

# Involuntariness is the Name of the Debt Game

(Notes on the Philippine Government's Debt Strategy)

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Filipinos in a shum community: bearing the weight of the debt burden.

## I. The Importance of Re-negotiating the Foreign Debt Restructuring Agreements

The burden of the Philippine debt service presents itself as a key constraint in the attainment of economic recovery.

Since March 1987, the Filipino people have been regaled with stories regarding the great debt restructuring deal that the country had obtained. In this section we discuss what economic recovery means and why economic recovery cannot be attained based on the features of these restructuring agreements.

The government has defined economic recovery to mean the recovery by 1991 of the per capita income level achieved in 1981. This is a modest objective - to stay in place as far as the per capita size of the economy is concerned in the ten year period, 1981-1991.

To achieve the modest goal, however, will require that the economy, as a whole, grow by an average of 6.5 percent per year from 1987 onward.

*Sustainable economic growth is made possible only by the undertaking of investment.* Investment creates additional capacity from which new output can be derived. An economy that has a constant and fully employed productive capacity can only hope to produce exactly the same amount of total output from that year onward.

At the start of 1987, there existed unused capacity left over from the contraction of domestic demand that occurred between 1983 and 1985 in connection with the International Monetary Fund (IMF) adjustment program. The growth that was experienced in 1987 soaked up practically all of the economy's capacity left standing after that program.

This means that beyond 1987, "sustainable" growth will not be possible, except if significant investment is under-



taken. The country could have "unsustainable" growth by continuing to drive up domestic demand. In the face of completely utilized domestic capacity, such additional demand can only be satisfied by imports. Because the country's export capability cannot be expected to increase dramatically at the same time, such imports will quickly reduce the level of international reserves and undoubtedly trigger a new balance of payments crisis. Such a development can be tragic for the Philippine economy.

In fact, even increases in export capability, which is said to be important in the solution of the Philippines' debt problem, will require investment.

The resources a country can apply for its investment can come from two sources: (1) that part of the country's output that is not needed for the consumption requirements of its inhabitants — called its national savings and (2) amounts that it can borrow from abroad, net of its payments to service its outstanding debt.

The reason why the issue of debt service is so critical for 1988 and beyond is that, given that investment will now be required for the attainment of sustainable growth, the question arises: are the resources available to finance such growth?

Based on the most optimistic calculations and the features of the debt restructuring obtained by the Aquino government so far, the resources needed to support economic recovery have not been identified.

In a good year, the country can afford to save 20 percent of its output. If all of these savings are efficiently invested, the country can achieve a growth rate of about 6.5 percent per year.

These figures are on the optimistic side since historically a 20 percent savings rate had only permitted at most a 5 percent average growth rate in output. In fact in the last eight years of the Marcos regime, such a savings rate would have permitted only a 2.5 percent growth rate since many investments were being carried out in which no increases in output were forthcoming.

Moreover, in recent years, when incomes had contracted, the country has been able to save only about 17 percent of its output. This is the lot of economies coming out of a deep depression. With a 17 percent savings rate, only a 5.8 percent growth can be afforded. This is high, but not sufficient for economic recovery. In fact, for 1987, it is unlikely that the 6.5 percent growth rate can be achieved. Even less than 17 percent would be available for investment if the groups in society with control over these funds cannot be stopped from investing these abroad.

These figures indicate that if the economy were to rely on its own resources alone and the best conditions existed, economic recovery would be within reach. *What makes economic recovery out of reach are the foreign claims on the country's investible funds, as enshrined in its debt restructuring agreements.* Because the other purpose to which

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President Aquino: honoring the debt Marcos incurred.

domestic savings can be applied is toward the servicing of the foreign debt.

Based on the debt restructuring obtained so far the Philippines will have to remit between \$14 to \$16 billion in the medium term. This would be net of money it would receive from abroad, assuming that best conditions prevail. This would represent between 5 to 8 percent of output, which will reduce the savings available for investment to 13 to 15 percent of output. (These percentages would be higher if the actual growth rate were lower. In 1987, it is unlikely that the target will be attained.) Under these conditions, the best overall growth rates that would be available would range from 4 to 5 percent.

These calculations are meant to explain that just to have a chance at economic recovery, what would be required is that the net foreign payments for the years 1988 and beyond should be brought down to zero.

