Manuel F. Montes

The Illusions of Economic Recovery

The Philippines' most recent balance of payments crisis which began in October 1983 is the fourth in its post-War history. That stabilization programs implemented in response to the crises in 1949, 1962, and 1970 did not prevent the fourth crisis provides fresh evidence that the country's underlying problem is that of lack of development and not insufficient adjustment to the world economy.

The country's dollar per capita income in 1983 was $760 (1985 World Development Report). With a 1983 population of 52.1 million (that is growing at 2.4 percent per year), the size of the economy is a little less than $40 billion. The size of present foreign debt is $26 billion. In 1983, there was a 1.3 percent growth in real GNP; but in 1984, there was a decline of 5.5 percent. For 1985, a decline of about the same size is foreseen. (See Tables 1 and 2 for semestral real GNP levels and growth rates in the recent period.)

The economy's adjustment to each of the three previous crises can be viewed as different efforts to maintain the underlying rent-generating and non-industrialized structure of the country. Between 1946 (the year of independence from the US) and 1949, the country's trade deficit was financed by war rehabilitation funds from the US. These funds were provided in exchange for Parity Rights which granted equal economic rights to US citizens. After World War II, the US ensured the restoration of landlord rule that had broken down during struggle against Japanese occupation. The depletion of the funds in 1949 caused the first crisis, necessitated the creation of a Central Bank and the implementation of an import-substitution strategy.

*(*Basis of remarks in a conference on "Money, Finance, and Trade-Reform" sponsored by World Institute for Development Economics Research (WIDER), a United Nations research unit, in Helsinki, Finland, November 11, 1985. The research assistance of D. Ungson and C. Bautista is acknowledged.)*

Table 1
GROSS NATIONAL PRODUCT QUARTERLY DATA (1982-1985) IN MILLIONS OF PESOS AT CONSTANT 1972 PRICES

	1982	1983	1984	1985
First Quarter	24,275	24,837	23,370	22,056
Second Quarter	24,811	25,764	24,640	23,744
Third Quarter	22,790	22,878	20,940	
Fourth Quarter	26,705	25,288	24,576	

Table 2
GNP GROWTH RATES, QUARTERLY DATA (1982-1985) AT CONSTANT 1972 PRICES

	1982	1983	1984	1985
First Quarter	1.10%	2.3%	–5.91%	–5.62%
Second Quarter	2.98%	3.84%	–4.36%	–3.64%
Third Quarter	–.76%	.39%	–8.47%	
Fourth Quarter	6.95%	–5.31%	–2.82%	

The import-substitution strategy did not overturn the rent-generating nature of the economy since it created inefficient domestic monopolies (many American-owned due to Parity Rights, others owned by the Filipino elite) in manufacturing that were heavily dependent on imported intermediate inputs (in 1983, 40 percent of imports were intermediate goods and an additional 28 percent due to oil). The 1962 crisis came about when the country's (mostly agricultural) exports could not finance both the important and profit remittance requirements of such an economy.

The country's first IMF program in 1962 involved the dismantling of the foreign exchange controls of the import

substitution period and a 50 percent devaluation. The country attempted a more export-oriented strategy that led to diversification of exports into raw material (such as logs and copper concentrates) exports. The 1970 crisis, while immediately precipitated by overspending in a presidential election campaign, provided further evidence of the inherently unstable nature of the economy's ties with the world economy. The 1970 IMF program called for tariff reductions and a 40 percent devaluation.

These adjustments basically maintained the unbalanced external economic relations existing since 1940 but provided a new source of financing. The country embarked on debt-driven growth. Since 1970, except for a brief period in 1982, the country has been on a standby program with the IMF. These standby programs called for increases in government revenue generation, tariff reductions, and realistic exchange rates. The Philippines invariably failed to meet targets in these programs, which were renewed anyway. The peso did not depreciate significantly because of the large inflows of foreign funds that slipstreamed behind the IMF programs. The 1972 declaration of martial law allowed a greater rate of inflow since it permitted dispensing away with cumbersome Congressional approvals for foreign loans.

The quadrupling of oil prices in 1974 which should have triggered off an adjustment toward less import dependence did the opposite because it provided the means by which the debt-driven growth strategy could be financed as international commercial banks desperately sought borrowers for OPEC funds. The position of the domestic elite that had become so tied up with rent extraction from agriculture and import dependent industries closed off the consideration of alternative strategies. Even a possibly inappropriate policy of import liberalization, while nominally a part of most IMF programs in the period was not pursued seriously until 1980, when the country was already in desperate need of the structural adjustment funds that went with it.

