.2	2.3	−3.5
Money (percent increase, end period)							
M3	19	10	7.3	13	9.6	12	12.8
Reserve money	49	15	20.6	11	13.6	10	31.6
GNP and prices (percent increase)							
Real GNP	0.9	−6	−6.8	0	−3.8	1	2.0
CPI (Dec–Dec)	26.1	40–45	50.8	10–15	5.7	8–10	−0.3
CPI (average)	10	45–50	50.4	20–25	24.9	10	0.8

Source: IMF (1984a; 1985a; 1986a) and Montes (1987).

Using the IMF assumptions on the course of domestic prices and real GNP, the program limits implied a reduction in real reserve money outstanding by the end of 1985 of 7 to 14 percent of their end of 1982 levels, which was *before* the jump in money supply took place. The ratio of reserve money to nominal GNP was assumed to rise only 7 to 15 percent from its end of 1982 level and be well below its end of 1983 peak. Broad money (M3) was projected to grow by 10 percent in 1984 and 13 percent in 1985. This implied a 20 to 30 percent rise in velocity from the end of 1982, again, before the huge monetary expansion took place.

Both the IMF and the Philippines recognized that the government financial institutions (PNB, DBP, and PhilGuarantee) would run substantial deficits in both 1984 and 1985, even after rescheduling. There was no real scope for internal actions at DBP or PhilGuarantee, but some possibilities for reduced losses at PNB. One of the performance criteria under the program limited central bank credit to PNB to a near constant amount over the life of the program.

The program required the elimination of all external arrears by the end of 1985, and an increase in net international reserves of the central bank of $2.8 billion over the course of the year. The program also set limits on new medium- and long-term external borrowing and ruled out an increase in short-term debt for the entire program. The growth in exports and reduction in imports was assumed to be sufficient to generate a trade surplus by 1985.

The program called for a rapid reduction of the public sector deficit, from 3.2 percent of GNP in 1983 (already a substantial reduction from 1982) to 1.4 percent during 1985. This was after the inclusion of government support to public financial institutions, whose shortfalls were expected to rise to 2 percent of GNP in both 1984 and 1985 (IMF 1984c, 31).

The Philippine letter of intent outlined a program of tax increases for 1985 that was estimated would yield revenues of 2.1 percent of GNP (IMF 1984c, 63).[11] Continued sharp reductions in expenditure were also to take place. The Philippines agreed to cut the investment program of public corporations in half from 1983 to 1985. For the first time the standby program covered the deficits of public corporations. The combined deficit of the thirteen largest public nonfinancial corporations was to be limited to P. 13 billion (about 2.5 percent of GNP) for 1984 and to P. 2.4 billion for the first quarter of 1985 (1.5 percent of GNP), with further quarterly limits to be set at the time of the first program review.

The Philippine government raised price ceilings on controlled commodities and increased administered prices for petroleum products and transport several times after the crisis. By the end of 1984 retail prices for petroleum products were more than double their September 1983 levels and electric power tariffs had been raised by 70 percent. During the negotiations with the IMF, the Philippines agreed to eliminate price ceilings for basic consumer commodities. By the end of 1984, this had been done for all commodities except rice, and rice followed during 1985.

The Philippine government raised minimum wages for public and private employees on several occasions during 1983 and 1984, although the increases did not match the rate of inflation. In addition, there were widespread complaints that firms were not abiding by minimum wage floors. Data on actual wages paid are scanty for the Philippines, but suggest a fall in real wages for unskilled manufacturing workers of about 5 percent during 1984. Actual compensation per employee in the national government was only 16.5 percent higher in 1984 than in 1983, despite a 50 percent rise in consumer prices. As part of the IMF program, the Philippines agreed to target wage increases for public sector workers at 22 percent during 1985, about the same as the estimated increase in prices.

The IMF program was unique in containing structural reform measures, measures that in some cases challenged the political base of the martial law regime. These fell in the areas of tax reform, the rehabilitation of financial institutions, and the dismantling of public and quasi-public monopolies in the agricultural sector. On tax matters, the program required a shift in tax orientation away from international trade and toward domestic transactions. This entailed the reduction or elimination of the variety of trade and foreign exchange taxes and surcharges that the Philippines had imposed since

October 1983 and the raising of taxes on domestic sales of a number of commodities. The Fund also obtained agreement to reduce the wide range of tax exemptions available to manufacturing firms through BOI incentives. The Philippines agreed to eliminate tax and duty exemptions for public corporations, although the requirement left an escape clause for the Philippine government in which they could review and possibly reinstate the exemptions.

By the time that the standby agreement was signed, the IMF had become more aware of the instability of the domestic financial system. In the agreement, it endorsed a central bank plan to strengthen the financial system by encouraging mergers. The agreement limited the credit of the central bank to PNB explicitly, and limited credit to financial institutions generally through strict limits on the expansion of reserve money. The Philippine government also agreed to prepare rehabilitation plans for government-owned financial institutions.

The most politically controversial part of the standby program was the requirement to disband government marketing and price restrictions in the agricultural sector. The monopoly on importation and marketing of grains by the National Food Authority (NFA) was the most important of the purely public controls on agricultural transactions. But the production levies, export restrictions, and other marketing controls on the sugar and coconut industries were far more important in the Philippines. Although controls in these industries had been given the imprimatur of public policy, the institutions and the funds generated by the controls were in private hands, those of two of the most important cronies of the martial law regime. Each control scheme acted as a substantial tax on production in the two most important traditional export sectors. The IMF program, in tandem with a World Bank loan for the agricultural sector, required that the Philippine government dismantle these controls and allow producers to trade at market prices through proposals to be worked out during subsequent program reviews.

The Marcos government generally resisted the structural measures affecting the most important monopolies, dissolving institutions and announcing, but not effectively implementing, policy reforms. The monopoly on flour distribution was removed from the NFA, but it retained a monopoly on wheat importation, with the pledge to gradually open it up to the private sector. The monopoly on exports of coconut products given to UNICOM and three other mills was abolished, but the ban on copra exports introduced in 1984 was maintained, as were the producer levies. In the sugar industry, Philsucom was reconstituted with a larger representation of planters, and NASUTRA was replaced by a new body owned by planters and millers. Reform of the sugar industry was made more difficult by the extremely low world sugar price and the large, unpaid NASUTRA obligations to planters. Regulation of the domestic sugar industry was tightened, and producer support through higher domestic prices was reintroduced.