This will mean that the country's debt service has to be reduced so it can devote all of its savings to finance its growth. The situation is dramatically different from the Marcos years, principally because the international credit situation changed completely after the Mexican debt crisis of 1982. In the Marcos era, a net of 4 percent of output used to be received from abroad to augment domestic savings in financing investment. In the present case, we are looking at remitting a net of 4 to 8 percent of output abroad. The



country is only trying to bring this down to zero. These outpayments can suddenly increase if world interest rates increase.

The Aquino government has been warning the people about the disastrous consequences that could be spawned by punitive measures foreign creditors will inflict should the country take a stronger negotiating stance on the debt problem. But what could be more disastrous than an impoverished country forced by its agreements to become an unwilling net investor abroad?

These warnings are also being issued oblivious to the defensive measures the country might undertake to avoid the consequences of punitive measures. They are also being issued with the assumption that punitive measures will cause little damage to the creditors imposing them or to the political and economic interests of their countries in the region.

What is important, therefore, is that beginning in 1988 the country overcome its existing debt service commitments, as presently constituted. According to our calculations, the country can afford to pay no more than 15 percent of its merchandise export earnings to be roughly in a situation in which no net foreign remittance will be made.

Under the present agreements, the country expects to pay 30-32 percent of merchandise exports in debt service. Nothing less than a renegotiation of the present relationship with foreign creditors would be required because otherwise the country would be considered in default.

## II. Government's Role in Debt Negotiations

What seems to be important at this juncture is to discuss the stance that the country must take with regard its foreign creditors.

### 1. The Government can only determine the Philippine position and not the overall outcome. It should not internalize the interest of foreign creditors.

The first important point to be made is that the decision on and the design of the stance the country will take is not the same decision on what the final shape the relationship will have at the end of the negotiations. The country is but one party in a relationship that will be decided by two or more parties. Among the more important "other parties" are foreign governments, particularly the United States and Japan, the international commercial banks, and the multilateral financing agencies, such as the World Bank and the IMF.

At the conclusion of a genuine negotiating situation, the opposite sides often leave dissatisfied because of the concessions they have to make to reach an agreement. What was curious about the March negotiations between the Philippines and its creditors was the fact that the Aquino government's negotiators were crowing about the achievement upon their

return (eating crow a week later after the Argentina agreement) while the banks were quietly glowing with satisfaction.

In the case of the Mexico negotiations, which now appears to have provided Mexico its first chance for recovery since 1982, recriminations characterized the end of the negotiations between the creditors, the U.S. government, and the Mexican government. For example, the banks' negotiating team were sour-graping that the rest of the banks would not agree with the settlement the team had agreed to.

Such messy relationships permit the continual reopening of talks, as has been the experience of the Latin American countries. What is bothersome about the Philippine case in both the Marcos and Aquino administrations is that within such an orderly relationship, talks can only begin again when the country is in such deep trouble attempting to raise the new resources needed to service its debt according to the existing orderly schedule.

In contrast, in a complex, many-sided relationship with foreign creditors, there are always many little things that are not working well enough which can provide the venue for continuing dialogue and readjustment.

*That the Philippine government can only deal with its own side in an inherently multi-sided problem imposes restrictions on government officials.* In particular, government officials, especially those that might be directly involved in the negotiations, should not be seen explaining the actions, and possible actions, that foreign creditors are threatening against the country.

By having officials explain to the public the monstrous things that foreign creditors might possibly do, the government throws away the possibility that the creditors might be convinced to do otherwise in the course of the negotiations. In fact, when Philippine negotiators finally sit down with foreign creditors after so eloquently explaining the creditors' side to the countrymen they are supposed to represent, what else can the foreign creditors ask for at that point except for capitulation, except possibly for a reasonable delay in reaching agreement to give the deal some measure of credibility?

An additional restriction the situation imposes is that the country's negotiators must always indicate that they are only representatives. This means that they should never give the impression that they know more about what must be done than the President, or the whole government, or the Filipino people. By giving the impression that the negotiators are really the decision-makers, one throws away the advantage that makes it possible to go back for consultations with those being represented when unacceptable terms seem difficult to refuse.

These restrictions should also apply to members of Congress, which, under the constitutional system, represents the highest policy making body of the land.

It is for Congress to set the foreign debt policy for the country, based on self-interest tempered by the best existing understanding of the situation. It is for the executive branch to prosecute the best implementation of such a policy.