The inflow of foreign savings was accomplished principally through the increase in government investment spending. While before 1970 government construction constituted less than 20 percent of total construction, by 1980 it constituted 43 percent of the total. The average level of government construction increased by 5 times between 1970 and 1980. Between 1975 and 1983, the country's foreign debt increased from $3.8 billion to $26 billion. After the second oil shock, which reduced the volume of international lending and induced higher interest rates, the country embarked on a massive, mostly short-term, borrowing spree. About half of the country's debt was contracted after 1979. Short-term debt comprised 30 percent of the total when the 1983 crisis struck, a burden that seems to be heavier than for most other debtor countries.

The calling in of short-term loans in 1983 forced the Philippines to declare a moratorium on interest repayments. The immediate effect was a full stop for imports (Tables 2 and 3) which halted manufacturing activity. Official government reports estimate a total of 800,000 layoffs in 1984. (Total non-agricultural employment was 9.9 million in 1984; agricultural employment about 9.7 million). The underemployment rate in 1984 increased from 30.1 percent to 36.2. Private estimates put the current underemployment plus unemployment rate not lower than 45 percent.

(Some observers have remarked that under the crisis there have been three "safety valves": the underground economy, the extended family system and overseas employment. None of these alternatives seem very "safe" to Filipinos who have no choice but to undertake them. Most working class Filipinos would prefer a stable job or enterprise in the formal economy, they would rather not have to share their food with jobless relatives, and they would rather work with dignity in the Philippines. These three safety valves are therefore only for the safety of the social structure and the elite.)

Negotiations with the IMF commenced upon the onset of the crisis, but it took until December 1984 before a package could be agreed upon. In the meantime, the Philippines attempted to fulfill its prior action commitments by successive devaluations and keeping a ceiling on monetary base. Table 5 gives an account of the extent of nominal devaluation that has been implemented. In a mark-up economy, the devaluation coupled with tight money supply to the private sector inflicted an unprecedented 50 percent average inflation rate in 1984 (Table 4).

Table 3
IMPORTS OF MERCHANDISE SEMESTRAL DATA
(1982-1985) CIF VALUE IN MILLIONS OF PESOS
AT CONSTANT 1972 PRICES

	1982	1983	1984	1985
First Semester	8,465	7,882	7,239	6,198
Second Semester	8,502	8,449	8,956	

Table 4
IMPORT GROWTH RATES
SEMESTRAL DATA AT CONSTANT 1972 PRICES

	1982	1983	1984	1985
First Semester	7.9%	–6.7%	–8.16%	–14.38%
Second Semester	2.6%	–.62%	6.00%	

Source of both tables: Preliminary Estimates, Aug. 1985.
NEDA.
National Accounts Staff, Statistical
Coordination Office.

Table 5
ANNUAL EXCHANGE RATE DETERIORATION RATE
(1982-1985)

1982	–7.5%
1983	–23.15%
1984	–33.45%
1985*	–9.84%

*From January to June only.
Source: International Financial Statistics.

Table 6
ANNUAL CPI GROWTH RATE
(1982-1985)

1982	7.92%
1983	10.01%
1984	50.35%
1985*	22.55%

*From January to August only.
Source: PIDS Datafile.

The distribution of the burden of the IMF monetary ceiling is interesting. The debt-driven growth period spawned numerous private and semi-driven enterprises that borrowed internationally under government guarantee. These enterprises were granted tariff privileges and monopoly positions but many started to fail as early as 1981. The Central Bank provided the financing so that the foreign guarantees could be fulfilled during the extended debt negotiations. In May 1981, parliamentary elections also forced the Central Bank to finance government overdrafts. To satisfy the monetary base ceiling, the Central Bank started selling its own bills at interest rates exceeding 45 percent (previous interest rate peaks never exceeded 18 percent on government bills). Such a strategy, while advantageous to monopoly enterprises and large banks with surplus cash, wiped out small banks and small businesses in 1984. The Central Bank finds itself in an unexplainable position of monetizing the interest payments on its bills and of having itself (contrary to its own objectives) caused widespread disintermediation as rich individuals withdrew their balances from the banks and purchased Central Bank bills. The high interest sterilization strategy killed off speculative demand for foreign exchange, caused a deep recession but did not allow the induced capital inflows to finance investment. Investment has dried up (Table 7) and the President, the Prime Minister, and the Central Bank governor find that they must exhort private businessmen to risk their money again at the same time that they cannot promise that the Central Bank will not resort to the same strategy once again in favor of monopolies and against small businesses. This episode is another example that lurking underneath apparently technical choices is the protection of entrenched economic interests. It is also an example that these interests do determine the choice of policy tools and stabilization paths.

