Directorate of
Intelligence

~~Secret~~

25X1

The Philippines: Laying the Foundation for an Economic Recovery

25X1

An Intelligence Assessment

~~Secret~~

EA 87-10031
July 1987
Copy 342

Page Denied

Declassified in Part - Sanitized Copy Approved for Release 2012/04/24 : CIA-RDP88T00539R000600790002-7

25X1

Directorate of Intelligence

Secret [redacted]

The Philippines: Laying the Foundation for an Economic Recovery [redacted] 25X1

An Intelligence Assessment

This paper was prepared by [redacted] Office of East Asian Analysis. Comments and queries are welcome and may be directed to the Chief, South Asia Division, OEA [redacted] 25X1 25X1

Reverse Blank

Secret
EA 87-10031
July 1987

The Philippines: Laying the Foundation for an Economic Recovery [redacted] 25X1

Scope Note

[redacted] 25X1 This new Assessment looks at the economy [redacted] and the status of Manila's reform program. It also examines the outlook through 1990, outlines the remaining tasks facing the administration, and discusses the potential impact of the new Congress. [redacted] 25X1

Probably the biggest unknown is the role of the Congress in economic policy making. [redacted] 25X1 relations between Aquino and the Congress will be strained, as both sides adjust to the transfer of legislative power." On economic matters in particular, the legislature will have an input into debates on the national budget, foreign debt, land reform, foreign investment, and the Military Bases Agreement with the United States. As the year goes on and Congress carves out its role in the political process, information on congressional tactics and positions in these areas would aid our analysis of the country's economic prospects. [redacted] 25X1

Declassified in Part - Sanitized Copy Approved for Release 2012/04/24 : CIA-RDP88T00539R000600790002-7

 25X1

The Philippines: Laying the Foundation for an Economic Recovery 25X1

Key Judgments

Information available as of 29 July 1987 was used in this report.

Since coming to power one and a half years ago, the Aquino administration has made encouraging progress in turning around the Philippine economy and laying the groundwork for a sustainable economic recovery. Manila's strategy emphasizing market-oriented policies and less government intervention, favorable international factors, and the delayed effects of a 1983 economic austerity program combined to bring about slight economic growth late in 1986, after two years of decline. We believe the recovery is continuing in 1987, with real growth likely to reach 3 to 4 percent. That estimate is lower than Manila's overly optimistic projections, but we believe it is evidence of solid economic gains. 25X1

If the administration can fully implement its remaining economic reforms, maintain workable relations with the new Congress, and benefit from a favorable international economy, our econometric model indicates the economy could grow about 5 to 6 percent annually during the period 1988-90. More probably, however, all the pieces will not fall into place, and growth over the rest of the decade probably will average closer to 4 percent annually. In either case, the rural economy probably would be a major beneficiary of the economic expansion, boosting Manila's efforts to improve living standards of the country's poorest and counter the Communist insurgency. 25X1

But the 1988-90 growth rate we project will not be strong enough to seriously undercut the insurgency. Even if economic growth averages 5 percent a year after 1987, per capita income levels would not return to their 1981 peak until 1994. Progress against the insurgency will be measured as well by the extent to which the government can implement a land reform program and guarantee justice and security throughout the country. Indeed, issues such as these are more important for their propaganda value than for their impact on the economy. 25X1

The Philippine Congress will become a new and potentially key variable in economic policy making when it convenes in July, and, if history is any guide, it will probably hinder rather than facilitate the administration's economic plans. Although many of the new legislators ran on the Aquino-backed slate, they come to office from widely different backgrounds and with various agendas. As a result, we believe the Congress may be eager to show its independence from the executive branch on economic issues such

Declassified in Part - Sanitized Copy Approved for Release 2012/04/24 : CIA-RDP88T00539R000600790002-7

25X1

as the national budget and foreign investment. In addition, it is increasingly clear that the administration is leaving the politically sensitive issue of land reform to the Congress to decide. If so, we doubt much progress will be made because most congressmen are either large landowners or owe their election to wealthy landowners. 25X1

No matter how the economy fares over the next few years, we believe Manila will continue to press Washington for additional financial assistance for both budgetary support and development projects. Moreover, it is probable that the aid discussions will become contentious at times, primarily because of the Philippines' unrealistic expectations of US largess. Manila may well use the prospect of difficult renegotiations of the Military Bases Agreement as leverage to try to obtain more money. The Aquino government probably will also try to gain US concessions on bilateral trade issues, such as US imports of textiles and sugar, in an effort to improve the prospects for economic recovery. 25X1

