View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Research Papers in Economics

This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Developing Country Debt and Economic Performance, Volume 3: Country Studies - Indonesia, Korea, Philippines, Turkey

Volume Author/Editor: Jeffrey D. Sachs and Susan M. Collins, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-30455-8

Volume URL: http://www.nber.org/books/sach89-2

Conference Date: September 21-23, 1987

Publication Date: 1989

Chapter Title: Introduction to "Developing Country Debt and Economic Performan
Volume 3: Country Studies - Indonesia, Korea, Philippines, Turkey"

Chapter Author: Robert S. Dohner, Ponciano Intal, Jr.

Chapter URL: http://www.nber.org/chapters/c9047

Chapter pages in book: (p. 373 - 400)

1 Introduction

The experience of the less developed country borrowers is filled with irony, but nowhere is this more apparent than in the Philippines. At the end of the 1970s the country seemed to have joined the third generation of rapid Asian industrializers. Economic growth had accelerated in the mid-1970s, despite the first oil shock and the recession in the industrialized countries. Investment rates were comparable to those of Korea. The structure of exports had shifted rapidly away from primary commodities, toward light manufacturing goods. Even agriculture expanded, as irrigation investments and new strains of rice turned the Philippines into a rice exporter by the end of the decade. Economic policy was managed by a group of university-trained technocrats, who enjoyed the confidence of the country's external creditors, and the Philippines was among the first countries to take advantage of the new, extended financing facilities of the IMF and the World Bank. The Philippines was also favored by the international banking community, and the "Philippine desk" became a path for rapid advancement within the international divisions of many commercial banks.

All of this would unravel rapidly after 1980. The Philippines was hit hard by the second oil price shock, as were other LDCs. A domestic financial crisis led to the failure of a series of major companies, many of which were bailed out by the government at great expense. The balance of payments deficit widened and was financed by more rapid external borrowing. The domestic growth rate fell year after year, even as surrounding countries were beginning to recover from the world recession. Political opposition to the government of President Ferdinand Marcos grew and spread to more

The opinions expressed in this study are those of the authors and not necessarily those of the National Bureau of Economic Research nor of any other sponsoring institution. Financial support from the United States Agency for International Development is gratefully acknowledged.

conservative sectors of the society. But a watershed was reached when the most prominent opposition politician, Benigno Aquino, was assassinated as he stepped off his plane on his return from exile in August 1983. In October the Philippines announced that it could no longer meet its debt repayment obligations, the first, and so far the only, Asian country to declare a moratorium in the current debt crisis.

The reputation of the country for prudent economic management and the reputations of its technocrats were shattered by the events of the 1980s. The Philippines had one of the best debt reporting and control systems of any LDC, and had carefully managed its obligations in the 1970s, lengthening maturities and refinancing on better terms. But in the 1980s it resorted increasingly to short-term borrowing, raising the vulnerability of the country to a cutoff of external funds. Much of this short-term borrowing was hidden through duplicate financing of trade transactions, or through borrowing in the offshore market by domestic banks' foreign currency deposit units. The net position of the monetary authorities was also obscured by a deliberate overstatement of the country's foreign exchange reserves of as much as $1.1 billion, or half of the reported total. In the end, the Philippines waited until its exchange reserves were nearly exhausted before declaring a moratorium, and the country failed to draw on the standby lines of credit that it had negotiated and paid for.

But the fragility of Philippine economic growth was nowhere better illustrated than in the loans of the major state financial institutions, the Philippine National Bank and the Development Bank of the Philippines. The asset portfolios of these two institutions literally dissolved in the 1980s. By 1986 their nonperforming assets totaled over $7 billion, or almost a third of the Philippines' total external debt. The deficits of state financial institutions, including the central bank, had become a huge drain on the resources of the government, amounting to 5 percent of GNP in 1986.

The buildup of external debt in the Philippines took place in a relatively short period of time, from 1975 to 1983. During this period the Philippines, like a number of LDCs, took advantage of the availability of bank credit and low world real interest rates to sustain domestic growth in the wake of the first oil shock. All of these LDC borrowers were hit by the triple shocks of the early 1980s—higher oil and reduced commodity prices, higher world real interest rates, and recession in the industrialized countries. The Philippines, with its high dependence on imported oil and short-term debt, was hit harder than most, and the breaking point came just as the industrialized world was recovering from its prolonged recession.