The IMF adjustment program agreed upon in end 1984 is currently being renegotiated due to the unexpected (at least from the viewpoint of government negotiators and the IMF), precipitous decline in the economy. The original program called for zero growth in 1985; the first semester 1985 decline rate for real GNP is already 4.6 and we expect a decline of at least 5 percent for the whole of 1985. The economic contraction reduced inflation from a peak of 63 percent in October 1984 to 15.8 percent in August 1985.

(Some local economists have fawningly interpreted the fall in inflation as a "reward" to government technocrats and the IMF, who nevertheless have sacrificed little themselves to deserve the reward. Government technocrats have so far suffered little or no losses in income or employment.)

The economy is in a "classic" situation of precipitous demand contraction (allowed by supply contraction and unemployment inducing the disappearance of demand. The depth of the contraction (1985 was the first year of negative growth for the economy) has brought up the problem that has come to be called the "irreversibility" of many stabilization programs. Businessmen euphemistically refer to the situation as a "crisis of confidence"; the problem is more real. It is a crisis of non-existence as businesses that might have borowed

Table 7
ANNUAL INVESTMENT GROWTH RATE
(1982-1985)

1982	3.5%
1983	8.18%
1984	–3.44%
1985	

Table 8
EXPORTS OF MERCHANDISE SEMESTRAL DATA
(1982-1985) FOB VALUE IN MILLIONS OF
PESOS AT CONSTANT 1972 PRICES

	1982	1983	1984	1985
First Semester	7,056	7,181	7,880	6,985
Second Semester	7,024	7,007	8,411	

Source of both tables: Preliminary Estimates, Aug. 1985.
NEDA.
National Accounts Staff, Statistical Coordination Office.

now that interest rates have fallen below 20 percent do not exist anymore. The consumers who have lost their jobs must also find some other jobs now (not in their old companies) before they can emit any demand for output. Monopoly banks and branches of foreign banks, who have prospered during the crisis, find that they have lent all they can to prime customers (monopoly soft drink companies, for example) but cannot find any borrowers for the excess funds they now have. At present, it is in the interest of the government to win relaxation of the budget deficit ceiling also to gain access to funds to finance impending re-election campaigns. How such spending, coupled with IMF constraints on aggregate variables, will affect surviving non-monopoly business is a current cause for concern.

The current IMF program called for 10 percent increase in merchandise exports in 1985 and a further 11 percent growth in 1986. Exports for 1985 have fallen by 12 percent because world prices for the country's agricultural exports are depressed. The current program also foresees annual interest payments on foreign debt in the order of $2.5 billion increasing to $2.8 billion by 1987 and averaging about $2.6 billion thereafter. This is at least 6 percent of a $40 billion economy, that is foreseen under the current IMF program to grow by only 4 percent per year (assuming normal export performance) after 1986 so that all of growth plus some more will be reserved for paying interest on debt. This cannot but impoverish further the domestic population. This also constitutes almost 40 percent of mechandise exports which will starve the local manufacturing sector of that much in terms of intermediate inputs. (Market forces through devaluation are supposed to somehow improve export performance and intensity substitution against imported inputs. The current IMF program also requires the prosecution of the import liberalization program began in 1980. Providing the needed financing for the beneficial adjustments to occur is presumably the role of the World Bank.) Thus even the long-term aspects of the current IMF program seems to endanger development prospects.

Important Macro Features of the Philippine Economy

Agriculture, which produces 26 percent of the GDP, is characterized by tenancy-based production. Population pressure has also generated significant numbers of landless agricultural workers in the rural areas. Agricultural products are of two kinds: (1) those for domestic consumption such as rice, corn, and vegetables and (2) those for exports, notably coconut products and sugar. Domestic consumption agriculture suffers under unfavorable terms of trade with industry, low incomes for peasants, and low productivity due to the tenancy system. The country has barely achieved rice self-sufficiency. Rice production responds depending on the availability of finance and imported fertilizer. Export agriculture has become heavily monopsonized, causing low incomes for tenants while maintaining backward production methods. The Philippines is basically a price taker in these agricultural exports.