*It is for the executive branch and the Central Bank to interpret policy decisions made by the legislature that happen to run counter to the existing agreements as instructions to reopen negotiations.* It is not for the Philippine Central Bank to interpret these legislative actions as instances of debt repudiation. Only the foreign creditors have the competence to make this interpretation, if it happens to be in their interest.

These points — drawn from an understanding of the nature of the democratic system that had become feasible only after the overthrow of Marcos — suggest certain important considerations regarding the role and the nature of the joint executive-legislative commission proposed by Senator Romulo. The purpose of such commission should be to determine the best possible negotiating stance of the country with regards to the foreign debt.

Being charged with determining the Philippine position, the last thing such a commission should do is to attempt to internalize both the debtor and the creditor sides of the debt issue. It should concern itself with determining the Philippine position based on the interest of the whole country. Such a position will not necessarily be in the interest of Philippine negotiators, who being representatives, should be charged with prosecuting such an interest.

It is always in the interest of negotiators to be instructed not to ask too much from the other side. One only needs to study the recent statement of Secretary-designate Jayme regarding his proposals to address the country's debt problems in his speech in last weekend's Philippine business conference to be alert to this problem. Mr. Jayme proposed six points:

1. the debt burden should be shared more equally.
2. debtor economies should be insulated from adverse external developments such as rising interest rates, falling commodity prices and protectionism.
3. balance should be restored between private and public financing from the advanced countries.
4. "realistic options" such as interest capitalization, export-earnings linked payments, debt conversion, and debt forgiveness should be considered.
5. new facilities for debt conversion should be established at the World Bank and the IMF.
6. changes in regulatory and tax system in creditor countries to ease accommodation of debtors' requests.

Of these six, the first item is a motherhood statement, which must be given life in actual policies. Of the remaining five, only item four is something that might be within the purview of Philippine policy, within the scope of the proposed commission. The other four items are appeals to the international community, which cannot succeed unless debtor governments (or the force of events, whichever comes earlier) can force the international community to accede. In fact, the very choice of the word "forgiveness" in item four betrays

the point of view from which these suggestions are being made.

This, in spite of the ringing phrases in the speech that we must not sacrifice "the urgent needs of our people to the payment of our debts." The working conditions of finance ministers and other debt negotiators of heavily indebted countries can be very difficult, indeed. But they can be made less difficult if only the creditor countries would deign to carry out the four reforms suggested by Mr. Jayme.

Being charged with determining the Philippine position, the proposed commission should fulfill its assigned responsibility, instead of reassigning the responsibility to other bodies or permitting events to determine policies by default. Thus, it should set out clear policies and avoid ambiguous approaches such as that of a flexible debt service ceiling (itself, a contradiction in terms).

The only guarantee that the commission will not internalize the creditor interest is to make the commission, instead of being merely a legislative-executive commission, a national commission. The commission must be organized in such a way that representatives of citizens that will be greatly affected by the government's foreign debt strategy, in particular the working class, farmers, consumers, the unemployed, small businessmen, and taxpayers enjoy a power of representation commensurate with the sacrifices they might be called upon to undertake.

## 2. The strategy on the foreign debt primarily involves a political decision, not a technical one.

Even creditors make political decisions. For example, the action by foreign banks refusing to confirm letters of credit after the Aquino assassination brought on the start of the 1983 balance of payment crisis was a political decision. At that point, the creditor banks were implicitly demanding that the Philippines begin servicing its outstanding debt at a faster rate by changing its macroeconomic policies.

A political decision is one which takes into account the relative strength of both sides. If it had been decided that the Philippines did not have sufficient strength to resist the punitive actions of creditors, then it might make a decision to accommodate their demands. But even this decision must be seen as a political one. It is unseemly, to say the least, for the Aquino government to try to explain that it was the technical considerations that made it not demand debt relief from the banks.

When Mexico forced the Reagan government to lock up the heads of the big commercial banks (setting aside their negotiating team) to force the banks to come to an agreement, a political decision was involved. A political approach to debt negotiations will not necessarily require table pounding, even though a certain amount of unpredictability might be advantageous.

