

REVIEW OF STRUCTURAL ADJUSTMENT IN THE PHILIPPINES

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Introduction

This paper reviews, albeit not comprehensively, the issues of structural adjustment in the Philippines. It focuses on the identification of those elements in past Philippine efforts at structural adjustment that appear to be critical in future structural adjustment efforts. The objective is to discuss the problems and the potentials of policy-based lending in support of future structural adjustment efforts in the Philippines.

This paper has six sections. The first section discusses the concept of structural adjustment while the second presents a review of structural adjustment experiences in the recent past impelled by foreign financing. The third section deals with the future structural adjustment challenges for the Philippines. The fourth section discusses the need for a more effective approach to structural adjustment design and implementation. The fifth section discusses the role of foreign financing in structural adjustment and provides some suggestions about the use of conditionalities. The final section provides some concluding remarks.

The Concept of Structural Adjustment Utilized

The term "structural adjustment" has meant a myriad of things because, in the absence of a commonly accepted analytical model¹ within which it can be studied, it has also become a convenient justification for an equally myriad number of policy suggestions.

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1. For example, there is a controversy between economists calling themselves structuralist macro-economists and the economists of the International Monetary Fund (IMF).

For the present purpose, structural adjustment is defined as the reform of a country's macroeconomic structural parameters so that these are supportive of medium-term development efforts. The crucial relationship in structural relationship exists between the rate of growth at the macroeconomic level and the current account deficit (or surplus) in the balance of payments. The level of the current account deficit is of course identical, in the accounting sense, to the amount of foreign savings that the country uses. Many structural parameters are critical in this relationship. Among the important parameters involved are: the national savings rate, the associated government tax to the Gross National Product (GNP) ratio, and the current account deficit to GNP ratio.²

To flesh out our conception of structural adjustment, we distinguish and relate structural adjustment to "stabilization." We also identify structural adjustment as principally a macroeconomic, as opposed to a microeconomic, issue. We then distinguish structural adjustment from development policy.

Stabilization and Structural Adjustment

We take a more medium-term view of structural adjustment and contrast it very starkly from stabilization. In common practice, stabilization refers to a reconciliation, in a very drastic fashion, between the level of domestic spending and the level of domestic production. The excess of the level of domestic spending over domestic production manifests itself either as runaway inflation, or as an unfinanciable current account deficit, or both. A reconciliation of the *levels* of spending and production with each other will "solve" an inflation or reduce the current account deficit to financiable levels. One can say, in no uncertain terms, that the Philippines from 1983 has managed some version of stabilization, but is still a long way off from structural adjustment (see Montes 1987). In the 1983-85 experience, exports in fact declined, inspite the temporary but vigorous 8 percent growth in world trade in 1984. This decline provides the most direct indication that structural adjustment did not accompany the IMF structural adjustment program of 1984. However, imports declined even faster to generate a current account surplus within a little over a year after the start of the program; this provided the basis for stabilization.

In contrast, a structural adjustment is related not principally at the levels, but at how the *growth rate* of the economy is consistent with a sustainable flow of foreign savings. A successful structural adjustment

2. See also Yanagihara (1988), page 21, for a discussion of other parameters based on an "open economy version of the Harrod-Domar growth equation."

will undoubtedly result in a reconciliation of the levels of domestic spending and output to a sustainable level. But a successful stabilization is not necessarily consistent with structural adjustment. In fact, if the stabilization strategy had resulted in significant dis-investment, a successful stabilization can set back the prospects for structural adjustment.

Micro-Macro Interaction

Structural adjustment is a macroeconomic concept whose actual realization depends upon the innumerable microeconomic responses to government policy. A critical element is the sufficiency of investment, both private and public, to permit a more externally financiable growth path. But the analytical distinction between the macroeconomic and the microeconomic is important in disentangling many of the confusing discussions that tend to accompany evaluations of structural adjustment programs; Helleiner (1988) provides a valuable discussion on the distinction.

The important macroeconomic variables are the fiscal deficit, the investment-savings gap, the current account deficit, the rate of inflation, and the exchange rate. Structural adjustment, while ultimately requiring microeconomic changes to permit a permanent realization of the needed adjustment, is basically a macroeconomic problem for which macroeconomic policy actions, of varying degrees of effectiveness and political feasibility in different countries, are available.

The important microeconomic issues relevant to structural adjustment discussions have to do with the trade regime, investment incentives, and the incidence of the tax system. Thus, the issues of import liberalization and trade reform are principally microeconomic issues, affecting the question of efficiency (and equity). Whether trade reform, an inherently microeconomic policy, is supportive of structural adjustment depends on its microeconomic consequences.³

As an example, Rodrick (1988) provides an analytical discussion of why, on commonly accepted neoclassical grounds, trade liberalization cannot necessarily be expected to induce or improve efficiency on production. He demonstrates that the arguments for efficiency-inducing effects, in fact, require an economic environment not often utilized in neoclassical analysis: the existence of economies of scale, or costly

3. The timing for implementing trade liberalization also constitutes another issue including the extent to which it is detrimental or beneficial to a stabilization effort. The relatively successful control of Israeli hyper-inflation compared to that of Mexico after 1983 might be partly attributed to the fact that, during their stabilization effort, Mexico liberalized imports (and generated expectations of further devaluations due to international reserve losses) while Israel did not. See Cukierman (1987) and Ros (1987).

entry, or x-efficiency for example.⁴

When such "imperfections" exist, trade liberalization will not necessarily be the proper policy to induce firm-level efficiency. Based on well worked-out results from second-best economics, general trade liberalization might even be the "wrong policy." Moreover, in such an environment, trade liberalization will genuinely not be a sufficient policy for the purpose of inducing firm-level efficiency.

It is possible for a country to have a poor microeconomic environment, at least on neoclassical grounds, but with an acceptable framework of macroeconomic management. Japan might serve as an example, though that country's success in attaining efficient production through distorted internal prices warrants a deeper examination of the proposition that the path towards the attainment of production efficiency is through the rapid alignment of domestic prices to "world prices."⁵

A country may have a poor macroeconomic environment while having a relatively good microeconomic environment. The United States could be an example. It is also possible to have a poor environment, both in micro-economics and macroeconomic terms, and the Philippines stands as a good example, even after the 1986 change in government.