7.6 Rescheduling Agreements with Banks and Official Creditors

7.6.1 Negotiations

When the Philippines declared a ninety-day moratorium on 17 October 1983, the initial expectation among foreign bankers was that the rescheduling exercise for the Philippines would be quickly accomplished. Instead the negotiations for the Philippines proved to be the most prolonged, and in some ways the most difficult, of any of the LDC borrowers. Nineteen months would pass before the Philippines finally signed a rescheduling agreement with its commercial creditors, and the moratorium was extended an additional six times. The reasons for the delay were varied. In part they reflected the inability of the Philippines to meet IMF prior conditions for the establishment of the standby program on which the financing agreement hinged. But Philippine negotiations with the banks were also held up by disagreements among the creditor banks on issues over which the Philippines had little control.

Agreements with the IMF and with the bank advisory committee were nearly concluded by the end of 1983, before the discovery that the central bank had been overstating its foreign exchange reserves prior to the declaration of the standstill.[12] The Bank Advisory Committee had agreed to a proposal to reschedule commercial bank debt falling due before 30 June 1985 and to extend $1.6 billion in new money to the Philippines, when the reserves overstatement was discovered.

This disclosure did more than push the negotiations back to their starting point. The trust that external creditors had in the Philippine technocrats vanished, and the emphasis in both bank and Fund negotiations shifted to prior conditions, frequent review, and "backloading" —pushing the largest funds releases to the end of a program, after intermediate conditions had been met. The reserves disclosure and the subsequent discovery of the extraordinary increase in the money supply in the latter part of 1983 also increased the importance of the IMF negotiations for a revised standby agreement, and for much of 1984 the commercial bank negotiations receded to the background. Negotiations with the bank advisory committee resumed in March 1984, only to be postponed until June, pending the completion of an IMF standby agreement. By the end of October a new Philippine letter of intent was drafted and sent to the IMF for approval. With the outlines of an IMF program in place, negotiations with the banks resumed in November.

The original financial package, negotiated in the latter part of 1983, called for a rescheduling of $9.1 billion in commercial and official loans maturing between the declaration of the moratorium and the end of 1984. In addition, there was a new money component of $3.3 billion, evenly divided between official and commercial bank creditors, as well as the IMF standby arrangement of $650 million. The $1.6 billion new money proposal for commercial banks represented about 10 percent of their outstanding exposure to the Philippines, a relatively large new commitment. With the delay in reaching a new agreement with the IMF in 1984 came increasing doubts among commercial banks of the willingness of the Marcos government to carry through adjustment measures, and an increasing reluctance to extend money to the Philippines. By the summer of 1984 the financial programming included all of 1985, with the proposal of $1.6 billion from the commercial banks extending over two years, and now including $2.7 billion in additional money from bilateral and official creditors.

Once the Philippines reached an agreement with the IMF and the letter of intent was sent, negotiations with the official creditors proceeded quickly. These were concluded on 20 December 1984, and the outcome is described in table 7.7. The restructuring covered 100 percent of principal and 60 percent of interest falling due between 1 January 1985 and June 1986. The remaining 40 percent of interest became payable on a staggered basis, ending September 1987. Due but unpaid principal and interest on obligations up to the end of 1984 (about $200 million) became payable over eighteen months. In addition to restructuring existing obligations, the agreement included long-term new money from official sources of $2.2 billion, slightly below the figure discussed in midsummer and early autumn. However, the creditor bank negotiations continued to be difficult and extended on into 1985.

7.6.2 Complications in the Negotiations

The primary reason for the delay in negotiating an agreement with the commercial banks was the difficulty that the Philippines had in reaching an agreement with the IMF. However, there were three additional issues that complicated the negotiation process with the banks, only one of which directly involved the Philippines.

Table 7.7 Philippine Debt Restructuring Agreement, May 1985

Commercial bank rescheduling	Amount ($ billion)	Maturity (grace)	Interest Spread
Debt falling due	5.88	10 (5 yrs)	1⅝
New money	0.925	9 (4 yrs)	1¾
Trade facility	2.97		1¼
Total	9.69		

Official Creditors	Principal Amount $ billion	Principal Amount %	Interest Amount $ billion	Interest Amount %
20 December 1984	0.725	100	0.258	60

Source: Central bank.

The first issue arose immediately after the Philippines declared a moratorium on 17 October 1983. The Manila branch of Citibank had accepted approximately $600 million in interbank deposits in its foreign currency deposit unit. When the Philippines declared a moratorium these deposits were blocked, and Citibank refused to make good the deposits from its home office. Several major creditors were affected by the Citibank action, including Wells Fargo of San Francisco, which filed suit against Citibank in New York to recover $2 million in deposits in the Citibank unit.

Two independent issues were involved in the Citibank FCDU dispute. The first was the status of the interbank deposits that other creditors had placed with Citibank's Manila office, and the terms under which those deposits could be withdrawn. The second issue concerned the responsibility for that foreign exchange exposure to the Philippines—whether Citibank, or its depositors, would have to put up the pro rata share for those deposits in any new money agreement for the Philippines.

The dispute was resolved in stages. In April, Citibank received permission from the central bank to remit 46 percent of the FCDU deposits to their owners.[13] The dispute over the remaining deposits and the exposure issue continued until November, when a compromise was reached. Citibank converted the remaining interbank deposits to four-year time deposits and accepted new money exposure for the 46 percent portion that it had remitted in April.

The second issue involved approximately $57 million in loans to Planters Products, Inc. (PPI), the largest importer/marketer of fertilizers in the Philippines. The company was in the private sector, and the loans did not carry a government guarantee. It was the insistence of PPI's creditors that the Philippines assume the obligations of the firm that formed the basis of the dispute.