The political decision on the debt strategy will include a



set of policy actions that the Philippine government is prepared to carry out to implement its policy. Thus, the political decision involves a decision on *defensive measures* that must be undertaken and, should these prove inadequate, the possible sacrifices that will have to be called for from the people in pursuit of its policy. A government, or any negotiating side for that matter, that is not prepared to accept hardships even in potential form, cannot demand too much from the other side. In the case of Brazil, this has meant being prepared not to service its debt until a satisfactory agreement is achieved.

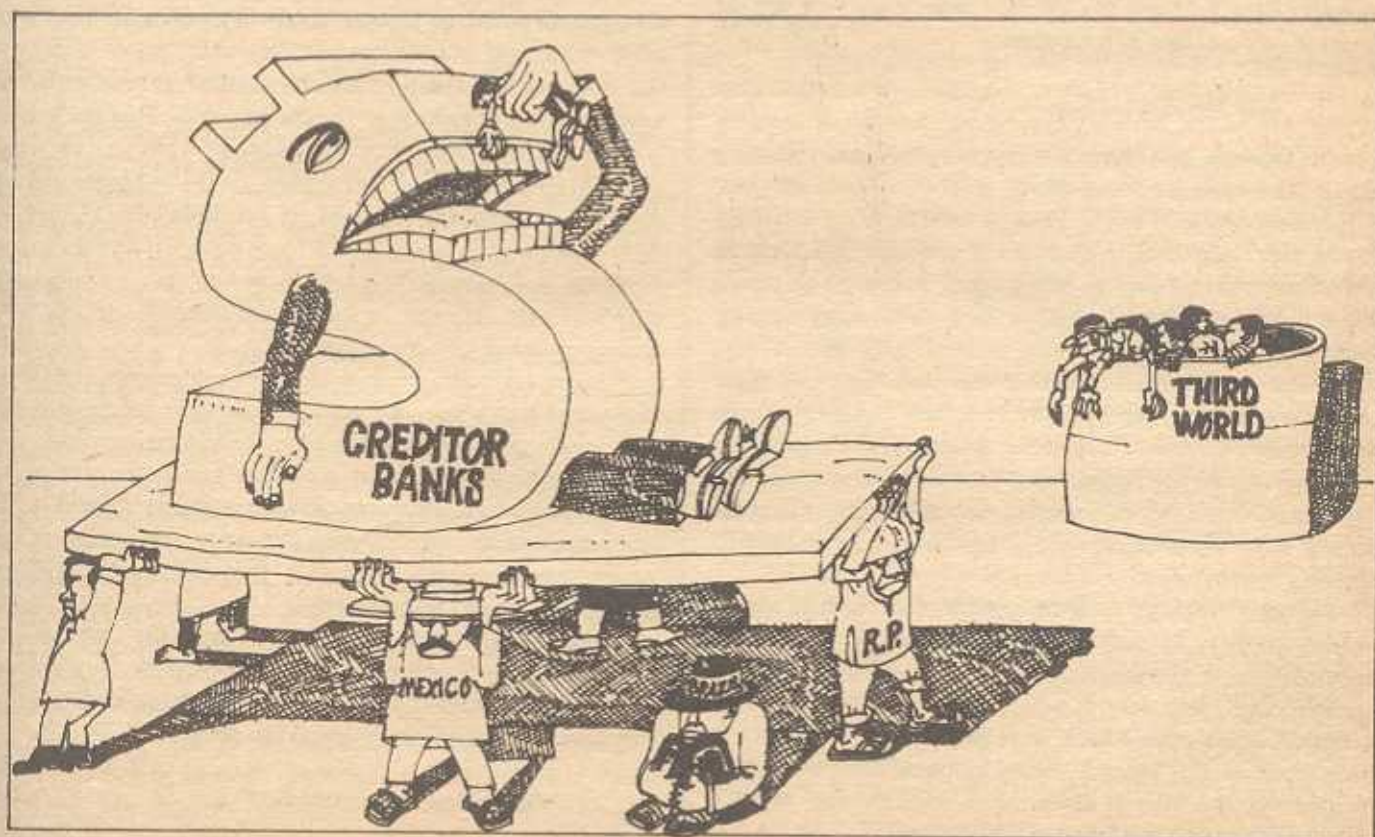
The implication of this is that because it seems to be necessary for the country to reopen debt negotiations it must be prepared to undertake those actions necessary to prosecute its "policy" (that is, if it exists). It is an unfortunate consequence of the continued orderliness of the Philippines' relationship with its creditors that it must now be prepared to declare a moratorium just to reopen negotiations. The opportunity for a quiet but drastic change in debt relations that could have been made with the assumption to power of the new government was missed in 1986.