The micro and the macroeconomic aspects, therefore, interact and provide limits to each other. For example, the most current and most careful (one is tempted to say, non-ideological) analyses suggest that a "realistic" (not necessarily "free" or floating, or "market determined") exchange rate policy and a steady, if not generous, program of export subsidies, rather than trade liberalization *per se* have accompanied successful export performance. In fact, export booms in manufactures have preceded trade liberalization: Korea and Taiwan in the 1960s, Brazil in the late 1960s and 1970s, and even Turkey in the 1980s.⁶

A more elaborate and theoretical example of the micro-macro interaction can be constructed around the neo-Ricardian proposition that the budget deficit does "not matter" because economic agents, anticipat-

4. Rodrick's analysis, firmly located within neoclassical economics, maintains as its hypothesis the profit maximization by firms. The paper principally tackles the use of the classical duality between maximizing profit and minimizing cost. If firms are truly cost minimizing (because they are profit maximizing), the existence of protection should not retard their efforts to improve their efficiency. An analysis based outside neoclassical political economy can bring into question the hypothesis of profit maximization. But this would be tantamount to a confession that neoclassical economics is an anemic approach for the analysis of trade liberalization.

5. Perhaps in desperation, the special cultural capability of the Japanese (or the Koreans) to carry out industrialization in such "distorted" circumstances often gets credit. The neoclassical tradition takes tastes and culture as given. Thus, such cultural justifications for an industrialization strategy based on trade liberalization cannot be situated within the neoclassical tradition.

6. See Rodrick (1988), p. 9, for a discussion of these propositions.

ing future tax increases necessitated by the need to pay for the debt created by the deficit, will increase their savings. Thus, the proposition appears to say that the macroeconomic problem created by the budget deficit does not exist, or at least is significantly alleviated, by an elegant microeconomic model of so-called forward-looking behavior. Private saving immediately makes up for public dissaving. (There is still the microeconomic problem, in the long run, that perhaps public spending is not as productive as private spending.)

This example, given the potential inappropriateness of the microeconomic proposition to the macroeconomic problem, should illustrate the importance of making the micro-macro distinction.

There can be no inherent impediment in including microeconomic projects in a structural adjustment program. However, a constant sensitivity to the micro-macro distinction makes for effective adjustment program design and evaluation. For example, greater time, if not financing, is unavailable in the case of microeconomic adjustments. If these are an explicit part of a structural adjustment program, then the necessary time and resources must be identified in the program.

Development Policy And Structural Adjustment

It is also important to relate and distinguish structural adjustment with and from development policy. In the medium term, while a successful structural adjustment functions merely as a support of development efforts, it is unavoidable that development efforts have a profound feedback effect on the state of "structural adjustment." In a highly indebted country like the Philippines, there is a supporting cast of other parameters that figure importantly in structural adjustment such as the net foreign resource transfer and the debt to GNP ratio. The fundamental issues in structural adjustment policy actually relate themselves to development strategy. Approaches to structural adjustment are already enveloped in technical controversy and must overcome political obstacles for effective implementation. When these become confused with the highly political issues of development strategy, the problem becomes even more complex.

When it can be managed, a country should enunciate its long-term goals and strategies and then provide the proper rationalization for the approaches, permanent or provisional, that might be required for medium term structural adjustment. It is very important to separate the development policy from adjustment policy, and to avoid hardened ideological positions about matters like the participation of foreigners or of the government in economic life, in policy dialogues.

Structural Adjustment Efforts in the Recent Past

Significant Philippine efforts at structural adjustment occurred in 1949, 1962, and 1970.⁷ Structural adjustment efforts in the more recent past are of greater interest for the present purpose of identifying issues in policy-based lending.

There have been five foreign financing-inspired programs in the recent past: the 1976-79 Extended Fund Facility (EFF) from the IMF, the two Structural Adjustment Loans (SAL) obtained from the World Bank in the period of 1980-85, the World Bank sectoral loan for agricultural inputs, and the World Bank economic recovery loan. The first four loans were obtained in the Marcos period, while the last was obtained by the Aquino government. The Aquino government also implemented the agricultural inputs sectoral loan.

EFF Program.

The Philippines secured the 1976-79 EFF in an atmosphere of generally easy availability of external financing; this came as a result of the eagerness of private international commercial banks to relend their OPEC deposits. Based on the principle that structural adjustment is best carried when financing for investment is available, the period was the most opportune time to establish the economy's external sector on a more robust basis. The facility gave a three-year financing valued at SDR 217 million (about US \$250 million). Three major areas of structural reform were identified in the program: a.) infrastructure investment; b.) tax reform; and c.) resource allocation. But according to a 1984 IMF evaluation (Thompson and Slayton 1985, p.65), progress "as regards the structural aspects of the program was not evident."

The program called for expansion of infrastructure in power, irrigation, and transportation to eliminate bottlenecks in private sector activity in agriculture. But...

"delays in project implementation" kept investment far below levels set under the program, even when these goals were revised downward. Worse, the Fund found that those projects completed were often of "doubtful economic justification."⁸

The EFF program aimed at moving the balance-of-payments towards an equilibrium.⁹ Instead, the infrastructure projects became in-

7. See Montes (1986) for a more detailed account of these crises.

8. Thompson and Slayton (1985) quoted an internal IMF evaluation report, p. 65.

9. Broad (1988), p.59.

creasingly dependent on foreign financing since the tax targets in the EFF program were not even approximated. The tax effort was considered a key target in the program and was projected to increase from their 1975 level of 13.6 percent to 16 percent by the end of the program. In the course of the program, the tax effort target was revised downward to 14.5 percent. At the end of the program, however, the actual tax effort had increased only symbolically to 13.9 percent.¹⁰ "None of the original ceilings on domestic and foreign borrowing or the floor on international were met."¹¹

The resource allocation component of the EFF program included trade reform, directed towards lowering the protection for consumer goods while raising that on intermediate and capital goods.¹² To be feasible, trade reform required the removal of import controls. "The relevant Central Bank office complied by splitting the existing restricted categories into subdivisions and then liberalizing only a handful of these new less-inclusive groupings."¹³ Under resource allocation, there were also intentions to remove interest rate ceilings and price controls. These intentions were not carried out.