But the Philippine debt crisis was not, at base, due to a series of unfavorable external events. The country had developed a borrowing momentum that could not be sustained, and the external shocks merely accelerated a process that would have occurred eventually. The roots of the Philippine debt crisis lie in the economic structure and also in the political

structure built up in the years since independence, particularly in the period after 1972. Foreign borrowing played a crucial role in both spheres. It produced economic growth well above what the domestic economy and the domestic policy environment could have achieved, providing temporary internal and external legitimacy to an authoritarian government. External funds also played an important role in building and maintaining a new domestic political structure that Marcos established to challenge the traditional Philippine elite. However, in the end, both the economic environment and the political structure created under the martial law years (1972–81) were inimical to the ability of the Philippines to sustain and service foreign debt, and the Philippine position unraveled quickly in the more adverse environment of the 1980s.

This study examines the features of the Philippine economy and Philippine politics that led to the rapid buildup of debt and the equally rapid spiral into recession and debt crisis. It also analyzes the prospects and problems faced by the current government of President Corazon Aquino in promoting economic growth and dealing with the debt burden inherited from the Marcos regime. The two are quite closely related. For just as the Philippine debt crisis was not due solely to external events, the economic problems that the Philippines now faces go well beyond its external debt burden and restricted access to foreign capital. The problems in the Philippines are the same as they have long been—how to achieve rapid and sustained economic and employment growth.

1.1 History and Background

The Philippines is an archipelago composed of some 7,000 islands, of which about 1,000 are inhabited. However, the bulk of the land mass and population are on the northern island of Luzon, the southern island of Mindanao, and a cluster of central islands called the Visayas. The climate is tropical, and the country is rich in natural and marine resources. The Philippines is a major sugar producer, accounts for about 60 percent of world exports of coconut products, and is an exporter of copper and gold. The Philippines was at one time a major exporter of logs and lumber, but the supply of these has been greatly reduced by deforestation and more recent attention to conservation. The country is subject to the vagaries of the weather, and typhoons or drought can cause major disruptions in agricultural production. The Philippines has a population of 57 million, somewhat larger than Thailand and well above that of Korea. The population is ethnic Malay, although the Philippines has experienced waves of Chinese immigration and intermarriage.

The Philippines was a colony of both Spain and the United States, and each played an important role in shaping the country. Spain brought Catholicism, now practiced by 80 percent of the population, and a system of

administration, modeled after that of Mexico, that divided the country into large estates, or *encomiendas,* that were given to Spanish settlers and to the church. The United States gained control in the Philippines in 1900 as a result of the Spanish-American War, and administered the colony until 1946. The United States shaped the language, educational system, and political institutions of the Philippines, but relied on the existing Philippine elite and never effectively challenged the land tenure system inherited from the Spanish colonial period.

The population growth rate is about 2.5 percent per year, one of the highest in the region, and has led to considerable pressure on the land. Up until the mid-1960s this was met by extending the area of cultivation, particularly by movement of Christian settlers into the underpopulated and largely Moslem area of Mindanao.[1] Since the mid-1960s, increasing population has meant greater population densities, an increase in landless laborers in the rural areas, and migration to the major cities, particularly Manila. Land tenure and land inequality are powerful and difficult political issues.

1.2 Politics and Institutions

The Philippine political system before 1972 can best be described as oligarchic—a small number of wealthy, landed families dominated politics, as well as the economic life of the country. The extended family was a particularly strong source of identification and status in the Philippines, and patron-client relationships linked the population to the oligarchic family in its area or region. The result was to give Philippine politics a highly personalized and regional orientation. The elite families competed among themselves in national politics, primarily for the presidency and the spoils that office could bring. (No president was re-elected until 1969, and the only presidents not to come from the elite group were Ramon Magsaysay in the 1950s and Ferdinand Marcos.) The system that resulted was a conservative one, generally protecting the interests of the elite, but the competition among elite groups allowed some democratization of the political process and some representation of the interests of regions and localities, despite the weakness of local government.

