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The Philippine Economy: Marcos's Options for the 1986-87 Elections

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An Intelligence Assessment

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The Philippine Economy: Marcos's Options for the 1986-87 Elections [redacted]

An Intelligence Assessment

This paper was prepared by [redacted] and [redacted] Office of East Asian Analysis, with a contribution from [redacted] OEA. [redacted]

Comments and queries are welcome and may be directed to the Chief, Southeast Asia Division, OEA, on [redacted]

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The Philippine Economy: Marcos's Options for the 1986-87 Elections

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Key Judgments

Information available as of 21 October 1985 was used in this report.

The economic instability that has characterized the Philippines since the foreign debt moratorium declared in October 1983—instability manifested in high inflation, capital flight, and bank failures—has been brought under control in recent months. President Marcos's government now faces the difficult task of moving a depressed economy off dead center as elections approach for local officials in May 1986 and for the presidency in June 1987. 25X1

We believe Marcos has three basic options for the economy as elections near:

- ***Spending To Win.*** A budget-busting spending spree aimed at gaining votes for the ruling party is a time-honored tradition in Philippine politics. Our econometric simulations show that real output could rise by 6 percent next year with such policies, but the drawbacks include renewed inflation, suspension of loan disbursements from foreign creditors, and fostering an appearance of political desperation.

- ***Adopting Foreign Creditors' Prescriptions.*** Marcos could attempt to broaden his political support with promises of a "new beginning," including institutions serving the needs of the working poor and an end to the business favors granted to political allies. Although such policies could raise national output by nearly 5 percent next year, wide-ranging policy reforms would threaten the source of much of the ruling party's financial support.

- ***Staying the Course.*** The path of least resistance for Marcos is intermittent compliance with the IMF's adjustment program, which to him means continued economic privileges for allies of the ruling party and deferring reforms that would threaten them. 25X1

We believe Marcos will conclude that the political and economic risks associated with either a preelection spending spree or sweeping policy reforms are too high. In our judgment, Marcos will choose to "stay the course" on economic policy while hoping for a rebound in exports to stimulate the economy. Our econometric simulations suggest that such an approach would permit a modest economic recovery through 1987:

- With favorable economic conditions abroad, GNP would grow by 3.4 percent in 1986 and nearly 6 percent in 1987, after declining by approximately 4 percent this year.

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- Consumer price inflation would decline to a 10-percent annual rate by 1987, while private consumption would be 10 percent higher than 1984 levels. 25X1

The electoral payoff to Marcos of such an outcome would increase as the economy picked up steam, while avoiding the inflationary side effects of a budget-busting spending spree. Few gains would be visible by the May 1986 elections, even if the economy resumed growth early next year. But, if an economic recovery carried into 1987, the ruling party's presidential slate probably would benefit from increased employment, low inflation, and voter perceptions that an economic rebound was under way. 25X1

Middle-of-the-road economic policies, however, would fail to set the stage for a sustainable, long-term recovery and would do little to reduce friction between Manila and its largest creditors—particularly the United States—over economic policy reform. Measures necessary to boost exports—such as dramatic exchange rate liberalization—probably would be postponed, making the post-1987 election adjustment more painful both economically and politically. In any event, prospects for lasting economic recovery also would be undermined if businessmen remained uncertain about the country's political future, felt threatened by economic privileges granted to Marcos's political associates, and concluded that Manila was losing the battle against the Communist-led insurgency. 25X1

In our judgment, Marcos almost certainly is concerned that confrontations over economic policy are likely as US economic assistance is increasingly tied to policy reform, especially in such politically sensitive areas as agricultural monopolies. Moreover, as local elections approach, we believe Marcos will become more sensitive to US efforts to push reform in any area—economic, political, or military. 25X1

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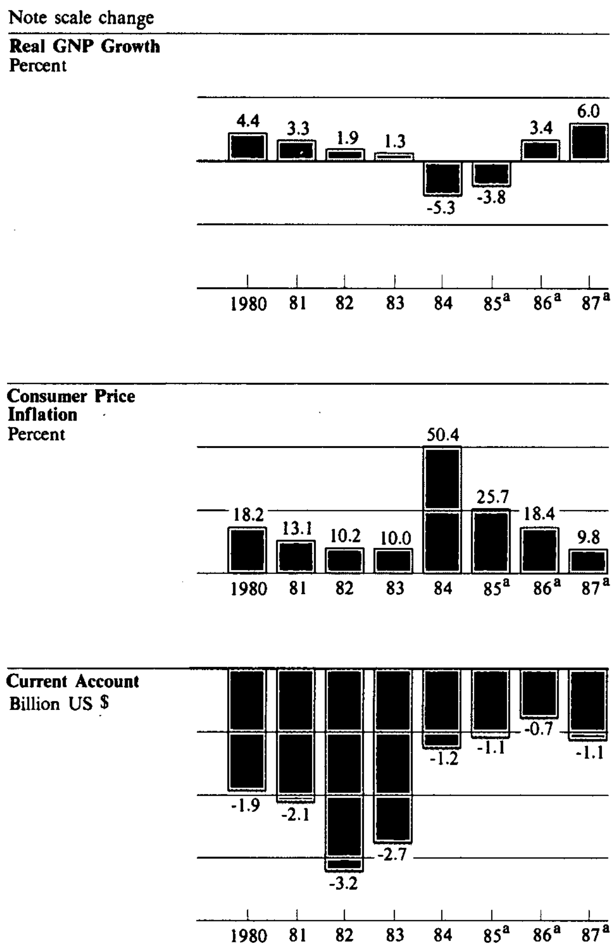
Figure 1
The Philippines: Economic Indicators, 1980-87



[a] Stay-the-course projections. See text for a description of assumptions underlying this approach.