The Philippine government administered price ceilings for fertilizer, a program started when world fertilizer prices rose sharply in 1973. Losses on fertilizer imports and on domestic production of fertilizer were made up by a subsidy program for firms in the industry, a program of which PPI had been the largest beneficiary. The company encountered severe financial difficulties after October 1983 because of restricted supplies of foreign exchange for imports and because the government fell behind in its subsidy payments. PPI's creditors argued that the firm was in effect a state-controlled corporation and the government's failure to provide the subsidies to which PPI was entitled was the reason for its financial difficulties. The creditors demanded that the Philippine government assume the loans before they would participate in the commercial bank rescheduling.

The Philippines finally worked out a compromise on PPI. The loans would remain in the private sector. However, Finance Minister Virata signed a letter of undertaking in May 1985 stating that the central bank would satisfy PPI's subsidy claim and that a rehabilitation program for the company would be initiated. While this compromise allowed the bank rescheduling to go forward, it did not lay to rest the PPI issue, which reappeared in the negotiations in 1987.

The last issue that almost derailed the negotiations was the reluctance of a major creditor bank to participate. The National Commercial Bank of Saudi Arabia had roughly $150 million in trade financing exposure to the Philippines. The bank initially refused to participate in the rescheduling program, holding out for a separate agreement with the Philippines.[14] Manufacturer's Hanover, the lead bank in the advisory committee, refused to sign an accord without the participation of National Commercial. This issue, along with the dispute over PPI, held up the commercial bank agreement for several months until National Commercial finally agreed in April 1985 to participate in the program.

The Philippine government finally signed its restructuring agreement with the bank advisory committee on 20 May 1985, over a year and a half after the country had declared its first moratorium. The terms of that restructuring agreement are also outlined in table 7.7. The agreement had three parts. The first was a rescheduling of $5.88 billion in debt falling due between 17 October 1983 and 31 December 1986. Of this restructured debt, about $3.4 billion, or 57 percent, was short-term debt.

The restructuring agreement included different provisions for debt that was owed or guaranteed by the public sector, debt of the private financial sector, and nonguaranteed debt owed by the private corporate sector. The outlines of the programs and the amounts involved are shown in table 7.8. Of these, the procedures for the restructuring of private corporate sector debt were the most complex. Creditors and their corporate debtors were left to work out arrangements for repayment of existing loans. Repayments could be made on the original schedule or they could be restructured. In addition, the central bank offered an option for foreign exchange cover for restructured private corporate debt. A final option, similar to the FICORCA program in Mexico, offered forward exchange protection and credit assistance for corporate borrowers in financial distress.[15] For all of the options under the private corporate borrowers program, counterpart payments were made to the central bank on the agreed schedule and the central bank assumed the corresponding external obligation, payable on the same schedule as restructured public sector debt. In each case, the commercial risk of the loan was borne by the original lender.[16]

The agreement also included a new money commitment by the commercial banks of $925 million, or 7.5 percent of their outstanding commitments on the date of the moratorium. This facility carried an interest rate spread of 1¾ percent over LIBOR, although a creditor bank could, at its option, receive its domestic prime rate plus 1⅜ percent.

The last part of the commercial bank agreement was a $2.97 billion revolving trade facility. This corresponded to the amount of trade financing

Table 7.8 **Commercial Bank Financing Program, May 1985**

	Amount (million $)	Maturity (grace)	Spread over LIBOR	Facility Fee (%)
Rescheduling:				
Public sector debt				
Medium. long term	2.059	10 (5 yrs)	1⅝	—
Short term	1.183	10 (5 yrs)	1⅝	—
Total	3.242			
Private financial debt				
Medium. long term	16	10 (5 yrs)	1⅝	—
Short term	1,594	4 (4 yrs)	<2	—
Total	1.610			
Private corporate debt				
Medium. long term	448	10 (5 yrs)[a]	1⅝[a]	—
Short term	585	10 (5 yrs)[a]	1⅝[a]	—
Total	1.033			
Total rescheduled	5.885			
New money facility	925	9 (5 yrs)	1⅝[b]	½
Revolving trade facility	2.974	30 June 87[c]	1¼	⅛[d]
Total	9.784			

Source: Central bank.

[a]Once counterpart deposit has been made and the central bank has assumed the external obligation.

[b]Or 1⅜ over prime, at creditor bank's option.

[c]Facility exists through 31 December 1986. final maturity date 30 June 1987.

[d]Per annum.

outstanding at the time of the moratorium, and each commercial bank agreed to maintain a level of exposure that was the same as that on 17 October 1983. The trade facility also included central bank overdrafts run up before the moratorium. Availments from the trade facility could be used to repay current and past due trade obligations. Any unutilized portion of the facility was to be placed on deposit with the central bank. The trade facility carried an interest spread of 1¼ percent over LIBOR and a facility fee of ⅛ percent.

The new money commitment, at $925 billion, was well below the original proposals of $1.6 billion in additional money from the commercial banks. The total financial commitment of the commercial banks in the Philippine program was roughly the same, with the smaller amount of new money balanced by the larger rescheduled amounts. Much of the difference was absorbed in the trade facility, which greatly exceeded the need of the Philippines for trade finance.[17]

The terms that the Philippines received in this first rescheduling were roughly comparable to those negotiated with other LDCs at that time (Chile in November 1984, Costa Rica in May 1985, and Argentina in August 1985), although they were less favorable than the terms that Mexico received in March and August 1985.[18] But, reflecting the suspicion with which the commercial banks now held the Marcos regime, most of the drawings under the new money facility were pushed toward the end of the program. The first drawing, to be made after the Philippines passed the second IMF program review, was for $400 million, almost all of which went to settle outstanding arrears. Subsequent drawings were scheduled for $100 million, $175 million, and a final drawing of $350 million after the Philippines had successfully completed its IMF review at the end of March 1986.

7.7 Evaluating the Adjustment Period

Measured purely in terms of stabilization, the Philippine adjustment program in 1984 and 1985 was a great success. The country was able to meet its external balance requirements under the IMF program. External arrears were eliminated by the end of 1985, and net international reserves rose faster than the program required. The current account deficit narrowed sharply and in 1985 was virtually balanced, a much greater change than had been anticipated in the program (see table 7.6). The extent of the Philippine adjustment may be gauged from the shift in the noninterest current account shown in table 7.9. In just two years this balance increased by 9 percent of GNP.