SAL I Program

In August 1980, a year and a half after the failure of the EFF program, Cesar Virata sent a letter to World Bank president Robert McNamara which contained a set of intentions about Philippine industrial policy. These were:

- a. Lowering of protective tariffs;
- b. Liberalizing import restrictions;
- c. Taking action to promote and facilitate exports and investment in export-oriented industries;
- d. Following a "flexible exchange rate policy... to reflect basic market forces;" and
- e. Restructuring specific industrial sectors to integrate them in the overall export effort.¹⁴

This set of intentions formed the foundation for the Philippines' Structural Adjustment Loan (SAL) with the World Bank. They used as basis the Five Year Development Plan 1978-1982 which was cited by the

10. Thompson and Slayton (1988), p. 66.

11. Broad (1988), p. 60.

12. Thompson and Slayton (1988), p. 66.

13. Broad (1988), p. 62.

14. Broad (1988), p. 65.

Bank "ad infinitum" as being "broadly consistent" with its own report drafted by Russell Cheetham.¹⁵ The report followed years of "policy dialogue," presumably even during the period of the failing EFF, between top government officials and Bank officials, and within the Philippine government.

The first structural adjustment loan (SAL I), approved in September 1980, provided US\$200 million and called for a three-phased tariff reform program to start on 1 January 1981.

The program required strict "prior action," or "front-loading" of conditionalities, the importance of which was one of the "lessons" favored in a World Bank evaluation of structural adjustment experiences drafted in 1988.¹⁶ On 1 August 1980, President Marcos issued Executive Order 609 which declared a comprehensive reform program affecting three-fourths of the Tariff Code.

Under the program, peak nominal tariff rates would be reduced to 50 percent by 1 January 1982 in Phase I. In Phase II, average effective rates of protection for food processing, textiles and garments, leather and footwear, and pulp and paper were to be reduced from 158 percent to 30 percent. Phase III was directed at reducing the average effective rate of protection from 53 percent to 18 percent in ten other key industries. Just as in the EFF program, removing import restrictions built up during the import-substitution period became a means to make the program effective.

Towards the end of 1980 and before the program kicked off, President Marcos gave in to pressure from certain elements of the business sector and slowed down the tariff reduction program. This change was done so hastily that the amended executive order stood wrongly numbered in the books.¹⁷ Thus began difficult years which saw the Philippine government managing to circumvent the overall intentions of the reform program (while satisfying the objectives symbolically) and the World Bank that became increasingly shrill in its controversy with the government. Nevertheless, the World Bank still approved SAL II in April 1983 with US\$302 million in new financing.

SAL II Program

In April 1981, the government sought to explain the already launched program to the business sector through a conference sponsored by *Business Day*, Manila's then foremost business newspaper. The situation

15. Broad (1988), p. 64.

16. World Bank, Strategic Planning and Review Department (1988), p. 22.

17. Broad (1988), p. 84.

was tinged with the irony of the staunchest, self-professed supporters of the private sector, technocrats, and economists from the academe who explained to the business sector why bankruptcies, unemployment, and some inflation were part of the inevitable pain of a structural adjustment.

The SAL period saw the proliferation of special import privileges to government and quasi-government corporations, while the government managed to attain the targets of reducing average nominal tariff rates from 43 percent to 28 percent.¹⁸ The domestic inflation rate which exceeded 10 percent annually in the period guaranteed the continued significant over-valuation of the exchange rate. The government fell behind schedule in dismantling the import licensing system, and had to abandon the effort when the balance of payments crisis erupted in October 1983, after the Aquino assassination.

The period was certainly a difficult time to attempt to carry out the formidable structural changes in the economy. In January 1981, a gutting of the financial sector occurred after a prominent businessman fled the country leaving behind US\$90 million in debt. This led to the replacement of the Central Bank governor. In 1982, the international debt crisis began, with the near default of Mexico.

Nevertheless, it would appear that these difficult conditions were interpreted as opportunities to implement changes that were not carried out in the EFF program. The replacement of the Central Bank governor with a technocrat was interpreted in the same way as the appointment of Cesar Virata as prime minister, an empowering of the technocrats. The corporate and financial bankruptcies were seen as an opportunity to clear the landscape to facilitate reforms. The fact that the necessary structural adjustments were not completed provides some indication that these "opportunities" were not really opportune.

There is, at least, a failure to interpret the empowerment of the technocrats. Montes (1986) provides a discussion about the narrowness of the technocrats' political constituency even in the Marcos government so that decisionmaking power effectively rested with President Marcos and his supporters. Effective power was held by a group that did not have any political commitment to the economic reforms so eloquently drafted by the technical people of the previous regime.

Yet, the grim determination to proceed with a program appeared to be there despite the fact that the external assumptions upon which the program had been based were overtaken by circumstances. On the side of the Philippine government, the grim determination was certainly derived from these external circumstances; the SAL at least provided

18. De Dios (1984) provides a discussion of the special privileges granted to these corporations.

some financing which could be obtained with a crafty if superficial implementation.

The balance of payments crisis of 1983 and the overthrow of the Marcos government permitted an overall cleaning of the slate. Upon its accession to power, the Aquino government found enormous political support for the dismantling of the private monopolies created under the Marcos government.

Agricultural Inputs Loan

In its search for an economic agenda, the Aquino government accepted a proposal drafted under the sponsorship of the Philippine Institute for Development Studies (PIDS) which called for liberalization, privatization, and agrarian reform as key elements of a recovery and a development program (Alburo 1988). The report maintained the technocratic trajectory from the Marcos years but placed great hope in the possibility that with the drastic change in government, drastic policy reforms would be possible.