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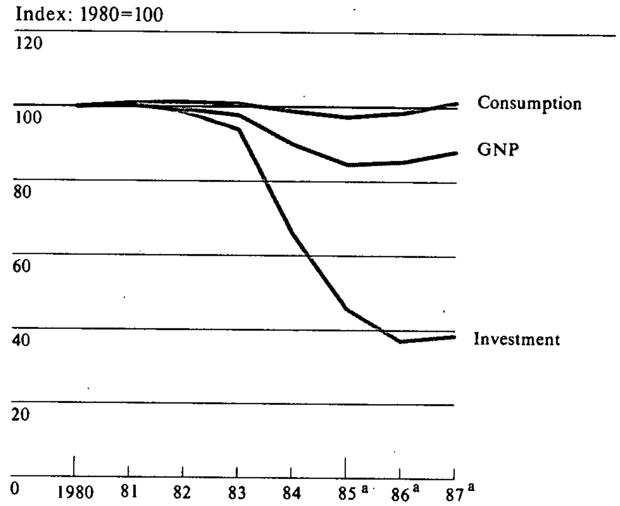
Figure 2
The Philippines: Economic Indicators per Capita, 1980-87



[a] Stay-the-course projections. See text for a description of assumptions underlying this approach.

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The Philippine Economy: Marcos's Options for the 1986-87 Elections [redacted]

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Two Years Into the Debt Crisis

The Philippines has made substantial progress containing its economic crisis and stabilizing the $26 billion debt-ridden economy.[1] Runaway inflation, record high interest rates, and aftershocks of two successive devaluations following the moratorium on debt repayments in October 1983 have been largely brought under control:

- Tight monetary policy has slowed inflation from an annual rate of 100 percent last summer to an adjusted annual rate of only 8 percent in recent months.
- Interest rates, which peaked at 40 percent late last year, have fallen to less than 20 percent.
- Weak local demand for imports and disbursements from the nearly $10 billion financial rescue package negotiated with foreign creditors have eased pressures on the peso so dramatically that the difference between the official exchange rate and the black-market rate—as high as 50 percent in early 1984—is now negligible. As a result, the exchange rate has remained stable for most of this year at about 18.5 pesos per US dollar. [redacted]

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Manila's economic policy makers are now shifting attention to stimulating the lackluster economy. By any standard, the damage produced by the debt crisis has been extensive, and local businessmen remain discouraged. Philippine economists estimate that national output fell by 4.6 percent in first half 1985, following a 5.3-percent decline last year. Bankruptcies and business closings have been widespread—during the first quarter of 1985, 800 of the country's top 2,000 corporations ceased operations at least temporarily. According to the US Embassy, the unemployment rate remains at nearly 15 percent—representing about 3 million people. At the same time, less than half of those employed hold full-time jobs. [redacted]

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[redacted]

Moving Toward Elections

Further deterioration of the economy over the next two years would be a major political handicap for President Marcos and the ruling New Society Party (KBL). Local elections are scheduled in May 1986 throughout the country for governors, mayors, and local leaders—a total of over 16,000 offices. Elected officials will exercise considerable political influence at the provincial level, according to US Embassy reports. As a result, most Philippine politicians believe that KBL election victories in 1986 are a vital building block for a successful bid by Marcos in the presidential elections scheduled for June 1987. [redacted] 25X1

The ruling party faces an uphill battle if its own public surveys are any guide.[2] [redacted] 25X1 [redacted] 25X1 the prospect of significant KBL losses in 1986—reflecting the concern of rural voters not only with the economy, but also with declining security, military abuses, corrupt local officials, and Manila's apparent indifference to their problems. The government's own internal reports estimate that in one region the opposition will win 90 percent of the election contests and more than half the contests in most of the other regions. We believe that this underscores the importance to the ruling party of achieving the appearance of progress in setting the economy on the road to recovery—which, in our judgment, will require continued progress in the fight against inflation, reasonably low interest rates, positive economic growth, falling unemployment, and an improving trade balance. [redacted] 25X1

Although Marcos's political fortunes have suffered because of the economic crisis and the widespread perception of economic mismanagement, we believe he has to some degree been protected by the ability of