The strongest political interest group after independence in 1946 was the sugar lobby, which dominated Congress in the early years of the Republic. The sugar lobby, and to a lesser extent other members of the traditional export sector, were the primary force in pressing for more liberal trade and exchange rate policies—avoiding overvaluation of the peso and limiting the degree of import protection. But the sugar industry's political power was weakened by its poor public reputation. The sugar barons were viewed as reactionary, self-serving, and already heavily favored, both by the U.S. sugar quota (which amounted to about a million tons per year at roughly twice the

world price) and by almost nonexistent taxation on agricultural land and income.

Challenging the sugar lobby in Congress, and eventually winning over them, was the domestic import-substituting industrial sector. This group barely existed before the 1950s, but by the end of the decade had emerged as a powerful political force. Sheltered by protection, benefitting from overvaluation of the currency, and shrouded in economic nationalism, their conflict with the traditional sector over trade and exchange rate policy formed the most important political debate of the late 1950s and 1960s.

The political institutions of the Philippines were patterned after those of the United States, with a president, two houses of Congress, and a court system, each with its areas of responsibility. The presidency was in fact much stronger in the Philippines. The Congress was an arena of "elite representation, horse-trading, and corruption" (Abueva 1979, 49) that served as a training ground for presidents. Little of a programmatic nature came out of the Congress; it had effectively ceded budgetary authority to the president. But it was a strong force on matters of taxation, foreign investment, and alien (Chinese) business operation. Local governments had a very small role, having little power of taxation and being dependent on the national government for budgetary support.

Presidential politics had a large patronage component. "What are we here for?" was the response of one Philippine president when questioned about corruption in his administration. The president effectively controlled the operations of the central bank's Monetary Board, and the allocation of credit through state and private financial institutions was used as a means of rewarding business supporters (Power and Sicat 1971, 67). Macroeconomic policy had a strong electoral cycle, as incumbent presidents tried repeatedly to assure their re-election through public expenditure increases.

1.3 Role of Government

The postwar period saw a tremendous rise in the importance of the Philippine government in influencing domestic activity, particularly in the 1970s. Indeed, much of the story of the Philippine debt crisis described in this study is the expansion of the national government's economic role and the political strategy behind it. However, the starting point for the Philippine government was much smaller than that of governments in other LDCs. Government expenditure as a share of GNP in the Philippines averaged only 11 percent in the 1950s and 1960s, versus 20 percent in Thailand and Korea, and 24 percent in Malaysia. Gross investment by government was only about one-fifth of total government expenditure.[2] Much of this was devoted to political patronage in the annual Public Works bill (termed "the Pork Barrel Bill" by domestic legislators), so that there was little systematic attempt to use the government as a vehicle for developmental capital formation.

The small scale of government reflected the ideological bent of the American colonial administration, but also coincided with the interests of the Philippine landed aristocracy and the commercial sector, the dominant political groups. Although the Philippine government had some early experience with state-owned enterprises, the prevailing orientation was toward private sector activity. Public utilities, transport, and communications were largely in private hands. Although the importance of public corporations and market intervention would grow tremendously, the Philippine government would continue to publicly maintain the primacy of the private sector.

Tax revenue as a share of GNP has been relatively low in the Philippines, consistent with the small government expenditure share. But beyond this, difficulties in raising tax revenues have been persistent constraints on the mobilization of domestic resources through the public sector. The utilization of potential tax bases has been low by international standards, as has been the efficiency of collection of existing taxes.[3] The division of political authority before 1972 gave the president de facto authority in allocating expenditure, but the Congress retained control over tax matters and resisted attempts to increase the revenue raised through the tax system. Of particular importance in the Philippines is the fact that agricultural property, and to some extent agricultural income, almost completely escaped taxation. As a result, export taxes have in part been used as substitutes for other taxes on the agricultural sector.

1.4 Economic Nationalism

Nationalism has been a persistent theme in Philippine politics and has had a large economic component. There has been a strong desire to "Filipinize" the country's economy—to reserve land ownership, use of natural resources, and participation in many economic activities to native Filipinos. Nationalist sentiment and policy has been directed against foreign investors, but also against "aliens"—non-Filipino citizens, who are mostly Chinese.