The Philippines was also successful in rapidly bringing inflation under control.[19] The consumer price index was rising at rates of 50 to 70 percent throughout 1984 (see fig. 7.2). But by May 1985 the inflation rate over the previous six months had been reduced to an annual rate of less than 10 percent. Over the entire year 1985 (December to December) consumer prices increased by 5.7 percent, the lowest inflation rate since the 1960s. During 1986 consumer prices actually fell.

Thus the Philippines, which had been borrowing abroad in the amount of 8 percent of GNP, was successful in making the adjustment to the severing of its access to the world capital market. However, this stabilization was purchased at a tremendous cost of output and income and with considerable damage to the financial system and many industries. Real GNP by 1985 had fallen 10.4 percent from its 1983 level. Per capita incomes fell by about 15 percent, which erased almost all of the gains since the first oil shock.

The effect was particularly severe on investment, which fell by 50 percent during this two-year period. By January 1985 the unemployment rate had

Table 7.9 Noninterest Current Account Balance (in millions of U.S. dollars)

	1982	1983	1984	1985	1986	1987
Balance	−1,575	−1,139	820	1,827	2,813	1,687
% of GNP	−4.0	−3.3	2.6	5.8	9.3	4.9

Source: Central bank, and NEDA, National Accounts Section.

risen to 14 percent and the underemployment rate was estimated at 45 percent. Although increases in legislated minimum wages did not nearly compensate for the rise in prices after 1983, there was widespread noncompliance, leading to increased, although still illegal, strikes in 1985.

The recession was unevenly distributed across sectors, as is shown in table 7.10. Conditions were generally less severe in the rural areas. Agricultural output continued to grow through the period after 1983, as devaluation increased production incentives and real incomes in the rural areas. The sugar industry, however, is a glaring exception to this characterization. The collapse of international sugar prices, the expiration of long-term supply contracts signed at favorable prices, and the inability of NASUTRA to make payments to sugar millers and producers, left many producers and workers

Table 7.10 **Real GDP by Sector and Manufacturing Industry Real Gross Value Added (total percentage change)**

	1983–85	1985–87
GDP market prices	−9.6	6.7
Agriculture	5.6	4.1
Industry	−19.9	5.7
Mining	−10.1	−14.0
Manufacturing	−14.2	8.0
Construction	−44.8	−6.9
Electricity, gas	4.1	33.1
Services	−9.8	9.5
Transport, communications	−5.9	6.0
Trade	1.0	7.7
Finance & housing	−37.1	34.3
Other services	−6.5	4.0
Total Manufacturing	−14.2	8.0
Miscellaneous manufacturing	32.0	−3.1
Basic metals	13.8	4.0
Publishing	7.3	18.3
Beverages	3.7	1.5
Leather	1.5	−2.9
Footwear	−0.5	16.1
Electrical machinery	−4.0	30.8
Food	−6.9	11.0
Rubber	−13.0	8.5
Tobacco	−15.5	−36.6
Petroleum products	−17.2	6.7
Furniture	−23.2	28.4
Wood & cork	−23.9	−22.4
Paper	−26.0	18.4
Chemicals	−26.7	−9.0
Textiles	−29.5	37.1
Nonmetallic minerals	−35.3	9.3
Metal products	−35.5	8.4
Machinery (nonelectrical)	−50.1	15.4
Transport equipment	−81.9	3.7

Source: NEDA, National Accounts Section.

destitute and led to widespread famine in the province of Negros Occidental. Output in the mining sector also dropped sharply during this period, again because of weak external prices.

The costs of the stabilization program itself were felt most heavily in the urban sector—by the construction and manufacturing industries and by the urban wage earner. The sharp fall in domestic investment led to a collapse of the construction industry. Within manufacturing, the industries that were hardest hit were the industries that the system of trade protection had worked so hard to protect—import-substituting industries producing intermediates or durable goods. In some cases, such as in transport equipment, major portions of the manufacturing sector went under during the stabilization episode. Export-oriented industries, such as footwear, electrical machinery, and much of miscellaneous manufacturing, fared better, although even here the recession had its costs.

Labor force data for the Philippines is sketchy, but indicates that industrial employment fell by about 9 percent between 1983 and 1985. Legislated minimum wages for nonagricultural workers fell in real terms each year after 1981. Actual compensation paid also fell in real terms during the 1980s; data from the National Wages Council estimates the drop for unskilled workers in Manila at 5 percent in 1984.[20]

In the sections that follow we look more closely at how the external and inflation adjustments were achieved and the reasons for their high output costs.

7.7.1 External Adjustment

Between 1983 and 1985 the dollar value of merchandise imports fell by 32 percent. It was this compression of imports that was responsible for the elimination of the current account deficit. Imports were reduced through lower incomes and, in particular, through the reduction of domestic investment. Capital goods imports fell by 54 percent over the same period. However, the severe shortage of foreign exchange, high black market currency premiums, and the tightening of quantitative restrictions on imports were also responsible for some of the drop.

Exports present a mixed picture, rising by more than expected in 1984 and then falling sharply in 1985. Over the entire 1983–85 period the dollar value of merchandise exports fell by 7.5 percent. Exports of the major traditional commodities—sugar, coconut products, lumber, gold, and copper concentrates—fell in volume as well as value during the period. This was the result of weak external prices, shifts in domestic production incentives away from traditional commodities, and in some cases, poor weather. Nontraditional manufacturers exports did reasonably well, with very strong gains in 1984 and somewhat weaker performance in 1985.

Although exchange and tax policy was designed to shield nontraditional exports, there is still evidence that this sector was hurt by the stabilization period. Consignment imports were allowed without restriction, and some firms with foreign partners were able to finance imports through equity contributions from their parent firms. However, domestic credit was extremely tight, and there were shortages of foreign exchange even for goods on the priority allocation list. Indirect evidence of the effect of the disruption of the domestic economy on the manufacturing export sector comes from Philippine performance in its largest export market, the United States. The Philippines lost market share to other exporters during this period in most of its important nontraditional exports (table 7.11).