25X1

Contents

25X1

The Philippines: Laying the Foundation for an Economic Recovery

25X1

The Economy Shows Some Life

Signs of a turnaround in the Philippine economy, debilitated by years of mismanagement and abuse under Ferdinand Marcos, began to show up in Manila's statistics in the latter half of 1986. By the fourth quarter, all sectors of the economy were expanding, fueled in part by the accelerated release of funds from the Aquino administration's $200 million rural infrastructure spending program, increased consumer confidence following the ouster of Marcos, and a significant improvement in the Philippine terms of trade. Growth for the quarter was almost 2 percent, making possible a small gain for the year and reversing the 9-percent fall in national output in 1984-85. The agricultural sector—benefiting from unusually good weather—was especially healthy in 1986, averaging a 5-percent gain in the second half of the year. The US Embassy reports that purchasing power and retail sales in the countryside have picked up, and, in some areas, farmers are enjoying higher prices for their crops after several profitless years. The current account also registered a sharp turnaround, producing a $1 billion surplus. In addition, inflation and interest rates continued to fall, the peso remained stable, and the Philippine stock market boomed.

International economic developments proved beneficial for the new government's efforts to revive the economy. Despite higher import volumes, lower oil prices allowed Manila to save about $500 million on its oil import bill, held down inflation, and helped reverse the country's current account deficit. Lower global interest rates cut about $200 million from Philippine interest payments on its foreign debt. In addition, the Aquino government assumed power at an opportune time in the business cycle, as the contractionary effects of the Marcos administration's necessary 1983 economic austerity program began to wear off.

In addition to the external factors, we believe the Aquino administration's economic reforms, especially in the agricultural sector, played a significant role in the turnaround. For example, the coconut industry, which accounts for at least 20 percent of Philippine agricultural production, benefited from a combination of the government's dismantling of the coconut monopoly and increases in world demand for Philippine coconut products. In addition, freer markets resulted from the elimination of protective barriers granted to business associates of Marcos. 25X1

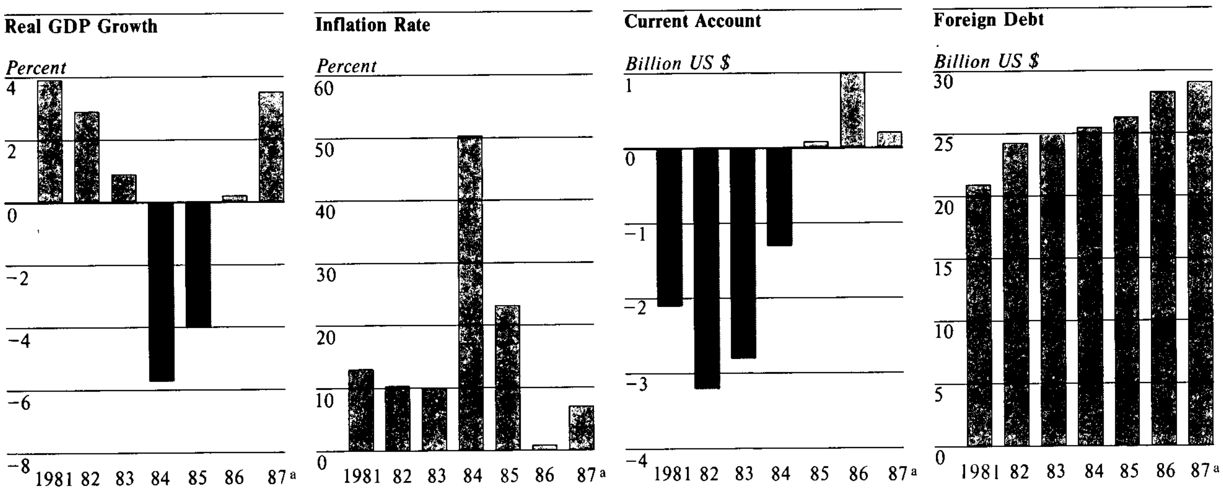
In our view, the recovery is continuing in 1987, but Manila probably will not reach its 6- to 7-percent target for economic growth because some factors outside the government's control—such as weather, oil prices, and world interest rates—have turned less favorable. In addition, Manila has instituted few economic reforms in recent months and has been unable to administer successfully some of its earlier reforms such as the grain price stabilization fund. We believe that, as a result, the economy will probably expand at a 3- to 4-percent rate this year, while inflation and interest rates remain moderate. 25X1