The PIDS proposal also provided the basis for the 1987-1992 Medium-Term Development Plan of the Aquino government. The agricultural inputs loan for US\$150 million was obtained to inspire the reform of the fertilizer sector in agriculture. The Aquino government permitted the importation of fertilizer, although it has not succeeded in privatizing the government's fertilizer company.

Economic Recovery Loan

The 1987 US\$300 million World Bank Economic Recovery Loan (ERL) provided financing inspired by structural adjustment and supporting reforms suggested in the PIDS proposal and the medium-term plan. The key areas that were covered under the ERL were fiscal reform, privatization, import liberalization and tariff reform. While the loan has been completed, the reforms in these areas remain unfinished. This will be discussed in the next section.

Tasks of Structural Adjustment In the Medium-Term

The Philippine economy has snapped back to growth since the change in government in 1986. The 1987 GNP growth rate of 5.7 percent represented the first year since 1982 that the economy's growth rate had exceeded that of its population growth rate. The recovery was made possible by the easing of liquidity constraints from the takeover of the Aquino government in 1986. This approach to recovery has fueled a

demand-led recovery.

For the period 1986-87, GNP has been growing at 3.8 percent, which means that growth has reached the maximum level theoretically possible under its historical incremental capital output ratios (ICORs)¹⁹ (see Table 1). The growth rate of 6.8 percent during the first semester of 1988 represents an economy that will require external financing that exceeds the average which has been historically available and comparable to the levels of the 1970s when international financing was freely available. In Table 1, the vigorous growth in imports, in the production of electricity, gas, and water provide indications of the demand-led growth made possible by the deep declines in output experienced in 1984-85.²⁰

Table 1
OUTPUT AND EXPENDITURES

	Percent of GNP (1987)	Average Annual Growth Rates		
		1972-82	1982-85	1985-87
GNP ^a	100.0	5.72	-3.42	3.80
GDP	101.3	5.78	-3.16	3.31
Personal consumption	74.2	4.73	1.27	3.19
Government consumption	9.3	5.69	-3.49	3.31
G D investment	12.9	9.20	24.90	4.68
Exports (g & nfs)	24.6	5.88	3.44	9.73
Imports (g & nfs)	24.0	6.55	-10.48	25.33
Agriculture	28.9	4.67	1.00	2.03
Industry	32.4	7.05	-6.71	2.82
Mining	1.6	4.12	-4.28	-7.25
Manufacturing	24.6	5.76	-4.25	3.92
Construction	4.2	13.69	-19.22	-3.51 ^b
Electricity, gas, water	2.0	8.76	4.58	24.04
Services	40.0	5.47	-2.95	4.67
Transportation	5.5	6.58	-1.39	2.96
Trade	16.0	5.70	2.39	3.79
Finance/housing	6.1	4.85	-16.08	15.87

a. 1987 GNP level = US\$34.4 billion.

b. -20.57 percent in 1986 and 17.21 percent in 1987.

19. ICOR for the period of 1960-1980 was 4.

20. Montes (1987) provides an analysis of the stabilization program implemented in the last years of the Marcos regime.

The stabilization efforts by credit squeeze in the last years of the Marcos regime had actually induced a fall in the absolute level of exports, and provides one basis for this recovery. Along with the realignment of currencies in this part of the world, this permitted a recovery in the export growth rate to 9.73 percent in the period of 1986-87. "Non-traditional exports" (dominated by garments exports) staged a strong recovery in 1987.

Recovery was further sparked by government-led wage increases and government investment. Construction activities actually declined in 1986 but recovered strongly at 17 percent in 1987; this made construction the most important "investment" sector in the current recovery. Such a pattern was also true in the high points of growth during the martial law years of 1976-79.

Imports increased by 25.3 percent per year in 1986 and 1987 after declining by 10.5 percent per year in the previous three years. This growth compounded by the shortfalls in planned official inflows has left the country with a level of reserves of about 1.6 months of imports.

The balance of payments (summarized in Table 2) demonstrates the recovery of the trade deficit of US\$1 billion in 1987. The current

Table 2
BALANCE OF PAYMENTS
(US\$ millions)

	1982	1985	1986	1987
Merchandise exports	5,021	4,629	4,842	5,720
Merchandise imports	7,667	5,111	5,044	6,737
Trade balance	-2,646	-482	-202	-1,017
Services (net)	-1,040	0	757	-76
Transfers (net)	486	379	441	554
Current account	-3,200	-103	996	-539
Direct investments (net)	17	17	140	205
Long-term loans (net)	1,548	2,787	815	242
Short-term capital (net)	-263	-1,731	-814	52
Errors and omissions	277	638	-102	89
Other items	—	693	207	215
Overall BOP position	-1,621	2,301	1,242	264

account balance has also recovered its deficit position to US\$539 million. A trade deficit of US\$1 billion was "achieved" in the first nine months of 1988, which points to the pattern of increasing trade deficits.

From the perspective of the Marcos years, the Aquino government has managed to engineer a recovery pattern not unlike the growth pattern achieved by the previous regime in its high-flying years, with construction investment as a leading sector. The question that must be raised is whether such a pattern is sustainable. As narrated in the previous section, in 1980, with financing for growth becoming increasingly expensive if not scarce, the Marcos government had turned to the World Bank and agreed to a structural adjustment loan.

The key policy issues, in the medium term, revolve around the following issues many of which were elements of the 1987 ERL:

- a. Industrialization and the import liberalization program that is being attempted in its name;
- b. Agricultural development and agrarian reform;
- c. Fiscal reforms and privatization;
- d. Financial sector development; and
- e. Debt service.

The prospects for sustainable economic recovery hinge on the effects these policies will have on the economy. A brief discussion of the record on these reforms so far, follows.