[redacted] 25X1

Table 1
The Philippines: Economic Policy Options

Policy Option	Staying the Course	Adopting Foreign Creditors' Prescriptions	Spending To Win
	A business-as-usual approach to balancing political and economic objectives . . . lack of dramatic economic reforms maintains traditional political alliances . . . Manila's most likely policy option.	Policies that pave the way for long-term economic growth . . . but would constrain Marcos's ability to finance election spending . . . require dismantling structure of economic privileges . . . least likely option.	Policies designed to boost KBL's election prospects by maximizing short-term economic gains- . . . would put Manila on collision course with the IMF, World Bank, and commercial creditors . . . an outside possibility.
Features			
Fiscal policy	Government expenditure limited by IMF guidelines, but some election spending likely. Spending increases 15 to 20 percent annually in 1986 and 1987.	Expenditures stay well within IMF guidelines and are focused on productive services. New taxes are imposed on incomes to expand the tax base. Spending increases 12 percent in 1986 and 15 to 20 percent in 1987.	Expenditures rise significantly above IMF guidelines, with emphasis on construction and public works. Spending increases 50 percent in 1986 and 15 percent in 1987.
Monetary policy	Limited by IMF guidelines, but occasional lack of compliance possible. Reserve money increases 10 percent annually in 1986 and 1987.	Reserve money remains within IMF guidelines, increasing 10 percent annually in both 1986 and 1987.	Also heavily expansionary—reserve money growth above IMF targets is necessary to finance increases in government spending. Reserve money increases 10 percent by the end of this year and by a 17-percent average rate in 1986 and 1987.
Exchange rate	Some depreciation of peso, reaching 21 pesos to the dollar by the end of 1985 and 24 pesos to the dollar by the end of 1986.	Complete float of the peso, requiring significant institutional and policy reforms. Exchange rate depreciates to 22 pesos to the dollar by the end of 1985 and to over 25 pesos to the dollar by the end of 1986.	Exchange rate is maintained at the current level of 18.6 pesos to the dollar.
Reforms	Only minimal reforms undertaken in agriculture and financial sector. Implemented only when pressed hard by the United States and international financial institutions.	Aggressive reforms in both agriculture and finance. Dismantle agricultural marketing monopolies, particularly in coconuts and sugar. Rationalize and merge failing private and public banks.	Reforms in agriculture and finance are not undertaken.

the populace to adjust to hard times. Despite a 16-percent drop in real income, for example, per capita consumption has fallen only 4 percent since 1981—offsetting the initial impact of the economic crisis for many Filipinos. Consumption has been sustained by sharply reducing savings, and, in some cases, actually drawing down holdings of financial assets. For example, the stock of personal savings fell by $250 million last year and has fallen further this year, according to government data. [redacted]

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There is, nevertheless, no doubt that the economy's troubles have had an impact at the polls. In our judgment, depressed urban areas—which have suffered the brunt of the economic decline since the debt crisis—contributed to the opposition's 16-to-5 sweep of Manila's seats in the National Assembly during parliamentary elections in May 1984. Unemployment and wage cuts have swelled the ranks of Manila's

Table 1
The Philippines: Economic Policy Options (continued)

Policy Option	Staying the Course	Adopting Foreign Creditors' Prescriptions	Spending To Win
Key economic outcomes			
GNP growth	1986: 3.4; 1987: 6.0	1986: 4.7; 1987: 8.6	1986: 6.2; 1987: 3.5
Consumer price inflation	1986: 18.0; 1987: 10.0	1986: 22.0; 1987: 10.0	1986: 19.0; 1987: 33.0
Implications	Politically acceptable for Marcos in view of mild inflation and healthy growth in 1987. However, "status quo" does not set the stage for a sustainable recovery. Necessary policy changes are postponed, making the eventual adjustment more painful.	Drawbacks include higher short-term inflation and significantly less "pork barreling." Nevertheless, agricultural reforms lead to improved distribution of income and thus increased spending. Financial reforms lower banking costs and interest rates, improving investment. Overall, this policy sets the stage for long-term sustainable growth.	Among the three options, this policy achieves maximum growth by 1986, but at the cost of severe inflation and lower growth in 1987. Constant exchange rate requires that imports be constrained by tariffs, quotas, or through the black market. The long-term implications of this policy are the most serious—a sharp recession would be necessary, probably by 1988, to stabilize the economy again.

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poor, with one-third of Metro Manila's population of 6.8 million now residing in squatter colonies and slum areas, according to press reports. A lack of trade financing because of the debt moratorium and tight credit policies precipitated a shortage of imported capital goods and raw materials, forcing manufacturing firms to delay or cancel production schedules. Manufacturing output—which is heavily concentrated in Manila and accounts for one-third of GNP—fell by nearly 20 percent over the last 18 months. Production by key manufacturing firms is now 35 percent below 1981 levels, and real wages in manufacturing have fallen by one-third.

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The rural economy—which supports nearly two-thirds of the populace—has been spared the full impact of the economy's slide, and it is no accident that the KBL won nearly two-thirds of the National Assembly seats outside of Manila in the 1984 elections. Despite a host of problems, including increasingly costly inputs—such as fertilizer and credit—and a growing insurgency, agricultural production increased by 1 percent last year and by 1 percent in the first half of this year, according to US Embassy reports—a marked contrast with the 10-percent decline in manufacturing. Rice and corn production, for example, are at near-record levels because of government credit programs, the cultivation of more land, and favorable weather.

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Economic Policy Options

Given constraints imposed on Marcos by his foreign creditors, we have identified three policy approaches that incorporate trade-offs between short-run political considerations and longer term economic growth to approximate the mix of economic policies that Marcos

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is likely to have available as the country moves toward elections.[3]

Spending To Win. A massive spending program aimed at winning votes for the ruling party—without regard for the budgetary consequences—is a time-honored tradition in Philippine politics, and in the short term it can be effective. We believe that with a 20-percent jump in public spending Marcos could point to visible increases in social services and public works by the 1986 elections. Additionally, increased funding for military supplies and soldiers' salaries could improve morale, and—we believe—security, in the countryside. We estimate that real output could rise by more than 6 percent next year, accompanied by higher levels of income and employment. Under this scenario, Marcos would also defer any economic reforms that threaten his political allies—whose wealth and influence are critical factors for the ruling party during elections.