The government must capture the high moral ground on the foreign debt issue. To achieve the 1988 target, the country cannot afford to service according to the terms agreed upon in March 1987. It must be prepared to declare a moratorium on

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A busy line in the local stock market: sharp drop.



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payments until new negotiations to reduce the burden are successfully concluded.

### III. On the Infeasibility of an Accommodating Negotiating Stance

The imperative identified in section one for the country to achieve a zero net outflow (or the equivalent of a 15 percent of merchandise export earnings maximum debt service) would not have to be attained from negotiations if:

1. new foreign lending, especially by the international private sector, voluntarily restarted in sufficient amounts; or
2. foreign investment began to flow into the country in sufficiently large amounts; or
3. the country's net exports increased by leaps and bounds.

The accommodating negotiating stance implemented so far by the Aquino government has been meant to prayerfully bring about these three positive developments.

The gentlest comment that one can make about this plan is that it is a pipedream. With sufficient political will, some of these developments will occur, but these cannot be expected to occur in sufficient quantity to present an alleviation of the debt problem. In fact, the very existence of the country's debt problem is a primary reason why we cannot expect to rely on these developments.

#### 1. New Foreign Lending

In the case of foreign lending, no significant voluntary lending has occurred since 1982, even for very accommodating countries such as the Philippines. The word voluntary here is very important. Voluntarism is what the accommodating stance is supposed to bring about. A tough negotiating stance is meant to force the opposite — involuntary lending. Foreign creditors have lent "new money" only because they have been forced to in negotiations and none of these amounts, supposedly newly lent, have been applied to fund new investment. Instead they have financed debt repayment.

The worldwide figures speak for themselves: in 1983 total international bank lending to developing countries reached \$35 billion. By 1985, the number barely reached \$3 billion and almost all of it in debt restructuring.

It does not make sense for private banks to lend money for new projects in countries like ours, where it has been identified that in the long term the overall ability to repay is impaired. Philippine debt is now selling at a discount of 50 percent. If some private bank were foolish enough to lend to the country at this time, it would be doing so knowing that the moment the loan is disbursed it is likely that only 50 percent of the amount of the loan will be repaid.

A significant proportion of foreign lending is undertaken by governments (such lending is called "bilateral") and multi-

lateral agencies. The Aquino government's preference for bilateral and multilateral borrowing is on record through statements by former Secretary Jaime Ongpin, who also believed that such loans were cheaper, presumably than commercial bank "new money," for the country.

This strategy is questionable for many reasons. First of all, the strategy is self-limiting since it implicitly supports the efforts of the private international banks to extract the payments that are due them from any accommodation the governments and multilateral institutions might provide to the country. Creditor governments have taken the view, rightly, that all parties should shoulder the burden equally and that private international capitalists should not escape from the costs of their proclivity to lend to dictatorships in the 1970s by raiding taxpayers' funds.

Secondly, bilateral and multilateral lending is naturally biased toward financing the importation of capital equipment from the donor countries. Thus, the net dollar proceeds of these loans, from which funds to repay existing debt can be drawn, tend to be a small proportion of the amount being borrowed. These loans can be very expensive particularly when the equipment being imported is not really required by the country, which increases its foreign debt in the process while providing only a small portion of the proceeds for its current debt service.

Recently, some of these loans have been for program loans (as opposed to project loans). Examples are the structural adjustment and the economic recovery program loans of the World Bank. These invariably require the government to implement some economic reform program. This has consistently involved a loss of sovereignty over the direction and pace of reforms. When the details of the suggested reform program are technically flawed, as has often been the case in IMF advice and in many World Bank projects, damage to the economy has been inflicted in exchange for the budgetary support. This damage has been experienced as inflation, factory closures, and unemployment.

Bilateral loans do tend to carry low interest rates, but, as pointed out above, are highly directed at capital importation from the donor countries. But multilateral agencies, such as the World Bank, lend at prevailing interest rates, just like commercial banks. Thus, even in the interest rate aspect alone, it is difficult to identify any concession to reality in the Aquino government's position that bilateral/multilateral lending can replace private lending.

Finally, the budgetary constraints of the United States and the Japanese government (as opposed to the Japanese private sector) point to the pie-in-the-sky nature of the Aquino government's reliance on bilateral finance.