While the Philippines reduced import levels, it had less success in shifting the balance of incentives in favor of the production of tradable goods. The peso had appreciated steadily in real terms from 1978 to 1982, measured both by comparison with the currencies of the Philippines' trading partners and by the ratio of traded to nontraded goods prices domestically. The devaluations of 1983 and 1984 reversed this process, but did not succeed in decisively shifting the real exchange rate in the Philippines. Although the devaluations were large, they were mostly offset by high rates of inflation in the country. In addition, the disparities in protection rates across sectors widened considerably during this early period, increasing the protection of much of the domestic industrial sector. The peso actually appreciated at the end of 1984 and in early 1985, eliminating the gains in competitiveness that had taken place in the two previous years (see fig. 7.1). The real depreciation that took place during 1986 was mainly due to the fall of the dollar; the Philippine peso experienced little change against the currencies of its Asian competitors.

In summary, the Philippines was successful in dealing with the break in external funding and the severe foreign exchange constraint of the adjustment period. The way in which this was done, however, increased the domestic output cost of the adjustment. What is more important is that the Philippines failed during this period to make the relative price adjustment

Table 7.11 **Share of Philippine Exports in U.S. Imports (percentage)**

	1980	1981	1982	1983	1984	1985	1986
Refined sugar	8.7	5.9	8.1	10.6	10.9	13.2	12.6
Lumber, shaped	11.5	14.1	8.4	13.5	11.9	10.4	8.5
Copper ore, etc.	58.4	50.5	27.7	17.3	24.6	0.0	0.0
Coconut oil	83.1	91.7	91.3	86.6	79.7	64.6	90.1
Transistors, valves, etc.	9.9	11.9	12.7	12.3	10.5	9.3	7.2
Electronic microcircuits	12.2	14.8	15.5	14.7	12.0	11.6	9.5
Electronic components	1.1	1.1	2.2	4.3	6.0	3.9	2.2
Furniture, parts thereof	4.4	5.4	3.9	3.4	3.0	2.4	2.0
Clothing	3.5	3.7	3.3	3.3	3.1	3.0	2.7
Footwear	1.3	1.6	1.0	0.7	0.6	0.3	0.3

Source: UN Commodity Trade Statistics, series D.

that would facilitate a resumption of economic growth in the face of the terms of trade deterioration that the economy experienced and the restricted access to international capital markets that the rest of the decade would entail. The adjustment episode halted and partially reversed the movement toward trade liberalization in the 1980s and did little to change real exchange rates.

7.7.2 Domestic Absorption

The current account balance reflects dependence on foreign savings as well as the balance in trade and service flows. Thus, the elimination of the current account deficit in the Philippines was also matched by an equivalent reduction in reliance on foreign capital to support domestic expenditure. Here we examine how this reduction was achieved.

We divide the economy into public, private, and foreign sectors, each of which can draw capital from, or provide excess savings to, the other sectors. The current account deficit of the Philippines is just the net demand for additional savings from the public and private sectors combined. This is shown in table 7.12, which is based on national income statistics.

During the adjustment period, 1983 to 1985, both the private and the public sector reduced their dependence on external finance. The adjustment was considerably larger in the private sector, where the net deficit position (investment minus savings) was reduced by 6.2 percent of GNP, compared to a reduction of 1.8 percent of GNP for the public sector. The extent of the adjustment by the private sector is even more apparent from the gross figures on investment and savings. The change in the net balance of the private sector was achieved in the midst of rapidly falling private sector savings. The

Table 7.12 **Savings/Investment Balances (percentage of GNP)**

	1980	1981	1982	1983	1984	1985
Private sector						
Investment	23.73	22.67	21.61	21.43	15.05	12.57
Savings	20.75	21.88	18.02	16.57	12.33	13.95
Personal	5.98	6.51	3.25	1.97	−0.80	−0.53
Corporate[a]	5.49	5.27	4.44	4.27	2.67	3.50
Capital consumption[b]	9.28	10.10	10.33	10.33	10.46	10.98
Surplus/deficit	−2.99	−0.80	−3.59	−4.87	−2.72	1.38
Public sector[c]						
Investment	6.94	8.04	7.16	6.09	4.11	3.69
Savings	4.98	3.79	3.20	4.00	4.02	3.37
Surplus/deficit	−1.96	−4.25	−3.96	−2.09	−0.08	−0.33
Net foreign resources/current account	4.95	5.05	7.55	6.96	2.75	−1.05

Source: NEDA, National Accounts Section.

[a]Includes savings by government-owned corporations.

[b]Including statistical discrepancy.

[c]National government plus government corporations.

reduction in private sector investment is enormous—over 10 percent of GNP since the early 1980s. Since depreciation remained roughly constant at about 10 percent of GNP, net investment by the private sector practically disappeared during this period.

Both individuals and corporations sharply reduced their savings after 1982. A number of factors led to the drop in savings: a reduction of corporate incomes during the domestic recession, an increase in capital flight that occurred in 1982 and 1983, and the desire to cushion consumption expenditure over the adjustment period. The Philippines is unusual among countries that went through adjustment during this period in that real consumption expenditure actually increased steadily throughout the process. (Although this was not enough to sustain real per capita consumption expenditure, which fell by 3.3 percent from 1983 to 1985.)

7.7.3 Monetary Policy and Inflation

The Philippines was highly successful in reducing the domestic inflation rate, in contrast to many other countries that have tried to adjust to a debt crisis. The domestic inflation rate dropped as quickly as it had risen in the Philippines; by 1985 consumer prices were rising at their lowest rate in two decades, and prices actually fell during 1986. Three factors account for the rapid reduction of the inflation rate: a tight monetary policy, the stabilization and unification of the exchange rate, and the absence of indexing and other features that add momentum to inflation.