According to Philippine Government statistics, the economy grew 5.5 percent in the first quarter of this year over the same period in 1986. The data, however, appear to overstate the upturn. For one thing, the economy during the first quarter of 1986 was struggling from the effects of the February revolution. Thus, growth in the same quarter this year looks particularly healthy in comparison. In addition, increased government spending on rural infrastructure projects and campaign spending for this May's national election probably provided an extra boost to the economy. Furthermore, recent revisions to the national economic statistics have lowered the level of economic output recorded for 1986 and thereby increased the rate of economic growth reported for this year. 25X1

25X1

25X1

Figure 1
Philippines: Economic Indicators, 1981-87



[a] Estimated.

[redacted] 313583 7-87

25X1

Much Left To Do

Although the Aquino government has made progress in restoring the economy, much work remains if the Philippines is to set in place a system of economic incentives needed to achieve sustained economic growth and political stability. The magnitude of Manila's task is clear:

- Per capita income has fallen about 15 percent since 1981, coinciding with the rapid growth of the Communist insurgency.

- More than two-thirds of all rural Philippine families are at or below the World Bank's poverty level of $150 per year in income, according to Philippine academics.

- Philippine Government statistics indicate the percentage of the agricultural population without land has grown from less than 10 percent in 1950 to almost 35 percent in recent years.

- The country is overborrowed; interest payments of $1.9 billion on Manila's $28 billion foreign debt absorbed more than 40 percent of Philippine merchandise export earnings in 1986, while exports have fallen at an average annual rate of almost 3 percent since 1980.

How quickly and to what extent Manila makes progress alleviating these problems will be a function of the Aquino government's economic reform program. Liberalization of trade and investment policies,

Figure 2
The Philippines: Status of Key Economic Reforms

■ Policies put into place, implementation under way.
□ Government moving slowly, implementation will take time.
□ Little accomplished so far, progress unlikely.

Policies	Instruments	Status	Comment
Fiscal Policy	Widen tax base, raise efficiency of tax collection.	●	Tax reform enacted July 1986, policy implementation underway.
	Privatize government financial and nonfinancial corporations.		Committee on Privatization and Assets Privatization Trust created, but moving slowly. Investor interest in purchasing assets low.
Trade and Investment Policy	Lower tariffs, eliminate quantitative restrictions and other nontariff barriers on imports.		Government continuing liberation begun under Marcos. Reforms slowed by Trade Department and industry.
	Encourage foreign investment through tax credits, increased incentives, less government intervention.		Draft code under debate. Finance, Budget Departments protesting that code continues strong government role. Investors tired of uncertainty.
Agricultural Policy	Dismantle sugar and coconut monopolies.	●	Combination of Manila's reforms, favorable international conditions have helped country's 1.4 million coconut farmers.
	Eliminate export taxes on all agricultural products, except logs.	●	Agricultural exports register a small gain in 1986, after a 25 percent drop in 1985.
	Remove impediments to fertilizer imports.	●	Fertilizer import industry grew from 5 firms in 1984 to 44 firms in 1986. Prices fell, consumption rose.
Rural Economy	Enact land reform program.	○	Aquino probably will let Congress decide about land reform. If so, progress is unlikely.
	Strengthen rural banking system.	○	Only 25 percent of rural banks sound; budget constraints limit Manila's efforts.

313584 7-87

25X1

for example, is designed to attract overseas investment, increase the competitiveness of Philippine manufacturers, and return the country to export-based growth. The sale of government-owned corporations will help ease Manila's budget deficit and free funds for other government programs, in addition to forcing the corporations to produce more efficiently. The success of Manila's agricultural and land reform programs is especially critical to government efforts to reduce poverty in the countryside and to counter the Communist insurgency.

Trade and Investment Policy
Despite stiff opposition from the Department of Trade and Industry and from protected industries, the government has pushed ahead with its trade liberalization plan and has continued to carry out commitments made to the World Bank and the International Monetary Fund (IMF) in 1981 to reform tariff and quota policies. Longstanding export duties have been removed from all agricultural products except logs. The elimination of import licensing requirements on over 1,200 products is also continuing. The outstanding question is the order and pace at which the remaining, more sensitive products, such as beef and fruit, will be decontrolled. Although affected industries will try to delay for as long as possible implementing measures that would open their products to competition, we believe Philippine officials will stick to the timetable for completing the trade program by 30 April 1988.