#### 2. New Foreign Investment

The second item of hope is new foreign investments. Again, this is problematical for many reasons. The domestic



political instability is itself an important reason why the country should not rely on foreign investment to pull itself out of its debt problem. In fact, political instability is a key reason why the private banks are in a desperate hurry to reduce their Philippine exposure.

At the overall level, we cannot expect a significant flow of investment worldwide. Though it must be admitted that a noticeable increased flow of Japanese investments had been occurring, it is not likely that such flows will be large enough to permit the world total to be increasing on a net basis.

The reason is the overall slower world economic growth rate. The crash of stock markets worldwide signals that this slowdown, foreseen much earlier by development economists, now enjoys wide public recognition. This public recognition will of course hasten its onset. It is expected that growth rates of the OECD countries will lose at least a percentage point in 1988.

The Philippines does stand the chance of being a recipient of the Japanese (and the smaller Taiwanese) foreign investment flow. But, beyond the political stability issue, the very existence of the debt service burden puts the Philippines at a disadvantage, especially against Thailand.

Any enterprise that locates in the country must internalize in its operations the burden of the debt service. This will be reflected in higher rates of sales taxes, higher costs of power and other utilities, and lower quality and availability of infrastructure and other services usually provided by governments. *These costs must be borne even before profits are made.*

Of course, the Aquino government may be half-proud of the fact that Philippine labor costs are now much lower than elsewhere and the success of the government in suppressing labor demands for living wages might make up for the costs of debt service for new investors. It must still be recognized that such efforts at suppression will continue to spawn labor unrest (and more political instability).

Then there is the matter of the debt equity swap, which the Aquino government has identified as the linchpin of its debt restructuring program. The government has the so-called Philippine Investment Notes (PINs) program, which is being continually revised and has mercifully not been significant.

Debt-equity swaps have been found to be very expensive for the countries that have undertaken them because they do not result in foreign fund inflows in excess of what might already have occurred even without them. There is no "additionality" to use the current jargon, and the country might as well have received the investment in its usual form and used the proceeds in the usual way for its current debt service. The country saves little in the immediate period from the retirement of debt through the swap since the biggest burden is the interest anyway, and most principal repayments are being rescheduled as a matter of course.

Debt-equity swaps provide foreign investors with a bargain, to buy local assets at a discount close to the discount

on the country's debt instruments on the world market. But they also endanger the controllability of the money supply and the stability of the exchange rate.

### 3. New Net Exports

The Department of Trade and Industry announced a so-called "fighting target" for export growth rate of 25 percent for the year 1987. The best that might be actually achieved for 1987 is a 10 percent growth rate. The NEDA's target of 8-9 percent growth rates over the next six years is less fantastic. However, these projections had been made without taking into account a slowdown in the world economy in the last half of the 1980s.

Export markets are not won overnight, even when costs are low as a result of the suppression of labor costs. Products, whose styles are continually changing, have to be designed and the capability to supply reliably demonstrated.

The idea of "net exports" as opposed to simply "exports" is important. The country continues to rely heavily on raw material exports. The prices of these products are subject to wide fluctuations. In fact, should the stock market crash translate into a deep world recession, the fall in commodity prices it will induce will be disastrous. The servicing of the foreign debt will have to be derived from these export earnings.

The Philippines has been developing its capability in manufactured products exports. But the "net export" content of these products is rather small; 90 percent of the value of garments and electronics exports must be imported, because the domestic industry is incapable of supplying the needed inputs. It will take effort and time before these products will earn enough net foreign exchange to contribute significantly in the debt service. But mostly, it will take investment. But investment is what is immediately constricted by the debt service itself.

Under the NEDA projections of 8-9 percent growth rate in exports, the country will still need additional foreign financing of \$7.6 billion beyond the accommodations that have been identified in the current restructuring agreement.

These considerations must be interpreted as a critique of the Aquino government's accommodating debt strategy. This strategy waits upon an accommodating external environment, instead of directing itself at determining what the Filipino people can do. Even the PINs program, the "linchpin" of the program, depends on the voluntary response of investors.

We have tried to show why we think an accommodating external environment to be unlikely. If we are willing to draw a lesson here we might say that, at this point, involuntariness is the name of the debt game. Any accommodations that the Philippines will require to achieve economic recovery will have to be pried from the negotiating table. **K**