Almost from the beginning of the American colonial period there was strong pressure for independence, from Filipinos and also from political groups in the United States opposed to the retention of colonies. As early as 1916 the United States committed itself to eventual independence for its Asian colony. U.S. legislation in 1934 established a commonwealth in the Philippines, with a ten-year transition to full independence, although the process was interrupted by the Second World War. After the war, the United States sought to assure continued privileges for American citizens in an independent Philippines. Using the leverage of withholding its aid and rehabilitation funds, the United States forced the country to accept a series of constitutional amendments and policies that would assure Americans parity with Filipinos in key areas. These were contained in the U.S.-Philippines

Trade Agreement Act of 1946 (the Bell Act), which required that U.S. citizens be given the same rights as Filipinos to own land, exploit natural resources, and operate public utilities. The Bell Act included provisions which established free trade between the two countries, although Philippine exports of sugar, coconut oil, and cordage were still subject to U.S. quotas. The act also prohibited export taxes and required U.S. approval before the Philippines could change its exchange rate. Although the provisions of the Bell Act were softened by the Laurel-Langley Agreement of 1955, and under that agreement the parity amendments expired in 1974, the provisions forced upon the Philippines after World War II were a source of much resentment, as well as a limitation on Philippine policy choices. The measures that shaped Philippine trade and industrial policy—the adoption of import quotas and industrial incentives—were in part due to the limited flexibility of the Philippines in addressing its first balance of payments crisis after independence.

The areas of particular emphasis in nationalist policy have included import and retail trade, natural resources and general land ownership, and processing and marketing of agricultural products. Import trade in the late 1940s was dominated by Western and Chinese firms. However, the import controls adopted in 1950 gave the Philippine authorities a powerful weapon for increasing the share of Philippine nationals. The import control legislation required that 40 percent of import licenses be allocated to new Filipino importers, with the share gradually increasing over time. By 1956 the import quota allocations to Filipinos exceeded 75 percent (Golay 1961, 321).

Filipinization policy in natural resources and in public utilities was hampered by the parity amendments, which gave American investors the equivalent of Filipino status until the expiration of the Laurel-Langley Agreement in 1974. However, regulatory opposition to rate increases was used to encourage the sale of American-owned utilities, and the Philippine Supreme Court's decision in the *Quasha* case (*Republic* v. *Quasha*, 17 August 1972), that property rights acquired under the parity amendments would lapse in 1974, encouraged American disinvestment in natural resource industries (Golay 1983, 142–43, 151–53).

In contrast to the highly sensitive areas discussed above, Philippine industrialization policy has taken a more liberal stance toward foreign ownership. Philippine policy did not discriminate against foreign industrial investors until 1957, when foreign exchange allocation for capital goods and raw materials import was used to favor Filipino firms (Golay 1961, 259–60, 330–33). During the 1950s, foreign investment in manufacturing industries increased substantially.[4] The Philippines went through an import decontrol period in the early 1960s, followed by a period of sluggish manufacturing growth and excess capacity. Under pressure from domestic manufacturers, government guidance of investment and preferences for Filipinos increased. The Industrial Incentives Act of 1967 required 60 percent Filipino ownership

in nonpioneer industries and a gradual transfer of ownership to Filipinos in pioneer industries. The act also established a Board of Investments (BOI) which was given considerable latitude in administering investment incentives, as well as the authority to limit investment in "overcrowded" industries.

Although foreign ownership has remained a sensitive political issue, foreign direct investment has not been an important source of external capital for the Philippines. Net foreign direct investment inflows, shown in table 1.1, have been a small proportion of domestic capital formation, among the lowest in any of the ASEAN (Association of South East Asian Nations) countries. The net investment figures clearly reflect the swings in Philippine trade and investment policy. The import controls of the 1950s drew foreign investors into import-substituting industries. The sluggish growth of the manufacturing sector during the decontrol period (1961–66) and the impending lapse of the Laurel-Langley Agreement is also evident in the reduction of foreign investment in the 1960s and early 1970s. This was a period of substantial disinvestment by American firms in mining, utilities, and other industries.[5] The imposition of martial law in 1972 led to greater efforts to promote foreign direct investment, but even during this period, the contribution of direct investment to total external capital inflows remained quite small.