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The policy's short-term appeal is largely offset by its medium-term costs. Despite the initial gains generated by massive government spending, our simulation shows budget-busting measures would rekindle inflation to rates exceeding 30 percent by 1987—the presidential election year—and trigger concern that another recession would be needed to correct for the overspending. Furthermore, without economic reforms to address the grievances bolstering Communist Party recruitment in the countryside, this policy package, in our judgment, would do little to stem the rising insurgency.

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This policy approach also would take Manila out of compliance with the IMF program, resulting in cutting off new funds from foreign creditors. Such a development would jeopardize Manila's relations with foreign creditors and complicate negotiations to reschedule foreign debt payments falling due in 1987. In our judgment, this second round of rescheduling may be necessary because export earnings and new foreign credits will probably be insufficient to finance principal repayments to foreign creditors, which will reach $2.3 billion in 1987—a $1 billion increase over 1986 levels—if Manila is to avoid curtailing imports or depleting foreign exchange reserves.

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Adopting Foreign Creditors' Prescriptions. Although we do not believe Marcos will reverse himself after 20 years and wholeheartedly adopt the economic reforms currently recommended by the IMF and World Bank, such an approach would allow him to broaden his support base by promoting a "new beginning." In such an event, Marcos could promise to make economic institutions more equitable—including reorganizing agricultural marketing monopolies, which currently generate enormous profits for a small group of businessmen who are political associates of Marcos. The economic benefits of policy reforms—illustrating the best case outcome from following IMF and World Bank recommendations—are considerable. We estimate that the combination of economic reforms and responsible fiscal and monetary policies—all of which build confidence in the economy among domestic and foreign investors—would raise national output by nearly 5 percent next year and by over 8 percent in 1987. These policies, moreover, would pave the way for long-term sustainable economic growth and include economic reforms, such as those in agriculture, essential to an effective counterinsurgency strategy.

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These achievements would be offset by some short-term dislocations if the country's financial system, agricultural marketing, and trade and tariff procedures are reorganized. For one thing, a sharp devaluation of the peso would temporarily accelerate inflation. More important, Manila's ability to engage in pork-barrel politics would be sharply curtailed. The US Embassy reports that Marcos is already impatient with the IMF, concerned that the high political cost of the Fund's austerity program—resulting from successive devaluations, cutbacks in government spending, and restrictive lending policies—may not justify the program's long-term benefits.

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Staying the Course. We believe that Marcos is most likely to stick with his time-tested approach to decisionmaking—seeking the path of least resistance. In

[3] The IMF is providing Manila with a $615 million balance-of-payments loan—with disbursements running through May 1986—in return for Manila's compliance with economic targets designed to improve the balance of payments, trim inflation, and improve the structure of public finances and agricultural marketing arrangements. Compliance with the IMF program has permitted Manila to reschedule $5.5 billion in amortization payments to foreign creditors due between October 1983 and December 1986 and obtain $3 billion in short-term trade credits and $925 million in medium-term loans.

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Influencing the Economy: Marcos's Policy Tools

Along with the level of world trade and the demand for Philippine exports, Manila's economic policies will largely determine the performance of the Philippine economy during the politically critical next 18 months. In analyzing Marcos's policy options, we have calculated the impact on the economy of the individual policy instruments at Manila's disposal. According to our analysis, the three most important of these instruments are exchange rate, fiscal, and monetary policies. [redacted]

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To capture the effects of permanent changes in these policies on the current account deficit and the foreign debt, and politically sensitive variables such as economic growth and inflation, we have simulated the economic outcome of a 10-percent change in the exchange rate, a 10-percent change in government spending, and a 10-percent change in the money supply. [redacted]