Table 9
EXPORT GROWTH RATES
SEMESTRAL DATA AT CONSTANT 1972 PRICES

	1982	1983	1984	1985
First Semester	–1.1%	–1.8%	9.73%	–11.36
	.11%	.24%	20.04%	

Source: Preliminary Estimates, Aug. 1985.
NEDA.
National Accounts Staff, Statistical Coordination Office.

Industry accounts for 31 percent of GDP. Industrial firms, heavily dependent on intermediate imports, typically enjoy oligopolistic positions in domestic markets. Notable export oriented exceptions are garments and semiconductor manufacturing in which, however, domestic value added constitutes 20 percent or less of total value. Export oriented mining contributes about 1 percent to GDP. Minimum wages are fixed by government but minimum wages are invariably not followed except in the largest of companies. There are also many small industrial companies, such as machine shops, but the structure of protection has always heavily favored the large established companies.

The service sector contributes almost 40 percent GDP and is constituted of low productivity jobs in trade and transportation.

Merchandize imports average about $7.5 billion, while exports about $5.5 billion in a good year so that the trade deficit has been of the order of $2 billion or higher. The current account deficit averaged $1.8 billion between 1976 and 1983 (an average of 2.2 percent of GNP in the 1970) a peak of $3.3 billion was recorded in 1982. The 1983 current account deficit was 2.8 percent of GNP. The target under the current IMF program is 1.1 percent for 1985 and 0.6 percent for 1986. These targets will be met in the face of the economic contraction.

Consumer goods constitute 7.2 percent of imports. The most active import items are raw material and intermediate goods imports (about 40 percent of the total) and capital goods imports (about 23 percent). The investment boom in the 1970s changed the import composition slightly and induced large increases in these two types of imports.

Raw material and agricultural exports (coconut products, logs and lumber, copper concentrates) constitute 16 percent of total exports and are the reliable items. Non-traditional exports have been growing in importance but are plagued by high import content and unreliable supply of inputs (for example, furniture manufacturers have difficulty obtaining wood locally). The recent experience of high interest stabilization policies resulted in the disappearance of financing for non-traditional exporters who lost many of their foreign markets in the process.

Table 10
SEMESTRAL DATA FOR NON-AGRICULTURAL WORKERS, METRO MANILA LEGISLATED MONEY WAGE RATE; IN PESOS/DAY
(1982-1984)

	1982	1983	1984
First Semester	31.82	31.82	43.97
Second Semester	31.82	36.69	53.63

Note: Figures are weighted semestral average.
Source: National Wages Council. Annual Report 1985.

Government expenditures represent about 12 percent of output. The government fiscal deficit as a percent of GNP peaked at 4 percent in 1902; under the current IMF program, the deficit is limited to 1 percent of GNP. The Philippines does not have an extensive subsidy program. The problem that faces the government, however, is the fulfillment of guarantees on foreign loans of government financial and non-financial institutions. These institutions lent extensively to private companies that have failed. The principal beneficiaries of the investment program were members of the elite who were allied with the government. For both 1905 and 1986, P10 billion is budgeted for the servicing of the guarantees and another P10 billion for debt servicing. (On an obligation basis, government expenditure totalled P83 billion in 1985 and is budgeted at P92 billion in 1986.) These disbursements are necessitated by the failure of many public and private enterprises to pay their foreign obligations which the government has accepted as its liability.

Thus the cost of guarantees alone is higher than the level of the budget deficit. Because of its interest in fighting the insurgency, defense expeditures cannot be cut. This necessitates the cutting back of real spending for social programs in education, health, and welfare. It also constrains the government against permitting the salaries of civil servants, the overwhelming majority of whom are elementary and high school teachers, to approach the inflation rate.

A significant part of government investment in the 1970s went toward energy projects, one half the cost of which went toward the construction of a nuclear power plant that is not yet operational. Since the resources for these projects were borrowed abroad, and the servicing of those debts have first priority, the government has been raising the cost of energy. This means that as the country devalues, the cost of one important non-tradeable project has been going up precisely to service the debt. This has hurt both consumers and manufacturing enterprises. As cutbacks in demand have been experienced, while the periodic debt servicing cost remains the same, the government finds it must raise the rates even more.

The current IMF program required the raising of new taxes in the order of P17 billion in 1985 alone. (Latest estimates show that the economic contraction is so severe that even the expected new revenues will not be achieved.) Ninety (90) percent of the new tax measures are indirect taxes (which already constitute 85 percent of total revenue). The offered explanation is that it has always been difficult to collect direct taxes; the crisis situation necessitated the raising of revenues quickly using the most practical means available.