The various indicators of monetary growth in table 7.13 indicate the tightness of monetary policy in 1984 and 1985 after the huge growth that took place in 1983. The growth rate of nominal money in circulation, both M1 and M3, was low by historical standards, and the real money supply dropped sharply in 1984. By December 1984 the real values of all three aggregates were at their lowest points for the decade. Velocity measures for money in circulation increased sharply in 1984, in line with the tightening of policy. The course of reserve money was quite different, reflecting the substantial fall in the money multiplier that took place between 1982 and 1985. This was the result of increased currency holdings by the public, as confidence in financial institutions diminished, and the substantial increases in reserve requirements of 1983 and 1984.

Interest rates lagged behind the increase in inflation in 1983 and its retreat in 1985. As a result, real interest rates, though negative during most of 1984, were at historically high levels through most of 1985 and 1986 (figure 7.3). The high real interest rates of these two years were the product not only of slow monetary growth, but also of the heavy public sector demands on available credit, a point which is discussed below.

The second reason for the reduction in inflation was the steadying of the exchange rate after October 1984 and the narrowing of the black market premium on foreign exchange, as bank trading in foreign exchange resumed.

Table 7.13 Money Supply and Growth Rates (billion pesos and percentages)

	1980	1981	1982	1983	1984	1985	1986	1987
Money supply								
Reserve money	16.19	17.80	18.64	27.72	33.45	37.99	49.98	59.53
Narrow money	22.54	23.52	23.50	32.49	33.63	35.83	42.66	52.38
M3	67.80	82.08	95.30	113.00	121.20	132.80	149.80	160.50
Growth rates								
Reserve money	10.7	9.9	4.8	48.7	20.6	13.6	31.6	19.1
Narrow money	19.6	4.3	−0.1	38.3	3.5	6.5	19.1	22.8
M3	18.2	21.1	16.1	18.6	7.3	9.6	12.8	7.1
Real money growth rates[a]								
Reserve money	−6.1	−0.6	−3.4	17.9	−20.0	7.5	32.0	11.4
Narrow money	1.5	−5.6	−7.9	9.7	−31.4	0.8	19.4	14.9
M3	0.3	9.5	7.0	−5.9	−28.9	3.7	13.2	0.2
Velocity								
Reserve money	90.8	94.8	100.0	76.1	87.5	87.0	67.9	64.2
Narrow money	82.2	90.4	100.0	81.8	109.6	116.3	100.3	92.0
M3	110.9	105.1	100.0	95.4	123.4	127.2	115.8	121.8

Source: Central bank, *Annual Report* and *Philippine Financial Statistics*.
[a]Calculated using December CPI.

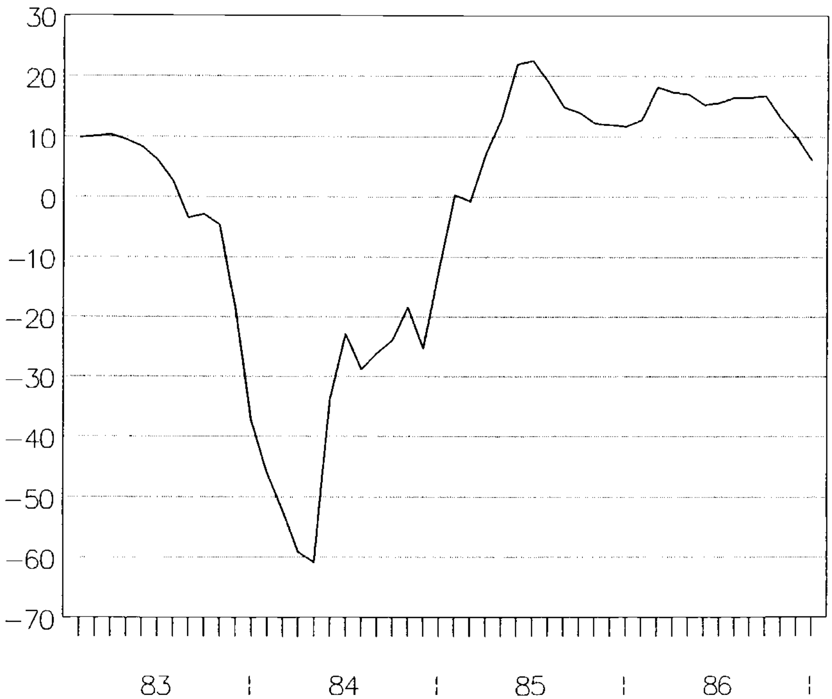

Fig. 7.3 Real interest rates
Note: Treasury bill rate less CPI inflation rate.

Monthly values of the exchange rate and the black market premium are shown in table 7.1 above. The black market premium was finally eliminated with the floating of the exchange rate in October 1984, and the exchange rate hit a peak the next month. In November the central bank reduced its purchases of foreign exchange in the market, and from November 1984 to June 1985 the exchange rate appreciated against the dollar, rising by a total of 7 percent before starting to depreciate again. However, the nominal appreciation of the peso resulted in an appreciation of the real exchange rate of about 11 percent (see table 7.2 and fig. 7.1). This reversal of the real exchange depreciation immediately became an issue with the IMF during and after the first standby review. The Philippine government argued that the limits on growth of reserve money prevented them from intervening in the foreign exchange market to prevent the peso's rise. The Fund in turn argued that remaining restrictions on bank holdings of foreign exchange had prevented them from purchasing and in fact had turned some banks into unwilling net sellers (IMF 1985a, 11–12).

The final reason for the sharp reduction in inflation in the Philippines is the absence of many of the institutional features that tend to perpetuate inflation in other countries. Price ceilings and administratively set prices were adjusted rapidly during this period to changes in the exchange rate and increases in external prices. In addition, by the end of 1984 most consumer goods price ceilings had been removed. Thus there was no buildup of price increases that had not yet been passed through to consumers. Nor were wages a source of inflationary pressure. Only about 10 percent of the labor force was unionized, and unions remained relatively weak under martial law.[21] Strikes were banned in vital industries, and prenotification was required for strikes in other industries. The government set minimum wages for agricultural and nonagricultural workers, with upward adjustments for cost of living increases. However, the adjustments were not automatic, and in the early 1980s real minimum wages fell significantly. In addition, distressed firms could apply to the National Wages Council for an exemption from the minimum wage rules, and noncompliance with minimum wage requirements was widespread. Finally, and most importantly, there seems to be a remarkable ability among the Philippine populace to tolerate real wage declines. Real wages fell significantly after the decontrol episode in the early 1960s and after both oil price shocks.