1.5 Trade and Industrial Policy

The thrust of postwar Philippine trade and industrial policy has been to encourage the development of industries serving the domestic market, through import protection and substantial investment incentives. In the process, the country has discriminated against its export sector, particularly

Table 1.1 **Foreign Investment in the Philippines (in millions of U.S. dollars)**

	A. Net Foreign Direct Investment Inflows						
	1946–50	1951–55	1956–60	1961–65	1966–72	1973–78	1979–83
Average annual inflow	20.2	28.2	26.9	−10.8	−13.6	99.6	44.4
Percentage:							
of GNP	.67	.66	.45	−.18	−.16	.65	.12
of Capital formation	N.A.	3.2	2.8	−1.4	−.76	2.3	.42

	B. Book Value of U.S. Investment (year end)					
	1950	1960	1966	1972	1979	1985
Total stock	149	414	579	608	913	1,032

Sources: A: Central bank, *Annual Report*, various issues; B: U.S. Department of Commerce.
Note: N.A. = not available.

the traditional commodity exports, through currency overvaluation and, in some cases, export taxes. Two attempts to liberalize the trade regime and encourage exports—one in the early 1960s and the second in the 1970s—were in the end unsuccessful, in part because the objective of protecting existing domestic industry was never abandoned.

A balance of payments crisis in 1949 led the Philippines to impose licensing requirements based on the degree of "essentiality" of the import. This led to the development of a domestic manufacturing sector providing "nonessential" consumer goods, as well as a group of industrialists dependent on import protection. Initially the policy was successful, spurring foreign direct investment and investment by domestic residents, and the country's growth in the early 1950s was among the highest in the region. In addition, as mentioned above, the allocation of import licenses was a powerful tool for Filipinizing the import trade.

Slowed growth toward the end of the 1950s, foreign exchange shortages, charges of corruption surrounding the allocation of licenses, and the continuing influence of the sugar industry led to a phased elimination of the import licensing system, as well as a devaluation of the peso, in the early 1960s. Although exports of the traditional sector increased, the overall experience of decontrol was disappointing. The economy continued to grow sluggishly, with the manufacturing sector remaining particularly weak, and the devaluation brought about a sharp rise in the domestic inflation rate. The period did not see the development of significant new exporting industries.

The experience of the decontrol period profoundly influenced those on both sides of the trade policy debate. Excess capacity and low profits in manufacturing led to increased economic nationalism, as well as calls for government intervention on the part of the domestic industrial sector. Proponents of trade liberalization and export promotion shifted their ground after the decontrol of the 1960s and advocated export promotion as a way of developing new industries without challenging the existing system of trade protection. In the remainder of the decade there was a gradual increase in the level of trade protection, as well as the adoption of industrial incentive systems which encouraged industries that exported, but also industries that served the domestic market.

1.6 The First Marcos Administration, 1966–69

The events of this period are in many ways a striking precursor to the accumulation of external debt in the 1970s and early 1980s. The rapid rise of external debt during the first Marcos term, much of it of short maturity, culminated in a balance of payments crisis in 1970, the rescheduling of external debts, and an IMF adjustment program.

Ferdinand Marcos defeated Diosdado Macapagal in his re-election bid in 1965, at a time of widespread dissatisfaction with the import decontrol

program. The Marcos administration immediately moved to accelerate economic growth and was more aggressive in its use of government expenditure and economic policy than previous Philippine administrations. During the initial years of Marcos' first term, fiscal and monetary policies turned decidedly expansionary. The national government greatly raised its capital expenditures, largely concentrating on infrastructural projects—irrigation, roads, schools, and communications—in the rural areas. In all, government expenditure rose in real terms by approximately 43 percent from 1964 to 1968 (two non-election years), and the share of government expenditure in GNP rose from 11.5 to 14 percent. The rise in expenditure was financed primarily by borrowing, both domestic and external, as the national government budget shifted from a slight surplus to a deficit of 3 percent of GNP.