The Aquino administration has made renewal of foreign investment a priority, but has not decided on a comprehensive plan to open up the investment market. The government has announced measures to attract overseas business, such as "one-stop" investing to reduce some of the bureaucratic redtape. A draft investment code developed by the Department of Trade and Industry, however, has come under attack from other government departments, according to the US Embassy:

- The National Economic and Development Authority (NEDA) and the Departments of Finance and Budget are upset that the Trade Department's Board of Investments would retain strong regulatory powers, including approval rights over potential investments.
- The Labor Department believes the code's incentives favor capital-intensive rather than labor-intensive investment. 25X1

The Trade Department is trying to garner private-sector support for the code's immediate implementation. Debates continue, however, and we believe the issue probably will be left to the new Congress to decide. Indeed, we believe Congress probably will take up foreign investment even though Aquino enacted the code by executive order before Congress 25X1 convened on 27 July 1987. The US Embassy reports many in the local business community fear that, if the code is left to the Congress, economic nationalists in the legislature opposed to the presence of multinational corporations in the Philippines would further slow implementation. In any case, some newly elected congressmen have said the legislature would review any executive order on investment and modify it as appropriate. 25X1

Foreign investors recognize the code's defects, such as the Board of Investments control over investments in "overcrowded" industries, but they also believe Manila's uncertainty is deterring potential investors, according to the Embassy. In our view, however, the code's implementation probably will not bring an immediate rush of investment. US and foreign businessmen have told US officials they remain concerned about the Communist insurgency, political instability, labor unrest, electric power shortages, and the lack of 25X1 a bilateral investment treaty. As a result, potential investors apparently have waited for "the other guy" to invest before committing resources themselves, and we expect this trend to continue. 25X1

Government Finances
Manila has had mixed results in trying to reduce the twin burden on the budget of an inefficient tax system and a large group of financially troubled government corporations. The Cabinet passed a plan to revamp the Philippine tax system in July 1986, broadening the tax base, enhancing collection efforts, and making the system more equitable. Indeed, Philippine Government statistics indicate that domestic-based tax

revenues in 1986 rose 10 percent from a year earlier. Although some measures have yet to be implemented, Manila has made a good start on tax reform, and we believe the government will continue its efforts.

Manila's financially troubled corporations, however, remain a problem. For example, the Philippine National Bank (PNB) and the Development Bank of the Philippines (DPB), which represent about one-third of the Philippine financial system's assets (excluding the Central Bank), are technically insolvent. In 1986, government support to these banks alone was about $850 million, equivalent to almost two-thirds of the entire budget deficit. Despite the obvious drain, Manila's program to sell 121 corporations owned or controlled by government entities, such as PNB, DPB, and the National Development Corporation, did not get under way until late last year, when the "Committee on Privatization" and the "Assets Privatization Trust" (APT) were created. The major financial and nonfinancial public corporations scheduled for sale to the private sector include:

Corporation	Government Owner
Petrophil Corporation	Philippine National Oil Corporation (PNOC)
Bataan Refinery Company	PNOC
Philippine Airlines	Government Service Insurance System (GSIS)
Commercial Bank of Manila	GSIS
Manila Hotel Corporation	GSIS
Pilipinas Bank	Philippine National Bank
Associated Bank	Development Bank of the Philippines
Republic Planters Bank	Sugar Regulatory Administration
National Steel Corporation	National Development Company (NDC)
Philippine Phosphate Fertilizer Corporation (PHILPHOS)	NDC
Philippine Association Smelting and Refining Corporation (PASAR)	NDC
Philippine International Corporate Bank	NDC

The Committee—a Cabinet-level group tasked with proposing to Aquino which government assets should be abolished, consolidated, or transferred to the APT or another entity for sale to the private sector—has turned over more than $5 billion in nonperforming assets to the Trust since December 1986. US Embassy officials say, however, that Manila estimates it will recover only about $1 billion from these assets. Given the generally weak balance sheets of these firms, the APT has found it difficult to attract buyers. Manila has also run into resistance from some of the affected corporations. For example, a US bank's efforts to buy shares of Commercial Bank of Manila, owned by the Government Service Insurance System (GSIS), were held up for several months by a GSIS director who would have lost his vice-chairmanship at the Philippine bank, according to the US Embassy. In addition, according to the US Embassy, APT Chairman Sycip believes procedural bureaucratic problems may slow a timely implementation of the privatization program. To create a greater constituency for divestiture, the government announced this spring that all proceeds earned by the APT would finance the politically important Philippine land reform program. But we believe the tying of the two programs probably will not overcome the hesitancy of potential buyers.