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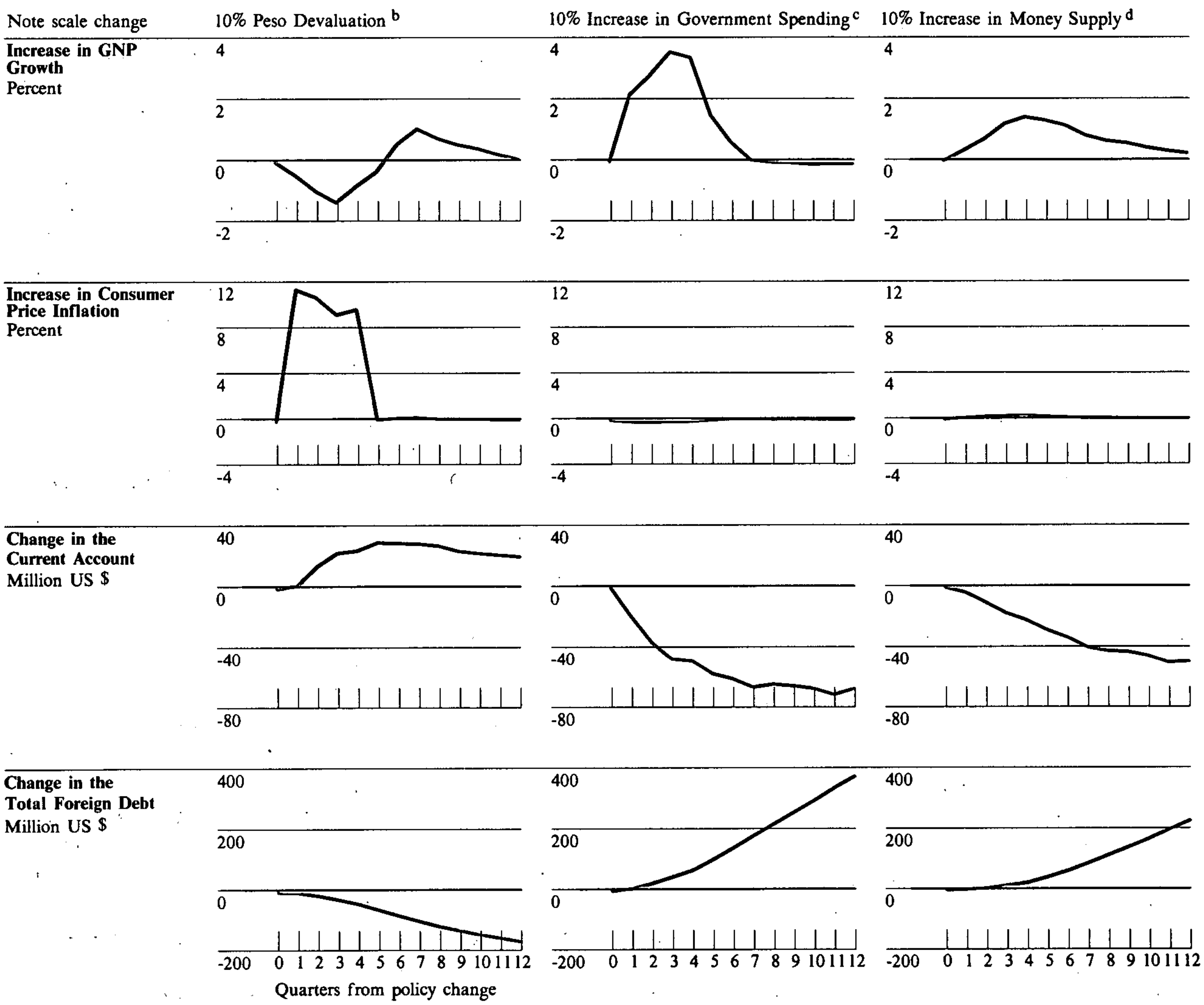
Among these three policy instruments, our analysis indicates that a 10-percent increase in government spending generates the largest and most rapid increase in economic activity—adding an extra 3 percent to total national output. By raising the demand for imports, however, this policy leads to a significant deterioration in the balance of trade and the highest level of foreign debt of the three policies. On the other hand, a 10-percent devaluation improves the trade balance—by increasing import prices and making Philippine products more competitive on world markets—and reduces the country's dependence on foreign capital. This policy, however, leads to significantly higher rates of inflation—and thus higher interest rates—which initially reduce national output by 1 percent. Although the impact on national output of a 10-percent increase in the money supply is not as dramatic as that achieved with the other two policy instruments, the effect is less destabilizing and longer lasting. [redacted] 25X1

In practice, Marcos will choose a combination of these and other policy instruments that best serve his political needs. There are limits, however, on his ability to manipulate individual policies. The IMF-imposed austerity program, for example, limits Manila's ability to increase government spending, cut taxes, and raise the money supply—traditional options for boosting the economy. The Fund program calls on the government to cut its budget deficit from over $775 million in 1982 to about $400 million in 1985, while raising tax revenues from $2 billion in 1982 to over $4 billion this year. Poor revenue performance this year will force Manila to introduce new taxes—a move that would depress domestic demand further. In addition, Manila must reduce government lending to public-sector corporations by one-third and limit wage increases to government workers. [redacted] 25X1

Other factors that influence the economy in the short term will remain beyond Marcos's control. Private- and public-investment spending—historically, an important engine of growth—is constrained by high interest rates and uncertainty about the economy, the country's political future, and the rapidly growing Communist insurgency, according to US Embassy reporting. Investment spending fell by 25 percent last year and is falling sharply again this year. [redacted] 25X1
[redacted] *the success of the insurgency is causing businessmen to rethink their investment plans, especially in rural areas.* [redacted] 25X1 25X1
[redacted] *for example, companies are pulling out of areas in Mindanao that are falling under the control of the insurgents.* [redacted] 25X1

Figure 3
The Phillipines: Impact of Economic Policy Instruments[a]



[a] Difference from baseline case.

[b] **10 Percent Peso Devaluation.** Most often talked about policy change . . . discourages imports by raising import prices . . . effect on the trade balance and the foreign debt are clearly beneficial . . . political reasons for Marcos to resist devaluation are easy to understand, however, because inflation jumps immediately due to higher import costs and remains significantly higher for a year . . . effect on growth is initially negative and only becomes positive after five quarters . . . model, however, may not capture complete supply response of exporters . . . such a devaluation would move the exchange rate from 18.6 pesos per dollar to 20.5 pesos per dollar.

[c] **10 Percent Increase in Government Spending.** Policy most likely to be used before an election . . . spending on construction projects, higher salaries, and increased government employment give immediate and significant boost to growth . . . effect tails off quickly however . . . overheated economy raises imports and prices . . . erodes the current account, adding to foreign debt levels . . . this policy change would increase operating expenses from 34.0 billion pesos per year to 37.4 billion pesos per year . . . such an increase would leave the budget deficit marginally above IMF guidelines.

[d] **10 Percent Increase in Money Supply.** Approach used to increase domestic credit and lower interest rates . . . increases both consumer spending and private investment . . . quick impact on GNP growth, which peaks four quarters after policy change . . . effect on the current account and foreign debt are clearly negative . . . policy often used to finance government spending . . . at present, such a policy would increase reserve money from 32.0 billion pesos to 35.2 billion . . . a level within IMF guidelines.