On the monetary side, the central bank initiated what it described as "massive credit relaxation," lowering the discount rate and greatly increasing rediscount ceilings. An industrial rehabilitation facility was established at the Development Bank of the Philippines that offered industrial loans for refinancing and the conversion of some loans into equity. Between 1965 and 1967, domestic credit increased by 40 percent, compared to a rise in nominal GNP of 18 percent.

The stimulative program of the Marcos administration quickly ran up against external payments difficulties. The increase in government and private investment led to a 24 percent rise in imports in 1967 and a further increase in 1968. By 1968 the current account deficit reached 3 percent of GNP.

The worsening external situation did not prevent the traditional run up in expenditure in the 1969 election year. Marcos became the first Philippine president to win re-election, in an election that was by far the most expensive and also the most violent and suspect of any up to that point. Government expenditure rose by over 25 percent in 1969, and the deficit of the national government tripled in that year. Most of the increase in expenditure was financed by the central bank; the money supply rose by 20 percent in the last four months of 1969 alone.

The increase in expenditure by the government and the outlays of government corporations and financial institutions had been financed by extensive borrowing, both internal and external. Much of that borrowing had been short term. President Marcos explained to a business group in Manila in early January: "We have unfortunately financed the foreign exchange requirements of our development with credits of short maturities. I am told by my advisers that because of the increase in short-term debts, the total payment for interest and amortization this fiscal year ending June 1970 will take over half our export earnings."[6] A summary of Philippine external debt in this period is contained in table 1.2.

Table 1.2 **Philippine External Debt, 1965–70 (in millions of U.S. dollars)**

Year	Public Medium & Long Term	Public Short Term	Private Medium & Long Term	Private Short Term	Total Debt	(% of GNP)	(% of Exports)
1965	286	73	190	51	600	10	56
1966	269	103	209	43	624	9	53
1967	281	209	445	145	1,079	15	90
1968	433	120	698	200	1,450	18	126
1969	480	196	959	276	1,912	22	173
1970	738	63	1,049	287	2,137	31	162

Source: Central bank, Management of External Debt and Investment Accounts Division. Data includes IMF obligations.

The major official creditors formed a Consultative Group for the Philippines in January 1970 and agreed to restructure the external debt in return for Philippine agreement to an IMF stabilization program. That program required that the peso either be sharply devalued or allowed to float. The Philippine government accepted the latter condition, and by year end the peso had fallen from 3.9 to 6.4 per dollar.

1.7 Stabilization and Martial Law

The early 1970s was a period of economic stabilization and recovery, accompanied by a rapidly deteriorating political situation. The devaluation of 1970, tighter monetary and fiscal policies, and the external commodities boom quickly restored external balance. But the increasingly violent domestic political situation would culminate in the suspension of the constitution and the declaration of martial law in 1972.

The macroeconomic outlines of this period are contained in table 1.3. The devaluation in 1970 was coupled with tighter fiscal and monetary policy as the government cut investment expenditure in 1970 and again in 1971. A rapid increase in exports moderated the fall in GNP during the stabilization. Some of this was due to the movement of existing exports into official channels, and the growth depended upon investments undertaken in the late 1960s, but the export response to the devaluation was still impressive. By 1972 GNP growth was above its previous trend and macroeconomic policy became more expansive. Current account balance was rapidly restored, and the rise in external commodity prices in 1973 resulted in an unprecedentedly large surplus. The foreign debt position of the Philippines improved markedly during this period, as moderate borrowing and rapid nominal income growth reduced the debt/GNP ratio sharply in the early 1970s.

The most startling event of this period is the marked decline in real wages that occurred after 1969. Real wages for both agricultural and nonagricultural

Table 1.3 **Macroeconomic Indicators, 1969–73 (annual percentage change, except where indicated)**

	1965–68	1969	1970	1971	1972	1973
Real GNP	4.9	5.2	3.9	6.5	5.4	9.3
Money supply (M1)	9.1	19.4	−1.2	10.3	24.9	12.3
Budget surplus (% of GNP)	−0.7	−3.5	0.2	−0.5	−2.4	−1.2
Consumer prices	4.2	1.4	14.8	15.0	16.6	16.5
Real wages (CPI) (index)	100	103	96	91	86	75
Export volume	2.8	2.0	14.4	9.6	3.7	7.7
Import volume	6.7	−2.1	−6.6	7.0	0.9	−6.4
Current account (% GNP)	0.0	−3.2	−0.7	0.0	0.1	5.0
REER exports (index)[a]	100	95	121	112	106	132
REER imports (index)[a]	100	96	126	127	129	144
Debt/GNP (%)	13	22	33	27	26	22