Import Liberalization and Industrialization

The import liberalization has been implemented in a haphazard fashion, in the absence of an overall industrialization strategy. The Aquino government managed to remove import licensing from more items than the Marcos government had succeeded in doing. As of May 1988, 2,185 tariff items were liberalized. There are 673 items not yet liberalized, although these were part of the original SAL schedule. The disposition of these items will be determined according to a) the power of the lobby against liberalization; and b) whether or not the Aquino government can put together a coherent industrialization program.

There have been failures at replacing some of the existing protection via tariffs as the government awaits a program from the Department of Trade and Industry (DTI). On 21 November 1988, DTI announced its tariff replacement program for consideration by Congress. It calls for the recovery of a maximum of 100 percent tariff rate and a minimum of 0 percent tariff rate. This would represent a departure from the original program which sought to narrow tariff rates to the range between 10 and

50 percent to increase protection for intermediate goods.

The difficulties that the government has experienced in defending the exchange rate ironically provides strong indications that the exchange rate management will not be consistent with the greater share of the burden it must bear to protect domestic economic activities. Domestic producers dependent on government-subsidized import substitution, coupled with the problem of the insufficiency of international reserves due to debt payments and import growth, have created enormous pressure to defend the exchange rate at all costs in 1987-88.

As in the Marcos period, the political economy for trade liberalization continues to be difficult. In the absence of an overall vision, much less, a program for industrial development, the decision making process in this area has degenerated into efforts at individual self-protection for firms with access to political power.

Agricultural Development and Agrarian Reform

The liberalization program is intended to have a salutary effect on agricultural development. Reforms in the sugar and coconut industries that had been monopolized in the Marcos regime have been completed; the fact that the most powerful cronies of Marcos had been involved in these industries made these reforms politically feasible. The responsiveness of the agricultural sector to these reforms is an important issue. The questions of crop mix and export-orientation are outstanding issues in agriculture.

Agrarian reform was identified as the centerpiece of the Aquino government's economic program. The present agrarian reform program, seeks to complete the Marcos 1972 agrarian reform program, augmented by sequestered and abandoned assets made available by the change in government. The implementation and design of the program, however, is mired in the political process. Administrative and financing obstacles have to be overcome. As long as agrarian reform is announced as a "centerpiece" but implemented begrudgingly, an atmosphere of uncertainty will prevail over the agricultural sector. This will provide a significant restraint to private sector investment in the agricultural sector in the medium term.

Fiscal Reforms

Fiscal reforms are a longstanding development issue in the Philippines. The present IMF program sets the target of a tax to GNP ratio of 12 percent. This is a long way off from the 16 percent target of the IMF's EFF program in 1976. The most significant recent initiative was the value

added tax system implemented in January 1988. This tax, recently rejected by the U.S. treasury department as being too administratively complicated to implement in the U.S., is meant to replace the sales tax system.

The elasticity of the tax system is significantly lower than that of most other countries. This creates an inherent imbalance between growth and government revenues. Table 3 reproduces some estimates of the possible scenarios of tax elasticity suggested by a World Bank team in 1986. The "pessimistic" scenario is the estimate by the 1985 IMF tax report on current elasticities of the tax system. The highest elasticity is that on income and profit taxes set at 0.8. The tax system depends heavily on international trade taxes and this provides the next highest elasticity at 0.6. There is also heavy dependence on sales and excise taxes. Here the elasticity is between 0.3 and 0.4.

The "baseline" scenario suggested by the World Bank is to achieve an elasticity of 1 for all categories of taxes. The "optimistic" scenario maintains the elasticity of other taxes at 1 while that for income and profit tax increases to 1.3.

A phased-in, steady reform of tax administration and the tax system are an indispensable element in medium-term structural adjustment. In the area of tax administration, there is an important need to improve the information base on which taxes are based.

It is also imperative to increase the tax intake from real property. This will require developments both on the tax administration and the tax system itself. An important goal for any Philippine government is the installation of a working system of real property registration. This will

Table 3
SCENARIOS FOR TAX ELASTICITY
FOR THE PERIOD 1985-92

<i>Type of Tax</i>	<i>Elasticities</i>		
	<i>Pessimistic</i>	<i>Baseline</i>	<i>Optimistic</i>
Net income & profits	0.8	1.0	1.3
Excise	0.3	1.0	1.0
Sales tax & licenses	0.4	1.0	1.0
Other domestic taxes	0.5	1.0	1.0
Import duties and taxes	0.6	1.0	1.0
Non-tax revenue	0.5	1.0	1.0

Source: World Bank (1986), Annex III, Table III-b.

require the completion, in as brief a period as possible, of cadastral surveys nationwide. It will also require organizing a system of maintaining real property information. This will provide a permanent improvement in the economic environment. The installation of such a system will permit tax reforms that rely more on property, particularly idle property. Increasing taxes on property will be supportive of agrarian reform efforts.

Privatization

On the expenditure side, the deficits of the government or government-controlled corporations running at about 1.5 percent of GNP are a significant burden. A program of privatization is underway, but significant delays, mostly arising from objections from the management of these companies, have been experienced. The "consolidated public sector" (national government plus the Central Bank) deficit in 1986 was 6.1 percent of GNP. This was expected to decline to 5.6 percent in 1987.

Financial Sector Development

The Aquino government has maintained the facade of reforms in the financial sector it had inherited from the Marcos regime. Among these reforms are the maintenance of unregulated interest rates and the setting of discount rates based on market conditions.

As of this writing, however, it has failed to implement reforms that it had committed to lower intermediation cost. These reforms included the removal of the gross receipts tax and the so-called "agri-agra" requirements which compelled banks to lend 25 percent of their portfolio in agriculture.

A key issue in the financial sector is "free entry", beginning with the relaxation of controls on increasing branches. While the other reforms in the financial sector have been implemented, albeit incompletely, free entry threatens the entrenched financial companies, many of whose dominant positions were created under the inspiration of the financial sector reforms which encouraged "unibanking", and during the crises of the early 1980.²¹

Another political constraint towards liberalizing entry stems from the fact that a few of the existing banks invested heavily in purchasing branching licenses during the 1983-85 shake-up of the industry. These banks stand to find their investment devalued should freer branching licenses be allowed.