25X1

25X1

Land Reform

Aquino made land reform one of the primary issues while campaigning for the presidency, and her administration has often stated that the problem of landless farmers is her government's highest priority. During the administration's first year, however, Manila gave land reform little more than lipservice. Indeed, Aquino took six months to appoint Heherson Alvarez to head the Department of Agrarian Reform; he resigned this spring to run for the Senate, and a successor has not been named. Manila did not focus on plans for land reform until early this year, responding in large part to a bloody confrontation between farmers and security forces in Manila. In March, the Cabinet drafted a six-year, $3 billion program to distribute 5.3 million hectares of land in four phases to small farmers and landless agricultural workers. The government has refined the program a number of times to cut costs and increase coverage, according to the US Embassy.

25X1
25X1

[redacted] many members of the Cabinet, including Finance Secretary Ongpin, want Aquino to use her executive authority and put the land reform program into place before the Congress convenes, despite a lack of detail on funding, compensation for landholders, and land valuation. The US Embassy says Ongpin believes about half of the current $2.2 billion cost could come from the sale of nonperforming assets under Manila's privatization scheme, even though APT Chairman Sycip has told US officials that the flow of funds from divestiture will always be "lumpy" and unpredictable. Manila is also asking for $500 million from its key bilateral and multilateral aid donors, but the US Embassy reports that foreign donors are reluctant to directly finance some parts of the program, such as the costs of land transfer and compensation. In addition, the World Bank believes that instead of a four-phase, six-year approach, Manila should implement all parts of its program simultaneously and said it would not provide any financial help if the Philippines enacts the program as it stands. [redacted]

Despite Cabinet pressures, it was increasingly clear that Aquino could not initiate a complete land reform program before Congress convened. According to the US Embassy, government lawyers advised her that an executive order concerning acreage limits, priority crops, and other key issues would illegally usurp congressional powers under the new Constitution. In addition, any action she took probably would have to be modest, given the imminent convening of Congress, and the potential backlash from the landless (who have high expectations) and small landed farmers (who are afraid of losing their property). As a result, the executive order issued covered the country's rice and corn lands as well as sequestered, foreclosed, and idle lands, leaving Congress the unenviable task of dealing with the highly political sugar and coconut lands, where some of the country's most powerful interest groups hold sway. [redacted]

Agricultural Productivity

Despite the uncertainty that remains on land reform, the Aquino administration's commitment to agriculture remains strong. Manila dismantled the coconut and sugar monopolies, lifted the ban on the export of copra (the raw meat from which coconut oil is milled), deregulated the fertilizer industry, and abolished export duties on all Philippine agricultural exports except logs. [redacted] 25X1 25X1

Still on the government's announced agenda for agricultural reform are plans to increase the availability of credit for farmers and to diversify agricultural production away from rice, corn, and coconuts. According to Philippine Government statistics, these three crops, which account for 85 percent of harvested land area, have an average production value only one-tenth that of crops such as mangoes, pineapple, and onions. Implementation of credit and diversification programs has been slow, however, because of inadequate funding and budget deficits. In our view, budget constraints probably will continue to hamper movement on these issues. The Philippine Agriculture Department, for example, estimates that the demand for agricultural credit in 1987 will be at least $3 billion. As of September 1986, however, Manila had only $300 million available in agricultural loan funds, and only about $34 million of that total was controlled by the Agriculture Department. In addition, the country's extensive rural banking system is nearly bankrupt, with less than 25 percent of rural banks being financially sound [redacted] 25X1 25X1

A New Environment for Economic Policy Making

Manila's ability to push ahead with its economic plans will depend in large part, we believe, on the government's capacity to work as a team, both within the Cabinet and between the executive and legislative branches. Judging from past experience, however, we expect discord and confusion to be more common than harmony. The Aquino administration's economic policy making team has never shown much aptitude for working together and, in our view, it is unlikely that this situation will change soon. Indeed, the public disputes among Finance Secretary Ongpin, Executive Secretary Arroyo, NEDA Director General Monsod, and Trade Secretary Concepcion have grown more acrimonious in recent months. We are particularly 25X1

Aquino's Economic Team: Esprit de Corps?