[a]REER (real effective exchange rates) are defined as the export or import unit value divided by the GDP deflator.

workers fell by about 25 percent between 1969 and 1973. Furthermore, real wages were maintained at this level through 1980, despite a 40 percent rise in per capita GNP over the 1970s.[7] The drop in real wages was at once the success and the failure of economic policy during the Marcos era. Low wage costs were the primary engine behind the rapid expansion of manufactured exports during the 1970s. At the same time the failure of real wages to increase and the sluggish growth of manufacturing employment were reflected in increasing income inequality and absolute poverty in the Philippines in the martial law regime. High recorded rates of economic growth did not translate into improvements in the lot of the Filipino masses.

1.8 Political Deterioration and Martial Law

The mixed but generally positive results of the stabilization period were accompanied by rising domestic political tensions and violence. The 1969 election, in which Marcos had been returned for a second term, was a low point in the Philippine electoral process. Marcos had spent far more than any previous incumbent in seeking re-election against an opponent who was generally given little chance of success. The campaign and election were also more violent than previous elections; by one estimate, two hundred people were killed during the campaign (Shaplen 1979, 211). The election greatly heightened political animosities and spawned violent protests by student groups in 1970 and 1971, directed against Marcos but also against the Philippine Congress, which was widely dismissed as corrupt, inefficient, and obstructionist. Public cynicism toward the government was increased by the constitutional convention that Marcos called in 1971, which was a thinly disguised attempt to extend his hold on power beyond the eight-year maximum in the existing constitution. This period also saw the reorganiza-

tion and heightened activity of the Communist Party of the Philippines (CPP).

The domestic situation continued to deteriorate in 1971 and 1972. A hand grenade was thrown into a rally of the opposition Liberal Party in August 1971, severely injuring candidates for the off-year congressional election. In the year that followed there were bombings of public buildings and almost constant demonstrations. Wealthy Filipinos were kidnapped and held for ransom. The New People's Army (the military arm of the CPP) widened its activity in Luzon, and the Moslem rebels in the South stepped up their attacks on Christian settlers. The Philippine constitution permitted the president to declare martial law in a time of national emergency, and Marcos considered doing so for some time. The pretext he eventually used for the declaration was a bombing attack on the car of his defense minister, Juan Ponce Enrile, on 22 September 1972, an attack that Enrile later admitted had been faked.

The evening of the attack, citing a conspiracy of leftist and rightist groups and the Moslem secessionist movement, Marcos declared martial law. That night, hundreds of persons were arrested by the military, including opposition politicians and journalists. Radio and television stations were closed, and the country's newspapers shut down. The Congress was dissolved, and under martial law powers, Marcos began to rule by presidential decree. The constitutional convention that was formed in 1971 continued, minus some dozen opposition leaders who had been detained, and in 1973 produced a draft constitution providing for a transition to a parliamentary form of government. The length of the transition period was left to Marcos' discretion, and the draft constitution also gave Marcos the ability to dismiss any member of the judiciary. The new constitution was ratified in a hastily organized referendum and upheld by the Supreme Court.

The martial law government moved rapidly to restore public order and, in its words, introduce a sense of discipline in Philippine life. The Philippines at the time was a heavily armed society, with local administration often in the hands of regional oligarchs and their private armies. The Philippine army confiscated nearly half a million guns from private citizens, moved to disband private armies, and integrated local police forces in the national bureaucracy (Abueva 1979, 36). After this and some heavily publicized executions, the incidence of violent crime dropped sharply. The new sense of discipline, or perhaps wariness, was evident in other forms of behavior. Tax collections rose significantly in the year after martial law, aided by the threat of severe penalties and a tax amnesty on the declaration of hidden wealth. The number of people filing income tax returns increased by a factor of four after martial law. And observers recall the period as the first in memory when Filipinos actually queued for buses.