This characteristic of the Philippine inflation process—rapid rises in the inflation rate followed by equally rapid declines—is evident from the first oil shock and from other inflation episodes in the country's postwar history. With this kind of inflation process, the tight monetary policy that was imposed in 1984 and maintained through 1985 and into 1986, despite the very low rate of inflation at the end, was a case of misplaced worry and significant overkill. While the Philippines definitely had inflation wrung out of the economy, the restrictive monetary policy of the period, coupled with other characteristics of financial institution policy, resulted in the virtual drying up of private domestic credit, as well as huge increases in its cost when available. The extreme domestic credit stringency drove many firms to the wall, both nonfinancial and financial, and left the financial system unwilling to take on anything but the most minimal lending risk.

The 1984–85 period saw continuing expansionary influences on the money supply. These included the expiration of the remaining forward contracts on foreign exchange, an almost doubling of net credit to the public sector, increasing assistance to financial institutions in distress, and mounting interest payments on outstanding central bank securities. However, in the last half of 1984 and throughout 1985 the central bank maintained a very tight monetary policy. Reserve money, the monetary component subject to ceiling in the IMF adjustment program, increased by only 11 percent from the end of 1984 to the end of 1985. When reserve deficiencies and reserve-eligible government securities are included, the base for deposit expansion increased by only 8 percent during the year. To achieve a tight overall policy, the central bank sold large amounts of its own securities to the banking system and directly to the public.

As discussed above in section 7.5.1, the sale of Jobo bills began in earnest in August 1984. These had short maturity, large denomination, and flexible interest rates, and defined a floor rate of interest for fully secured loans and other financial obligations. Between June and December 1984 the stock of outstanding central bank securities rose from P. 10 billion to P. 14 billion, or to 15 percent of the domestic credit extension of the central bank (see table 7.3).[22]

The central bank continued to sell its own securities in 1985. In addition, starting in the first quarter of that year it entered into a number of reverse repurchase agreements with commercial banks. Under a reverse repurchase agreement, the central bank would sell government securities to a bank with an agreement to repurchase them at an agreed upon price at a later date (typically thirty days). By September 1985, outstanding central bank securities and reverse repurchase agreements had risen to over P. 38 billion (28 percent of the domestic credit extension of the central bank) before diminishing toward the end of the year.

Credit tightened dramatically in 1984 and 1985 as a result of the stricter monetary policy of the central bank and also due to an unprecedented fall in intermediation by the financial sector. The real money stock fell by 31 percent between the end of 1983 and the end of 1985, while real M3, a measure of funds available from banks and quasibanks, fell by 26 percent.

The fall in domestic intermediation had a number of causes. The first was uncertainty about the safety of the financial system, which led to increased demand for currency by the public. Diminished confidence particularly affected nonbank institutions active in the money market—investment companies and finance companies—as deposit-substitute holdings dropped by over two-thirds in real terms. The financial system was also affected by significant disintermediation, as the central bank and the Treasury sold their securities directly to the public. Between the end of 1983 and the end of 1985, central bank and national government securities held by the public increased from P. 19 billion to P. 56 billion, reaching a level corresponding to 42 percent of M3.

Commercial banks responded to the credit tightness and increased uncertainty in the financial markets in much the same way as did the public, by shifting into safer and more liquid assets. In table 7.14 we show components of commercial bank asset portfolios in the Philippines. Between December 1983 and September 1985 there was a significant increase in bank holdings of liquid assets, particularly in their holding of central bank securities and reverse repurchase agreements. At the same time, there was a shift out of other assets, particularly loans and discounts, which fell over the period in nominal terms and by 44 percent in real terms. The result of this shift in bank asset portfolios, combined with the direct sale of government securities to the public, was a significant redirection of available credit toward the public sector and away from the private sector. Domestic credit to the private sector fell by 20 percent in nominal terms and by 50 percent in real terms between the end of 1983 and the end of 1985. Here, as in the case of expenditure, most of the adjustment was done by the private sector.

Some fall in private credit demand would have been inevitable given the reduction in expenditure that the stabilization program entailed and the foreign exchange constraints that limited imports of necessary inputs and equipment for many industries. However, the reductions in real credit

Table 7.14 **Commercial Bank Asset Portfolios (billion pesos)**

	Jun 83	Dec 83	Jun 84	Dec 84	Jun 85	Sept 85
Liquid assets	66.1	57.4	76.3	95.3	106.1	104.4
Central bank obligations	16.0	16.2	23.5	31.2	40.0	37.3
Total loans	132.5	151.8	158.4	153.4	137.4	129.6
Loans & discounts	94.6	109.2	117.8	116.3	104.5	97.4
Total assets	232.8	248.2	278.9	303.5	293.0	287.9
Percentage shares						
Liquid assets	28.4	23.1	27.4	31.4	36.2	36.3
Central bank obligations	6.9	6.5	8.4	10.3	13.7	13.0
Total loans	56.9	61.2	56.8	50.5	46.9	45.0
Loans & discounts	40.6	44.0	42.2	38.3	35.7	33.8
Memo item: real loans & discounts	100.0	95.1	83.5	67.2	58.0	53.4

Source: Business Day, quarterly surveys, data from published bank *Statements of Condition*.

Note:

Liquid assets: Cash, checks, due from the central bank and other banks, secured trade accounts, bonds.

Total loans: Loans and discounts, interbank loans, agricultural/agrarian reform bonds, bills purchased, customer liabilities.