Almost from the beginning of its term, the Aquino administration's economic policy making team has been wracked by dissension. Differences in philosophy and personality between Cabinet members have been aired regularly in the Philippine media and show no signs of stopping:

- *Finance Secretary Ongpin, the leading advocate of market-oriented policies, and Executive Secretary Arroyo, who has a nationalist bent, routinely clash over the direction of Manila's economic reforms. Ongpin is particularly upset with his rival's delaying tactics in implementing fiscal and tax programs, even after Cabinet approval, as well as Arroyo's increasingly imperious manner. Indeed, the US Embassy reports Arroyo reorganized the Finance Department without obtaining Ongpin's approval.*
- *Ongpin and Director General Monsod of the National Economic and Development Authority disagree over possible solutions to the country's foreign debt problem, with Monsod occasionally calling for a repudiation of selected foreign loans and Ongpin opposing such a move because of the damage it would bring to Manila's relations with the international banking community. Arroyo also has publicly lambasted Ongpin over the latter's handling of the debt negotiations with Manila's commercial lenders, but he and Monsod are not allies. In a well-publicized incident earlier this year, Monsod kicked Arroyo in the shin during a Cabinet meeting because he delayed one of her policy recommendation papers for several months, rather than passing it on for Aquino's approval.*
- *Trade Secretary Concepcion, reflecting the concerns of many in the Philippine business community, has tried to slow Monsod's and Ongpin's efforts to remove Manila's restrictions on imports. On the other hand, Monsod and Ongpin have criticized the Trade Department's plans to implement an omnibus investment code, claiming Concepcion's department would retain strong regulatory powers over potential investors.* 25X1

concerned that Arroyo—who has his own, primarily nationalist, views of government policy and who frequently obstructs the flow of business to and from the President—remains in good graces with Aquino and secure in his position, according to the US Embassy. In contrast, we believe Ongpin is growing tired of the Cabinet infighting and may not stay in the government, or may be forced out, should the quarreling continue. If Ongpin leaves, it may signal a turn toward more nationalist economic policies. 25X1

When it convenes, the Congress will be a new variable, and potentially major participant, in economic policy making. For example, under the new Constitution, the administration must submit the 1988 national budget to the legislature within 30 days of convening. Although the Constitution is vague over the congressional role regarding the foreign debt, saying only that a report detailing "loans to be contracted or guaranteed by the government . . . which would have the effect of increasing the foreign debt" must be submitted to the legislature, we believe nationalists in the Congress probably will be eager to get involved in the debt issue and may try to use their budgetary powers as leverage. Most congressmen will almost certainly resist meaningful land reform because they are either major landholders whose interests are ill served by such a program, or they owe their election to wealthy landowners, and we doubt much progress will be made. The legislature probably will also use the reactions of Aquino and her family to the possible disposal of their own substantial landholdings as a gauge for congressional plans. 25X1

Using history as a guide, we believe the Congress will be an obstacle rather than a facilitator of the government's economic plans. Although many of the new legislators ran on the Aquino-backed slate, the "pro-government" affiliation probably has little political relevance because Aquino's coalition was never united behind a platform. Congressional members also come to office from widely different backgrounds and with various agendas. In addition, a number of congressmen probably will use their office to establish their own presidential credentials. As a result, we believe the legislature will be contentious and eager to show its independence from the executive branch. Even Aquino's 22-member Senate "team" probably will not be a rubberstamp for the President's policies. Unless Aquino and her aides can adapt and engage in traditional Philippine congressional horsetrading, key economic initiatives probably will languish. [redacted]

The Near-Term Economic Outlook

If the administration can implement its economic reform program, maintain workable, if not cordial, relations with the Congress, and benefit from the international economy, our econometric model indicates that the economy could grow 5 to 6 percent annually during the period 1988-90. More probably, however, all the pieces will not fall into place, and growth over the rest of the decade probably will average closer to 4 percent. Even this lower rate probably would help to sustain political stability. For one thing, rural Filipinos most likely would be the major beneficiaries of the growth, giving Manila's efforts to counter the Communist insurgency a boost. But the growth rate we project during the next few years will not be strong enough by itself to seriously undercut the insurgency. Even if economic growth averages 5 percent a year after 1987, per capita income levels would not return to their 1981 peak until 1994. Moreover, economic growth is only one aspect of the counterinsurgency; progress will be measured, too, by the extent to which the government can guarantee justice and security throughout the country. Indeed, we believe some economic policies, such as land reform, probably would have a greater impact on civilian attitudes toward the insurgency because of their propaganda value than on the economy itself. [redacted]