21. A "unibank" combined the banking and investment house functions.

The financial sector presently labors under the problem that government borrowing rates are high (about 15 percent or more) while deposit rates have fallen to 4-5 percent. The high rates of interest have been precipitated by the exchange rate imperatives of the Central Bank. "Free float" of the peso, plus the "free market" determination of interest rates, plus a level of reserves insufficient to defend the exchange rate compels the Central Bank to "lead" the market by accepting high interest rate bids on Treasury bills from the private banking system. This situation has created significant intermediation favoring the defense of the exchange rate and limited intermediation, if not dis-intermediation, for private investment purposes. In this macro-policy environment, there is little competition and effort towards deposit mobilization while the banks have excess liquidity, mostly held in the form of high-yielding government securities.

Until significant reforms are completed in the financial sector, it will be difficult to provide countryside credit and credit for export-oriented industries.

Debt Service

A new set of debt restructuring agreements were completed in 1987 to replace those put in place in 1985. All the principal payments and 70 percent of the interest payments scheduled on bilateral credits through June 1988 were restructured. In the case of commercial bank debt, all principal payments due between 1987 and 1992 were pushed back with a seven and a half-year grace period.

With these agreements, the country obtained barely sufficient balance of payments financing for 1987. Table 4 shows that debt service for the six-year period 1987-1992 will total US\$19.2 billion and will average at least 30 percent of exports in goods and services. The net resource transfer will depend on the success in obtaining new inflows. The present international reserves of the country at US\$1.63 billion, represent about 1.6 months imports for the coming year. There is a clear need to support the balance of payments in the near term.

From the above, the present implicit strategy on the debt problem obviously reveals certain limitations. Relying on accelerated official borrowing to service debt has created a stock of about US\$1 billion in unutilized, foreign assistance commitments. The existing limits on bureaucratic capability to carry out projects particularly in underdeveloped areas which were evident even during the EFF period as shown above, prove to be the bottleneck. Project lending also has a limited immediate impact on easing the debt burden because such lending typically involves a significant amount of imported equipment. Further reliance on

Table 4
DEBT SERVICE
(US\$ billions)

	1987	1988	1989	1990	1991	1992
Debt service						
Before rescheduling	4.4	5.3	4.5	5.1	5.3	5.1
After rescheduling	2.9	3.0	3.0	3.4	3.7	3.7
Principal	0.7	0.7	0.7	0.8	0.9	1.0
Interest	2.3	2.3	2.3	2.6	2.8	2.7
Debt service/goods and services exports	31	32	30	30	29	28
Interest/GNP	6.2	6.2	5.7	5.2	5.0	4.8

official project lending raises the danger that the government will be compelled to rely increasingly on projects with low internal rates of return whose costs will only be evident in the long term, as had occurred in the Marcos period.

Worldwide, the strategy of "new money" is beginning to run out of steam. The principal reason is that such a strategy increases the debt outstanding of a country, and in the present world environment, weakens their credit standing without creating additional output from which future debt service could be obtained. This would not be true if the internal macroeconomic environments of highly indebted countries were otherwise supportive of private investments. But the typical situation in these countries, as in the Philippines, is one of high domestic interest rates.

This brief discussion should provide an indication that, at this juncture, the Philippines is in need and will benefit enormously from a consistent and comprehensive growth-oriented structural adjustment program.

That there exists an inherent balance of payments problem on the basis of the foreign debt problem alone can be the starting point in the design and implementation of such a program (or set of programs).

The stabilization that was achieved in 1985 could have been a valuable platform from which a steady, medium-term adjustment program could have pushed off. Experiences in other countries have shown that stabilization is an important precondition for effective medium-term adjustment.²²

22. Helleiner (1988).

Two years and the comfortable level of international reserves at the end of 1986 have been squandered. There are, however, offsetting positive influences that still provide possibilities for a medium-term structural adjustment process that will not partake of the desperate while half-hearted quality of past efforts. Among the two most important positive influences are: a) the revaluation of the currencies of Japan, South Korea, and Taiwan; and b) the softness of the price of crude oil.

The controversies on the nature of the adjustment required will continue to be difficult. From a useful listing made by Helleiner (1988), the following constitute the areas where the controversies are foreseen to arise regarding structural adjustment programs in the Philippines:

- a. The level and evolution of the exchange rate;
- b. The increase in nominal interest rates and domestic financial liberalization;
- c. Import liberalization;
- d. Export promotion ;
- e. Openness to external private capital;
- f. Social programs and assets, and income distribution; and
- g. Increase in the role of markets and prices relative to that of government.²³

The next section will discuss the management of conflicts that can be expected to arise in all of these issues.

Approach to Structural Adjustment

The government's medium-term program represents a clear statement of objectives which are consistent with structural adjustment. The outstanding issues relate to the nature of the actual programs to be put in place to achieve these objectives and the availability of resources that would be required to implement these programs.

Private Sector's Response and Policy Environment

It can be said that previous approaches to adjustment have not been built around a national consensus. Adjustment programs have been inspired by, for want of a better term, "Anglo-American" economics, which have emphasized the automatized response by the private sector and other agents outside the government to changes in policy environment.²⁴ Thus, the implementation of programs have relied heavily

23. Helleiner (1988), p. 15.

24. The term was suggested by Mr. Yanagihara in a private conversation.

on drastic changes in policy thrust and then had to wait upon the actual changes in the environment to be put in place. This approach has tended to be corrosive of the relationship between the private sector and the government, in spite of the latter's self-professed advocacy of the private sector's role in the economy. There has typically been no prior study, much less consultation, about the nature and magnitude of the private sector response, because such measurements (and objections that might be raised in prior consultations) are considered to be flawed until the policy environment has changed.

The implicit view of structural reforms in this approach is that these reforms are "disembodied" truths, whose value is constant regardless of the social and political environment in which these must be implemented. The value of the reform suggestions are independent of the "bodies" that must implement them and the "bodies" that should theoretically benefit from them.