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Table 2
Political Implications of Marcos's Economic Policy Options

Policy Options	1986 Elections		1987 Elections		Net Appeal to Marcos [a]
	Political Cost of Implementing Policy	Economy's Contribution to Vote	Political Cost of Implementing Policy	Economy's Contribution to Policy	
Staying the course	Least	Least	Least	Moderate	Greatest
Spending to win	Moderate	Highest	Moderate	Least	Moderate
Adopting foreign creditors' prescriptions	Highest	Moderate	Highest	Highest	Least

[a] We assume the net appeal to Marcos of each policy option is an estimate of the economy's contribution to the vote for the ruling party minus the political costs of implementing the policy. The political costs, in our judgment, are the fallout arising from policy reforms directed against the economic privileges of powerful KBL allies, such as coconut industry king Eduardo Cojuangco and sugar magnate Roberto Benedicto, and the reaction of two key groups of foreign creditors—international financial institutions, such as the IMF and World Bank, and commercial banks, particularly in the United States.

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this case, few new economic reforms would be implemented, but the economy would also be spared unsettling policy changes. Although we expect that Marcos would attempt to create the illusion of reform by carrying out some of the measures recommended by the IMF, he would leave intact the economic privileges of powerful and supportive interest groups. In addition, while Marcos would boost government spending for activities appealing to voters—such as constructing schools, health centers, and roads—the spending could be financed largely by redirecting funds already in the government's budget, rather than embarking on a budget-busting spree. Funding for the ruling party's campaign would be directed through such government agencies as the Ministry of Human Settlements, after being generated by reductions in outlays for other ministries.

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If Marcos follows this course, a modest but politically acceptable economic recovery is likely in 1986. We estimate GNP would grow by 3.4 percent next year and nearly 6 percent in 1987. Significant gains are also projected in trimming inflation—in 1987 consumer prices will rise by only 10 percent—and private consumption in 1987 would be 10 percent above 1984 levels. We believe that the economic turnaround would follow modest improvements in various sectors of the economy—such as finance, housing, and services—that are already under way but are overshadowed economically by the unexpectedly large decline in exports this year—down by 14 percent during the first 8 months of this year. In addition, the IMF is loosening its restrictions on the supply of reserve money at Manila's request, raising the ceiling from 31 billion pesos in March 1985 to 38 billion pesos for December. As a result, domestic credit is more readily available at lower interest rates, a development that facilitates inventory restocking by businesses and stimulates domestic borrowing.

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Marcos is also likely to "stay the course" because such policies are beginning to show modest positive results. For example, stable exchange rates and lower inflation rates have largely put an end to panic hoarding of consumer goods and currency speculation by businessmen and bankers, leading to a resumption of financing for more normal business purposes. Furthermore, the agricultural sector is rebounding, and even depressed coconut exports are showing signs of picking up, according to industry data. Finally, we estimate that the cumulative effect of past devaluations, the availability of trade credits, and some modest improvement in the world markets for Philippine products could raise export earnings by 20 percent next year.[4]

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Some Caveats. However Marcos proceeds, the economy's outcome will be particularly sensitive to the performance of exports. Exports represent over 20 percent of GNP and generate another 20 percent of national output as they flow through the economy. Our analysis—based largely on our econometric model of the Philippine economy—indicates that a 10-percent increase in export earnings raises the GNP growth rate by 4 percentage points. The model also shows, however, that, if export growth is flat next year, GNP will decline by more than 5 percent—rather than show the 3.4-percent growth we project.

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The pace of US economic growth, in turn, will be a primary determinant of Philippine export levels. Sales to the United States account for nearly 40 percent of Philippine exports, and sales to this country have been responsible for nearly 90 percent of the increase in Philippine exports since 1979. Our econometric model shows, moreover, that a 1-percent increase in the US economy leads to a nearly 1-percentage-point increase in Philippine GNP growth. In addition, our analysis concludes that US economic growth has twice the impact on Philippine export levels that Japanese growth has.

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Even if all went well under our "staying the course" scenario, per capita incomes in 1987 would still be 12 percent below the 1981 peak of $775 per person, and the economic recovery would remain vulnerable to disruptive political events in the Philippines. A half-hearted commitment to the IMF, moreover, would result in on-again, off-again compliance with the Fund program and continuous haggling over specific program targets; and, more important, it would delay disbursements by the IMF and trade financing provided by foreign commercial creditors. This has already occurred because of Manila's recent failure to implement reforms in the sugar and coconut industries and to enact new taxes requested by the IMF.

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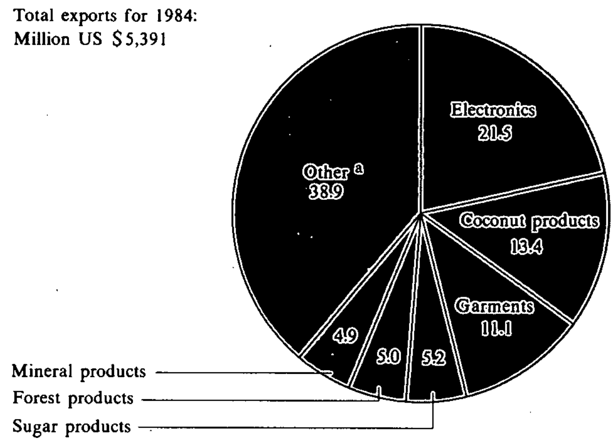
Figure 4
The Philippines: Exports by Commodity, 1984

Percent



[a] Includes fruits and vegetables, copper, handicrafts, chemicals, food products, machinery, furniture, and textiles.