The Central Bank has always been the principal source of credit for the economy. A complicated system of many rediscount windows and the lending to the treasury serves this purpose. The cartelized banking system mainly serves the credit needs of the corporate owners of the banks. There is a market for treasury bills principally because of regulations on portfolios of banks. Some Central Bank bills are also reserve eligible. There have always been strict controls on capital flight but the favored have also always succeeded in circumventing these controls. It is difficult to measure the extent of Filipino capital abroad but reasonable estimates are in the order of $16 billion.

The Central Bank supported the investment strategy of th 1970s by providing swap arrangements and forward cover for the foreign borrowings of the financial system.

Some Elements of a Critique of Past Stabilization Programs

The 1983 crisis brought on a full-blown IMF stabiliztion program in the Philippines. Prior to this, IMF and WB interventions were motivated by the possibility of financing the country's accession into "NIC-hood". Thus the critique can be directed at these two periods.

Prior to the crisis, IMF-WB programs actually financed the deleterious overvaluation of the peso. Indeed, after 1980, when the country was forced to implement tariff liberalization, the rapid reductions in tariff rates (from arithmetic average tariff rates of 13 percent to the present 29 percent) the peso continued to be overvalued so that the country was shedding off its protection without the possibility of benefiting from the policy. These programs also failed because favored groups always managed to obtain exemptions from IMF conditions. Before the crisis, the IMF inexplicably accepted these exemptions and shortfalls. For example, government revenue targets under the extended fund facility were never attained. The peso also continued to be overvalued.

An important flaw in the non-crisis programs is therefore the assumption that domestically powerful groups would accede to impositions that would ultimately threaten their entrenched economic positions. It should be recognized that IMF and WB programs never had these objectives; these programs were designed to increase efficiency and growth. However, they generate results opposite from both their implicit and explicit objectives since, they caused the further entrenchment of politically powerful groups. These groups profited from the foreign finance construction projects, from

Pat Roque/Photo bank

the overvalued peso, from the tariff protection, and later on from exemptions from tariff cuts. The implicit IMF and WB faith that a less democratic government could exploit development finance more rapidly was turned against these agencies when their funds or the private inflows their funds induced were misinvested.

The stabilization policies in the immediate crisis period seem suddenly so orthodox in the light of previous IMF flexibility. They require ceilings on monetary base, on the government deficit, a freely floating exchange rate, removal of price ceilings on products, wage restraint. They have also induced the orthodox effects: immediate inflation, rapid demand contraction, success in balance of payments and inflation targets, but with much irreversible damage. The hope is that import liberalization will repair the damage but because mainly ungainly enterprises have survived, the system's responsiveness to the longer term elements of the program will be limited. It seems that recovery will almost require a greater role for government and large monopolies – something that can be considered anathema even to IMF thinking.

It is unlikely that large domestic enterprises will respond significantly to export incentives.

The serious damage the current adjustment program has had on the Philippines should tell us that it would be giving too much credit to the IMF to think that its suggestions are based on some coherent development model that has been subjected to sufficient scientific evaluation to justify its application. If this application did not result in such high human cost, scientific evaluation would not be important; but the costs are enormous. In the case of the Philippines we can identify the following inconsistencies:

1. By a combination of policies, it is always possible to meet any given balance of payments target and any inflation target at any given point in time. But must these targets be met at the cost of dismantling a significant proportion of a country's industrial and financial structure? Such a strategy endangers long-term growth prospects and sets the stage for subsequent balance of payments crises.

2. The IMF always protests that it is apolitical and only has the best interest of the majority of a country's population in mind in its program design. The IMF programs in the Philippines demonstrate that before the 1983 crisis, the IMF (and the WB too) provided enormous support while wasteful investment and increasing concentration were taking place. After the crisis, the government continued to invest in failed corporations and to support increased concentration, while under an IMF program. Certainly, the IMF's economic model or ideology would look upon these developments as repugnant. Does the IMF's acceptance of these developments (and its provision of financing) imply an offsetting ideology, say a political model or theory, that might be traded off against economic goals? It seems incumbent on the IMF to identify this political model, as it does its economic model. Otherwise, it would be overvaluing its economic model – which in the Philippine case turns out not to have the importance the IMF forces subject countries to attach to it.