Real loans: Deflated by monthly consumer price index.

availability were far greater than output reductions in the economy as a whole and in manufacturing, and there were numerous complaints in the Philippines about the availability of credit as well as its cost. This was true even in industries that were not as market limited as manufacturing, such as export industries and agriculture. Commercial bank credit to agriculture declined by 36 percent in nominal terms in 1984 and stayed constant in 1985 (Montes 1987, 29). For industrial forms the result of the stringent credit measures was widespread bankruptcy, particularly among firms in the import-substituting manufacturing sectors, although data on the extent of insolvencies is very sketchy. Perhaps one-quarter to one-third of all firms faced debt servicing problems.[23] In many cases, newer, technologically efficient firms with high debt/equity ratios went bankrupt, while less efficient but less extended firms survived (World Bank 1987, 10). Among surviving firms there has been a significant deterioration in financial ratios, particularly in sugar milling, mining, construction, and cement.

The stabilization episode was also an extremely difficult one for financial institutions. Sharply increased interest rates in 1984, after a period in which the government had been urging banks to lend on longer term, caught many banks in a term squeeze as funding costs increased faster than the earnings of loan portfolios. In addition, the high reserve requirement (which yielded 4 percent interest) plus the 25 percent lending to agriculture requirement (much of which was met through government bonds yielding 9 percent) plus a tax on gross bank receipts resulted in a very high rate of taxation of intermediation when inflation rates rose. This raised break-even bank spreads, causing difficulties for banks and their loan customers.[24] The domestic recession and high interest rates turned many loans into nonperformers. Finally, the general financial uncertainty and instability led to substantial withdrawals from several institutions, including investment houses and finance companies, one major savings bank, and several smaller banks. Twenty-three financial institutions failed in 1984 and another fifty-eight failed in 1985 (IMF 1986b, 34). Central bank emergency assistance increased sharply on several occasions during 1984–86, threatening the country's monetary targets. The system for delivery of credit to the rural sector essentially broke down. The bank responsible for financing of the sugar industry, Republic Planters, became insolvent. Over 100 of the roughly 1,000 rural banks became insolvent, and arrearages of rural banks as a proportion of central bank rediscounts to them reached 83 percent in 1985.[25]

Ironically, what may have saved many financial institutions was the extensive central bank borrowing at high interest rates that allowed banks to greatly increase the yield and liquidity of their portfolio by buying securities. This eventually involved large transfer of interest payments from the central bank and the passing of the brunt of the adjustment to the bank's traditional customers.

7.8 Conclusions on the Adjustment

The crisis and adjustment period in the Philippines reflects a striking about-face in Philippine relations with the IMF and its external creditors. After a period of relatively lenient standby programs, regularly exceeded by the Philippines and then renewed, the Philippines was placed under an extremely stringent program that was successfully carried out in what would prove to be the last months of Marcos' hold on power.

This period demonstrates that institutions have memories, and these are reflected in their programs. The events of 1983—the speed with which the 1983 program targets were exceeded, the overstatement of international reserves, and the tremendous increase in the monetary base—all served to transform the IMF from "doting parent to vengeful god" (Montes 1987, 21). This resulted in prior conditions and an IMF program that were unusually harsh.[26] The stringency of the adjustment that was actually carried out also reflected the unwillingness of creditors to supply additional funds to the Philippines and resulting capital inflows that were less than the IMF program. The Philippines compounded its problems by waiting until its foreign exchange reserves were almost exhausted, by failing to draw on standby credits that it had negotiated, and by delaying its declaration of a moratorium until after the central bank had run up substantial overdrafts.

After years of failing to meet conditions in IMF programs, the Philippines met or more than met the conditions in this one. The assiduousness with which the Philippines pursued these targets was in part due to the limited options that the country had; foreign exchange was extremely tight, and the release of funds under both the IMF and commercial bank programs, other than for settling arrears, was quite slow and subject to frequent reviews. But Philippine adherence to program conditions also reflected the increasing domestic opposition to the Marcos regime after the Aquino assassination and the need of the government for external support.[27] The stabilization program as it was carried out represented a tremendous gamble for the regime, as it tried to simultaneously meet the external conditions while protecting its supporters, forcing a greater burden of adjustment on the private, nonassociated sector (Montes 1987, 21–27).

The adjustment program that the Philippines carried out demonstrates the power of monetary restraint in an economy without institutional inflation mechanisms. The adjustment saw a tremendous shift in the noninterest current account and the elimination of both the current account deficit and inflation. In contrast to many debtor countries in Latin America, stabilization in the Philippines was rapidly achieved. But the stabilization was accomplished through reduction in income and a particularly large reduction in investment expenditure, at severe cost to the domestic economy and population. Little was achieved to lay the foundations for recovery and growth. The Philippines reduced imports, but did not shift resources toward the tradable goods sector. Despite the large devaluations, the real exchange rate at the end of 1985 was nearly unchanged from its level in the early 1980s. Beyond the income loss and unemployment, the severity of the credit squeeze traumatized the financial and industrial sectors, forcing many firms under and undermining the willingness of the banking system to take on lending risk, factors that would later delay the recovery of confidence and investment.

8 The Aquino Government and Prospects for the Economy

The "New Society" proclaimed by Marcos in the early 1970s failed to produce its promised improvements in the welfare of Filipinos, and, as martial law continued, opposition to the Marcos government grew. The oil shock and subsequent fall in commodity prices hurt incomes, particularly in the rural areas. Although measured economic growth was substantial, regional income disparities increased, and over the decade the proportion of the population living in poverty remained high.[1] Continuing arrests and human rights violations by the military brought protests, particularly from the Catholic church.

But the most crucial loss of regime support came in those groups that had provided the initial constituency for martial law. The patronage machinery on which the political foundations of martial law rested, especially the particularistic interventions and the generation and distribution of monopoly rents, tended over time to narrow the base of political support. By 1985 Marcos' base was dangerously thin.

The early support for the government within the rural sector faded as the momentum of land reform dissipated and as military abuses and corruption increased. Even though agricultural terms of trade were falling, the government increased its taxation of important crops through export and producer levies and through monopolization of trading and processing activities. The increasing incidence of rural poverty aided the insurgency, and the communist NPA took over effective administration, including taxation, in several areas.

Although the military had been the main beneficiary of martial law, opposition within the armed forces developed over promotions and over the deployment of forces against the Moslem and communist insurgencies. Before 1972, the Philippine armed forces had been small, relatively professional, and reasonably effective. Martial law greatly expanded the size