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Points To Ponder

For the Philippines. Although a modest economic recovery would enhance political and social stability, we believe that the KBL's prospects in the local elections remain clouded. Few economic gains will be visible by mid-1986, and Marcos and his ruling party have little time to make up for the hardships voters have endured during two years of economic crisis. In addition, Marcos must overcome the public's growing resentment over the corruption and wealth of the political elite—heightened by recent widely circulated press exposes—and end lingering doubts about his

[4] Protectionist measures by Manila's trading partners will make this target more difficult to achieve, but it is in line with the IMF's projections. In any case, a 20-percent increase in 1986 brings exports earnings to a level only 2 percent above 1981 earnings.

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ability to manage the economy. Under these conditions, we believe that Marcos's likely choice of economic policies will, at best, have a limited influence on boosting his party's fortunes in the 1986 elections.

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By 1987, however, an economic recovery—well into its second year and gaining momentum—could benefit the ruling party and woo some of the middle class back into the KBL fold. In addition, we believe voters' resentment toward the ruling party will abate if employment rises and inflation continues to decline. Although voters in Philippine elections tend to mark their ballots on the basis of the personality and patronage of each candidate, an improving economy would be an important factor in determining the election outcome, as would issues such as the state of the insurgency and political reform.

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Outside the realm of electoral politics, benefits of "staying the course" would be far more modest. Because such an approach fails to rectify economic grievances that feed the Communist insurgents' popular appeal, a modest economic recovery might do no more than slow the insurgents' momentum.[5] Although we believe a rebounding economy would undermine the Communists' success in mounting large-scale demonstrations by peasant organizations and ease many of the economic hardships that sustain the increasingly militant labor movement, in our judgment, Manila also needs to vigorously pursue equitable rural development. Measures include focusing on increased public works projects and social services and fundamental reforms in rural institutions such as land tenancy, agricultural credit, and marketing monopolies.

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[5] These economic grievances center around disputes over land titles, land tenure systems, equal access to government economic institutions and services—such as rural banks and agricultural extension agents—and inadequate and declining social services.

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For the United States. Manila's business-as-usual approach to the economy assures continued friction with the United States over economic policy reforms necessary to ensure long-term economic growth, a viable resolution to the debt crisis, and a more equitable distribution of income. According to US Embassy reports, the United States is already identified by many senior officials in Manila as the prime mover behind efforts by the IMF and World Bank to reform economic policies and institutions. In addition, the Philippine press has suggested that recent disclosures in the US media of the First Family's overseas wealth were instigated by US Government agencies to embarrass Marcos.

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Marcos, in our judgment, almost certainly is concerned that confrontations over economic policy are likely as US economic assistance—totaling nearly $250 million this year—is increasingly tied to policy reforms in such politically sensitive areas as wheat imports, fertilizer distribution, rural credit, and sugar and coconut marketing. As local elections approach, we believe that Marcos will become more sensitive to US efforts to push reform in any area—economic, political, or military. He has already reacted to moves by the US Congress this summer to cut military assistance and increase economic aid. Marcos created a bipartisan commission in the National Assembly to review US-Philippine relations—including the Military Base Agreement and the $900 million in compensation called for in the 1985-89 agreement. By forming the commission, we believe Marcos has also signaled the United States that various forms of retaliation to further pressures are possible—ranging from harassments over minor issues, such as visas for US servicemen at the bases, to an abrogation of the bases agreement, which we believe is unlikely.

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For the Economy in the Longer Term. Even if the Philippines enjoys a modest economic recovery during the next two years, the long-term outlook remains poor if Manila follows the approach to economic policy we think it will. Inefficient economic institutions and policies—especially in agriculture, banking, and manufacturing—would continue to hobble the

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economy. A comprehensive package of agricultural reforms, for example, would allow that sector to grow by over 4 percent annually, according to our projections—compared with annual growth rates of 1 or 2 percent if current agricultural policies are retained.[6] [redacted]

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In addition, we believe flexible exchange rates—unencumbered by foreign exchange controls and tariff barriers—and further depreciation of the peso are necessary to reverse the long-term decline in the international competitiveness of Philippine export industries. Among other things, Manila's failure to move more aggressively on exchange rate reform discourages exports and encourages imports, and, as a result, will continue to swell the trade deficit when the economy resumes more traditional levels of growth. Furthermore, [redacted] reforms in public finance and investment policies are needed to raise domestic savings and reduce the country's reliance on foreign capital. [redacted]

25X1

25X1

A continuation of Marcos's policies beyond the presidential election would bode ill for the economy even if a modest rebound provided an aid to his reelection. According to US Embassy reporting, a sustained and vigorous recovery will be elusive as long as local businessmen and foreign investors remain uncertain about the country's political future and feel threatened by government agencies and Marcos's political associates. We believe that legislative or administrative reforms will not be sufficient if they are circumvented by Marcos through presidential decrees that he uses to perpetuate systemic corruption and favors granted his political associates. According to press reports, many leading members of the Philippine business community argue that the country's economic problems will not be resolved until political reforms are undertaken. Moreover, if businessmen conclude that Manila is losing the battle against the Communist-led insurgents, renewed capital flight would undermine any economic resurgence. [redacted]