Winning-Losing Approach

These policy changes have also been implemented within a view of economic policymaking as one of winning some policy battles some of the time, and losing on others. International financial agencies have some clout some of the time when the country is in need of financing, and have less clout in other times. Logically, the design of a mutually acceptable set of policy changes should be the primary consideration.

Based on this model, there are some ironies in the record reviewed above. When the Philippines was in dire need of foreign financing, there were severe political restrictions, in carrying the reforms. When financing became plentiful, as in the 1976-79, a Dutch disease set in to postpone reforms.²⁵

The "winning-losing" approach has put the Philippine "policy dialogue" process in an unhealthy groove. Broad's (1988) study provides extensive documentation on how the Bretton Woods agencies had their well-identified champions within the government, and how the design and implementation of their policy suggestions were ruined as these suggestions met fundamental resistance from other elements in the government.²⁶

The policy process has become stuck in ideological positions. Because the discussion has been dominated by whether or not the suggestion had been made by the World Bank or the IMF, it has become

25. See Bautista (1988).

26. In fact, the historical parallel is that of Ferdinand Magellan, who found the Philippines for the Spanish and who is credited with proving the earth is round. Magellan did not circumnavigate the earth himself since he was killed taking sides in a local conflict.

very difficult to discuss the effectiveness of a policy reform on its merits and its effects on the economy and the population.

It is unfortunate that the Aquino government has reestablished the Marcos 1970s paradigm in which internationally-minded technocrats dominate the planning staffs, while supporters with strong roots in large business dominate the finance, the Central Bank, and trade and industry. This is unfortunate on two counts. *First*, it guarantees the re-emergence of the unproductive and debilitating adjustment policy debates of the Marcos era. *Second*, since the possibility of strong executive leadership at the highest level is either not possible or desired in the immediate future, there is a more limited probability of reconciling inconsistent policy initiatives than in the Marcos regime.

This approach has been counterproductive, to say, the least. As documented above, in many instances, actual reforms have not been fully implemented, while international funding has had to be continued for other, perhaps more political, reasons. The most current example is the import liberalization program. The studies that preceded its implementation in 1980 dealt principally with identifying differential protection rates, through the computation of effective protection rates. There was no study about the potential response should these rates be altered to be more neutral towards exports, in spite of the fact that the program, by its nature, depends heavily on private sector response. There was only an indirect and limited attempt to identify the financial resources required to be supportive to such private sector response; studies for this purpose formed part of sectoral studies supporting financial liberalization. But in spite of these shortcomings, the import liberalization program is now being implemented haphazardly, in order to obtain foreign financing.

When policy reform programs are implemented without sufficient consultation and explanation, no one actually owns the program. The Philippine government has too often justified the implementation of elements of an adjustment program as having been required by the World Bank or the IMF. Thus, the government manages to lay the blame for programs at the door of foreign donors, but implements parts of the program anyway. Foreign donors blame the government for half-hearted implementation, but then come back and design subsequent programs.

Under this approach, there appears to be a studied avoidance of identifying potential winners and losers. This makes it difficult to design program sequences that permit the attainment of objectives in a politically-sustainable manner. For example, a real devaluation is often unavoidable in an adjustment program. But a real devaluation, as opposed to a purely nominal one, is only possible if some domestic social group will accept a cut back on its real income or, in the case of asset owners, real wealth. It would be more productive to identify which

groups must accept these cutbacks and design programs that will at least partly neutralize their objections to these cutbacks.

Internationalist Approach to National Economic Development

The policy lending approach attempted so far contains an excess of internationalist baggage which are incoherent to countries whose problems center on the national one of developing their own economy. Objectives towards national economic development do not exclude the goal of improving efficiency in domestic economic operations; thus it is counterproductive of foreign advisers to imply that they are the principal guardians of efficiency. This is because the concerns of developing countries do not revolve around the problems of attaining efficiency in world trade or production.

For example, the present actual content of the import liberalization program in the Philippines is "tariffication", the replacement of quantitative restrictions with appropriate tariffs. In some products, this approach will not result in a reduction in protection. In many other products, because of the relationship between the protection of imported inputs and that of domestically produced outputs, there will actually be an increase in protection for domestic value added (as long as the exchange rate regime is appropriate).²⁷ Because of their internationalist responsibilities, one can hardly expect the proponent international agencies to be promoting the import liberalization program as one that might increase the level of national protection. The very choice of terminology, "import liberalization," suggests a reduction in protection and is consistent with the promotion of efficiency at the international level. An earnest effort at international efficiency will require, if anything, the prior repression of the increasing protectionism in the industrial economies.

Filipino technocrats, dependent on a narrow domestic political base, often with minimal business exposure, and heavily dependent on their international reputations, have blithely accepted the terminology of "import liberalization," a terminology, in this case, that might have been usefully avoided.²⁸

These experiences suggest that there should be a search for alternative structures for designing and carrying out structural adjustment programs, whether foreign-assisted or not.

It is critical that the agenda for adjustment programs be more

27. In the absence of an overall industrialization program, it is difficult to evaluate the appropriateness of increases and decreases in the protection or particular industries that would result from the "tariffication" program.

28. Ironically and in practically all cases, the international reputation of these technocrats have been built solely from their Philippine government service.

publicly generated from domestic circles. At the present time, the consultation process is heavily concentrated within the government and the large business sector mostly based in Manila (through business associations such as the Philippine Chamber of Commerce and Industry but mostly through other informal channels). That these limited consultations partake of much controversy is not a sufficient indication that they result in implementable policies nor in commitment of the bodies consulted.

A structure that suggests itself is the formation of *ad hoc* commissions, in which government (executive and legislative), academics, the business sector, media and non-governmental organizations are represented to formulate:

- a. A shared analysis of the problem requiring reform and adjustment;
- b. A set of ordered goals; and
- c. A set of strategies and policies.