The international economy must be favorable if the Philippine economy is to have a sustained expansion, but the good fortune Manila enjoyed in 1986 is unlikely to last. World economic growth, for example, will have to be strong enough to allow Philippine exports to increase. In particular, Philippine commodities exports—which account for approximately 40 percent of total export earnings—almost certainly cannot afford another precipitate drop in prices such as occurred in the early 1980s. Global interest rates must also remain moderate. [redacted] a percentage-point increase in world interest rates adds about $130 million to Manila's annual debt service. Moreover, international oil prices will have to stay relatively soft to avoid bloating the Philippines' fuel import bill. [redacted]

25X1

25X1

25X1

Implications for the United States

No matter how the economy fares over the next several years, we believe Manila will continue to press Washington for additional financial assistance for both budgetary support and development projects. Moreover, it is probable that aid discussions will become contentious at times, primarily because of the Philippines' unrealistic expectations of large amounts of aid from the United States. In our judgment, many members of the Aquino government believe Manila deserves special treatment from Washington because of the country's special relationship with the United States, the presence of US military facilities, and the Philippines' attempt to restore democracy. [redacted] 25X1

In addition, Manila may well use the prospect of contentious renegotiations of the Military Bases Agreement as leverage to try to obtain more aid. The agreement calls for a review every five years—with preliminary discussions of the next review likely to begin later this year—and is subject to termination with one year's notice in 1991. For example, Presidential Press Secretary Benigno hinted at a news conference in April that Manila would take a potential US

25X1

Congressional rejection of $50 million in supplementary military aid to the Philippines in 1987 into account when it prepares its negotiating position for the coming talks. 25X1

Besides financial aid, we believe the Aquino government will try to engage US help on other bilateral economic issues. Manila has expressed disappointment with the limited increase in the Philippine share of US quotas on textile and sugar imports for this year, believing Washington should have treated the Philippines more favorably because of Manila's efforts to reform the economy. In addition, Philippine officials, concerned over possible protectionist trade legislation, told a visiting US Congressional delegation early this year that they hoped Washington would give Manila exceptional trade concessions similar to those granted under the Caribbean Basin Initiative, such as duty-free access to US markets. 25X1

Appendix

Treating the Debt Hangover

Patient History

Underlying Manila's attempts to restore long-term economic stability is the country's $28 billion (and still growing) foreign debt, which was brought about largely by the Marcos government's high-investment growth strategy of the 1970s and early 1980s. Government guarantees to private Philippine borrowers linked to the Marcos administration and Manila's support for an overvalued peso—which artificially cheapened imports—spurred a spending spree and increased the debt tenfold during the period 1970-84. In the early 1980s the borrowing binge was aggravated by rising global interest rates, lower prices for Philippine commodity exports, and the 1981-82 worldwide recession. Under Marcos's austere 1983 economic program, tight fiscal policies cut government spending, while restrictive monetary policies brought about higher domestic interest rates. The cumulative impact fell mostly on investment; from 1983 to 1986, domestic investment decreased almost 20 percent annually. Foreign investment also fled the country as the political situation deteriorated. [redacted]

Symptoms

Despite the recent $10.3 billion rescheduling agreement reached with its commercial creditors, which lowered the interest rate on the commercial loans and put off principal repayments for seven and a half years, Manila continues to suffer the impact of its enormous foreign debt. [redacted]

We estimate that interest payments in 1987 will equal about $1.8 billion, or almost 40 percent of merchandise exports, and probably will exceed $1.5 billion annually in 1988-90. By pinching the resources available for investment, consumption, and government spending, this annual debt service burden threatens to draw the Philippines into a vicious cycle: low economic growth leading to budgetary gaps that can only be filled by new loans that raise the debt servicing obligations, further inhibiting growth. [redacted]

[redacted] Manila will need $1.5 billion in new loans by the middle of 1988, or maybe even as early as the end of 1987, and up to $7 billion between 1988 and 1992 to meet debt service obligations. A recent Philippine National Economic and Development Authority study forecasts an external financing gap of $6.6 billion in 1987-92, according to the US Embassy. The study stresses that failure to fill this gap may keep Manila from achieving its development targets, and calls for new money commitments from the Philippines' commercial creditors. [redacted] 25X1