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[redacted]

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Appendix

Econometric Model of the Philippines

To analyze Manila's ability to tailor the economic environment to its political needs, we have extensively overhauled our econometric simulation model in recent months. The model consists of 76 equations; 23 describe economic behavior—such as consumer spending patterns, investment decisions, and the level of consumer prices—and 53 are accounting and other economic identities describing relationships between different variables. The model concentrates heavily on the foreign-trade sector. 25X1

Recent improvements include:
- Refining the data base from updated National Income Accounts through mid-1985 and improving on the price deflators used to adjust for inflation.
- Refining the behavioral equations to markedly improve the model's predictive ability.
- Reestimating all the behavioral equations using the new data. 25X1

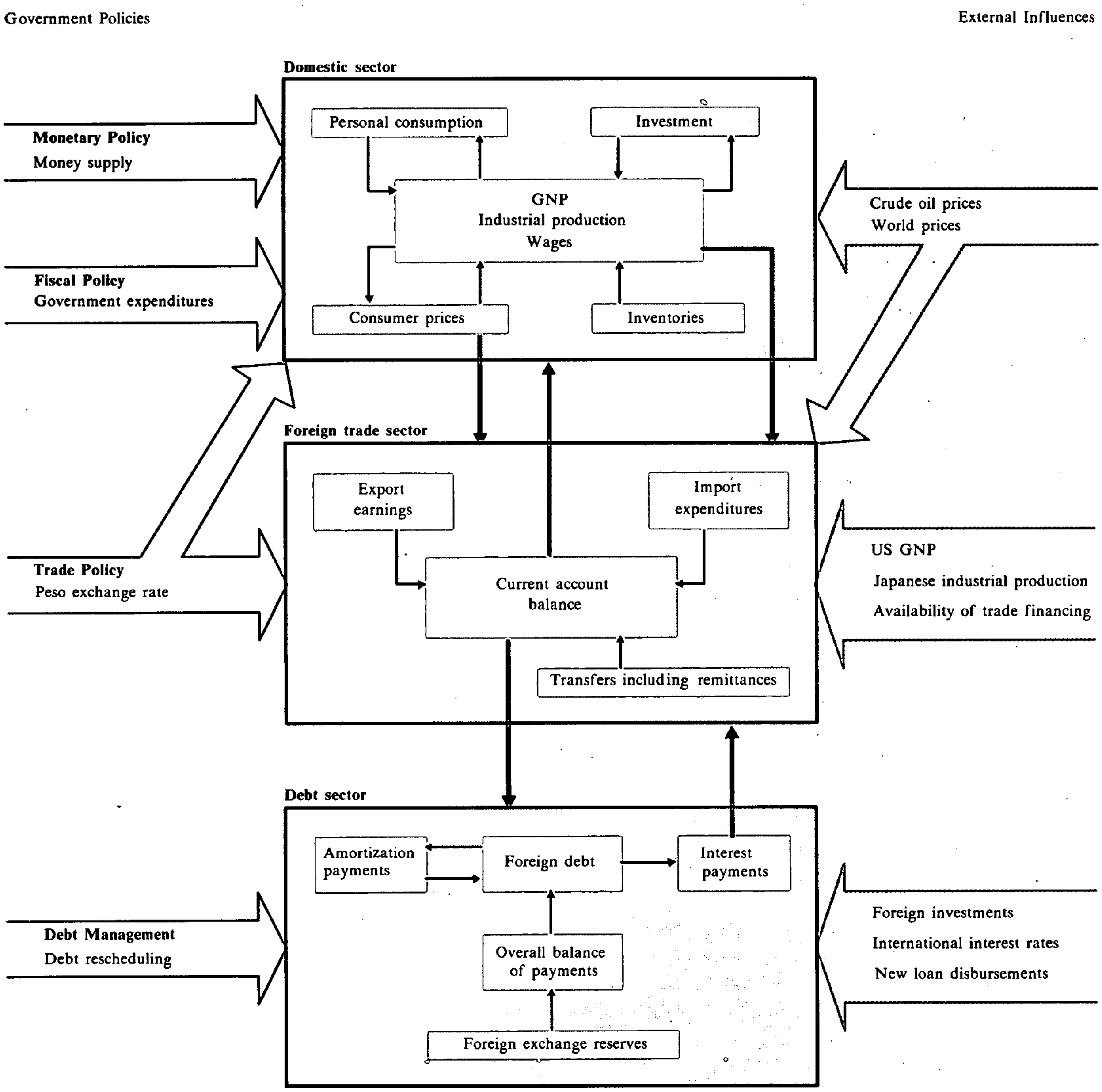
Even with these improvements, however, the model contains several weaknesses, requiring additional analysis outside the framework of the model to simulate outcomes:

- Although we have allowed for several supply constraints facing the economy—such as the foreign debt repayment moratorium—the model is largely influenced by trade flows and reflects the demand for output rather than the suppliers' response. Thus, it is possible that we have understated the exporters' response to an exchange rate depreciation.

- The model does not explicitly track individual sectors of the economy, such as agriculture, industry, mining, or services. It does not, for example, simulate how the output of an agricultural crop would respond to changes in agricultural prices or to the dismantling of an agricultural marketing monopoly, such as coconuts, sugar, or fertilizer.

- The model does not easily simulate the economic effects of such factors as the insurgency or political uncertainty. 25X1

Figure 5
Econometric Model of the Philippines



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