The success of these commissions will require decisive leadership from the executive branch in order to make clear the immense responsibility these commissions hold and the clear potential for implementation of their recommendations.²⁹

The work of these commissions must be sufficiently sensitive to the fact that some policies can be put in place without direct legislative action (for example, a development plan for an industry or area that can be financed outside of Philippine treasury resources) while others will require legislative action.

Perhaps this is the point to interject the priorities, in terms of issues, that the writer himself sees. These are:

- a. A program to increase the tax revenue to GNP ratio to at least 16 percent in the medium-term, with a corresponding increase in the percentage of direct taxation to total taxation to at least 50 percent. There is a clear need to support efforts to improve tax administration, to set up a system of property registration;
- b. A program of industrialization which shall serve as a basis for trade reform, instead of the other way around, and that identifies a few key industries for development. There is a clear need for assistance in developing a long-term and medium-term industrialization program; and
- c. A reform of incentive administration that forces accountability from the favored groups and individuals.

29. The author must confess a certain degree of pessimism about the ability of the current executive branch in this regard.

There are many other priorities (financial development, agrarian reform, and others) and these will have to be determined from the political process and the determination of the government to implement structural adjustment.

Role of Foreign Financing

The question that we attempt to discuss in this section is: what is the role of policy-based lending? A question that immediately arises is: What is the role of conditionalities in such lending programs?

The ultimate goal of policy reforms is the actual start-up of economic activities, the setting up firms and micro enterprises, that these reforms are meant to foster. In this regard, project lending has a direct role since it results in the installation of actual equipment and facilities. The sustainability of these enterprises and the utility of these facilities are, however, dependent on the viability of the policy regime within which they were established. For example, in a relatively open economy, any drastic devaluation alters all costs, invalidates many operational assumptions, and endangers the continued existence of many enterprises.

Given the past experience of the Dutch disease, the role of foreign financing in policy changes should originate directly from the resource requirements that these reforms require. For example, there might be estimates of temporarily higher costs of imports due to changes in exchange rates or tariffs.

Conditionalities

The lesson that we can draw from the record of the country's debt-driven growth period is that the motivation for these resources should not originate from an overall motivation to finance the overall balance of payments or to finance, on an overall basis, a particular government. This principle is the source of the justification for conditionalities. Conditionalities embody the intention that policy-based lending represent resources to support particular policy reforms and do not represent resources provided out of geopolitical or friendship considerations. In fact, a strict constructionist approach of utilizing economic targets in the setting of conditionalities is more protective of sovereignty than a more generalized policy that gives the foreign source of fund power to accede to requests for fund releases.

Our suggestion that conditionalities are required raises the following questions:

- a. In what form should these conditionalities be?; and

b. How should the structures of enforcement look like?

There have been sufficient experience in conditionality, too large to review here, to provide guidelines for the first question. One can state here some of the insights from these studies.

Conditionalities should relate to only a few variables because our imperfect understanding of how economies actually work will create inconsistencies in objectives when too many of them are being targeted. Conditionalities should also relate to variables or policies over which the implementing agency has actual control. A budget deficit to GNP ratio target is not totally under the control of government since the GNP outcome is difficult to predict. In many IMF programs, the full employment assumption typically utilized becomes problematic when actual GNP falls short of forecast and the government is compelled to cut back on expenditures more drastically than originally intended.

There are also technical considerations. In Latin America, for example, inappropriateness of measuring certain conditionalities without inflation adjustment has been experienced.

Another example is the suggestion of two-tiered conditionality, which permits a ranking of objectives. Bacha (1987) makes the suggestion that when the balance of payments is the primary target, as it would be in an IMF program, separating external from domestic targets, such as the public sector deficit, would be appropriate. If the external targets are "genuinely" met, i.e. achieved not principally through fortuitous external circumstances, there would be no need to meet the domestic targets, which are often inordinately restrictive in IMF programs.³⁰

Beyond these caveats on conditionality, one can imagine that adjustment programs in the future can be designed so that adjustment measures are undertaken not only by the deficit countries but also by the surplus countries. (This was Keynes' proposed approach for the IMF, vetoed by the United States).

This possibility opens up a whole new era of program design. It might permit, for example, targets on the amount of imports a country supporting an adjusting country would undertake. In this case, resource support will include the very important access to foreign markets.

The question of structures of enforcement is more critical. Many of the problems of past enforcement arose from the situation that the evaluator and the fund releaser were both the same agency. The practice of piggy-backing on World Bank policy lending magnifies the power of the evaluator, whose function is often decisively carried out by

30. A decomposition exercise can be carried out. An example of fortuitous factor is the fall in the price of crude oil.

a staff person, often with limited experience in the country, and finding himself (herself) in the thick of a domestic debate on matters of fundamental policy.

We support suggestions made in other fora that design and the monitoring of such programs increasingly call upon some "second opinion" from other disinterested parties. Perhaps, such committees can also include academics from third countries.

For bilateral policy-based lending, committees such as these might have to be constituted on a more formal and ongoing basis. One can envision a process in which a domestic commission determines an adjustment program in a particular sector, after which the government searches for foreign financing for such a program. If bilateral financing is found appropriate and acceptable, such a committee can be formed to design the operational program and the conditionalities.

It is important that such committees maintain an effective amount of neutrality from both the funding source and the Philippine government. Such credibility will depend on the composition of these committees.

At the present time, an immediate possibility is the organization of a new consultative group for the Philippines whose secretariat would be supported by an advisory committee such as that suggested here. Without precluding their earnest participation in such an aid program, it would be productive if such a secretariat would be located outside of the Bretton Woods agencies.

Conclusion

The setting up of effective policy-based lending structures is critical to the economic recovery efforts of the Philippines. Such lending should be complementary to project lending. We have identified in this paper the limits of project lending. We have also pointed to the fact that project lending can help to directly make the microeconomic adjustments needed to make the macroeconomic efforts in structural adjustment possible.

It appears from the previous discussion that effective policy-based lending will require more cumbersome structures to ensure appropriate design and sufficient commitment from the implementing government. These more cumbersome procedures are, however, indispensable and unavoidable.

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