25X1

Possible Remedies

Rescheduling. Manila's traditional solution has been to reschedule its repayments when financial crunches are imminent. Manila calculates that its recent agreement with commercial creditors will save almost $2 billion over the 17-year life of the agreement as well as postpone over $9 billion in principal amoritizations during the seven-and-a-half-year grace period. On the other hand, Manila recognizes that renegotiations merely put off the inevitable and that sustained economic growth is the only lasting solution to the debt crisis. [redacted] 25X1

25X1

Economic Growth. If the economy could sustain a high growth rate into the next decade, additional debt might not be necessary. In fact, a moderate increase in foreign debt might even be desirable if it ensures growth. According to our model of the Philippine economy, an economic expansion of as much as 5 to 6 percent annually in 1987-90—compared to our baseline estimate of 3 to 4 percent—would gradually reduce Manila's debt-to-GNP ratio from 85 to about 70 percent. [redacted] 25X1

25X1

Export Growth. Although many Philippine-manufactured exports have a high import content—75 percent in electronics and over 50 percent in clothing, for

25X1

Econometric Model of the Philippines

To analyze the impact on the Philippine economy of external changes as well as Manila's ability to tailor economic policies to its political needs, we have extensively overhauled our econometric simulation model in recent months.

Recent improvements include:
- *Refining the data base from updated National Income Accounts through the end of 1986 and improving 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.*

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

25X1

- *Because of a lack of data, the model's ability to predict the impact of a policy change on the monetary sector is weak. For example, the increased dollar inflow from a rise in exports probably will not be reflected fully in the money supply, understating the inflation rate as a result.*
- *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.*
- *The model does not easily simulate the economic effects of such factors as the Communist insurgency or political uncertainty.*

25X1
25X1

example—our model indicates a robust 10-percent annual increase in exports over the rest of the decade would easily outpace import growth, keeping the current account in surplus. Short-term debt probably would rise along with the higher imports, but Manila would still be able to pay its annual obligations. Nonetheless, we do not believe exports will grow quite this fast, in large measure because of the mediocre global outlook for commodities exports, which account for about 40 percent of Philippine exports.

Foreign Investment. Constrained from boosting public investment because of the lack of money, the Aquino administration has counted on a resurgence of foreign investment to fuel growth. To attract overseas investors and reduce its debt burden, Manila is using both traditional and new financial instruments. *Debt-for-equity swaps* allow investors to purchase Philippine debt from commercial creditors or financial institutions at a discount. The investor can then redeem the debt at the Central Bank for pesos for conversion into equity in Philippine projects. In this way, debt is extinguished and new investment flows into the country. According to recent Philippine Government data, more than $350 million in debt-for-equity conversion applications had been filed with the Central Bank through mid-May 1987. Although Manila has approved less than $95 million in swaps so far, bankers estimate $200-500 million may be converted by the end of 1987.

25X1
25X1

Under Manila's recent debt rescheduling agreement with its commercial creditors, the banks have the option of converting some of their interest receipts into *Philippine Investment Notes* (PINs). Those banks purchasing the six-year, dollar-denominated PINs—sold at about 90 percent of their face value—may hold the note to maturity and receive full value, trade it in secondary markets, or redeem it for pesos before maturity and use the proceeds to invest under Manila's debt-for-equity program. The government hopes the innovative plan will conserve up to $50 million a year in foreign exchange as well as attract new investment. The plan's success, however, is not ensured. For one thing, the small amount of trading in other Third World debt instruments suggests that the necessary resale market may not develop. 25X1

Even if Manila's debt-to-equity and PINs programs are successful in attracting new investors, we believe they will not be enough to solve the government's debt woes. In our view, foreign investment would have to increase at unrealistic rates to have much of an impact on the debt. For example, an annual 25-percent increase in foreign direct investment in 1987-90 probably would add less than 0.5 percentage point to annual economic growth, according to our model. A 50-percent boost in foreign investment, on the other hand, would add 1.5 to 2 percentage points to our baseline growth figures, beginning in 1988. We believe such rapid growth of investment is unlikely, however, given political uncertainty as well as the government's continuing problems with liberalizing its foreign investment regulations. 25X1