Initially martial law was met by public ambivalence. The declaration had been widely anticipated and was viewed as a power grab by Marcos. Yet

there was a widespread willingness to give Marcos and martial law a chance. The disorder of the early 1970s had frightened many people, and the restoration of public safety was widely appreciated. There was also the feeling shared by many that the political system in the Philippines had not served the country well; few mourned the passing of Congress. Finally, although the factors that precipitated martial law were political and security issues, the Marcos administration moved quickly to provide an economic justification for "constitutional authoritarianism." Marcos himself declared that the conquest of mass poverty and the democratization of wealth were to be the major aims of his "New Society." One of the first acts of the martial law government was to institute a heavily publicized land reform.

Central to the acceleration of economic growth and the distribution of economic benefits promised by the regime was a greatly expanded governmental role in development. With the Congress removed from the budgetary process, Marcos sent orders to his executive departments to prepare a list of bottlenecks in each of their functional areas and to draw up proposals for investment projects. The planning mechanism was reorganized and strengthened with the formation of the National Economic and Development Authority (NEDA). Marcos increasingly staffed government bureaus with technocrats—Filipinos with advanced degrees in economics, business, and engineering—who were in turn drawn by the prospect of rapid implementation of policy by a progressive government.

The result was a swift increase in government expenditure, particularly public investment, supported by somewhat higher tax collections and an increased resort to foreign funds. The growing importance of the public sector is only partially indicated by the rise in national government expenditure shown in table 1.4. Much of the increased investment was done off the books of the national government by state-owned corporations in the energy, agricultural infrastructure, and transport areas. The last line of table 1.4 shows the rapid rise of total public investment expenditures, including

Table 1.4 Public Sector Expenditure, Revenue, and Investment (percentage of GNP)

	1970–72	1973	1974	1975	1976	1978	1980	1982
National government expenditure	12.7	14.3	11.7	16.0	15.2	14.8	14.4	15.7
National government revenue	11.9	13.2	12.2	14.4	13.4	13.6	13.1	11.4
National government surplus	−0.8	−1.1	0.5	−1.6	−1.8	−1.2	−1.3	−4.3
Government investment[a]	1.6	2.3	3.4	4.3	6.6	7.2	6.9	7.2

Source: NEDA, National Accounts Section. Bureau of the Treasury, *Cash Operations Statements.*

[a]National accounts basis, includes government corporations.

those of public corporations. By 1978 total public investment had risen to 7 percent of GNP, or 30 percent of total domestic capital formation.

Martial law, and the administrative and policy changes that quickly followed, met with a favorable response from the foreign aid and multilateral community. The flow of official development assistance from members of the OECD Development Assistance Committee (ODA) more than doubled after 1972.[8] Support for an accelerated program of public investment can be seen in the World Bank's Country Economic Report on the Philippines, published in 1976:

> The basis for the structural changes that are expected is a substantial increase in investment, both public and private, which would move the economy towards sustained growth of incomes and employment and a more acceptable distribution of wealth. The large investment program cannot be financed out of domestic savings alone; large foreign inflows will be required. . . .
>
> Public investment in infrastructure will need to be raised to about US$1,000 million a year by 1980 compared with the present level of about US$400 million (both at 1974 prices). With a GNP growth rate of about 7 percent per year, public investment would need to be raised to at least 5 percent of GNP compared with the present 3 percent. (15–16, 26)

There was a second force behind the growing importance of the national government which, although it had an economic component, was primarily a matter of political consolidation. As described above, Philippine politics had been dominated by a relatively small number of wealthy families. It was still possible for outsiders to enter and succeed in politics, but the entrenched power of the elites in the Philippine Congress had successfully blocked policies inimical to their interests. Marcos himself was an outsider. Although from a well-to-do family in the Ilocos region of northern Luzon, he was viewed as a parvenu by the traditional elite.

With martial law, Marcos achieved a transformation of the political structure in the Philippines, successfully entrenching and consolidating his own power, and at the same time establishing his own family and that of his wife in the upper rank of the Philippine elite. The key to this was a greatly expanded national government, both as a means of centralizing authority and displacing the regional powers that had characterized Philippine politics, and as a patronage machine for rewarding supporters and punishing opponents. The use of patronage was by no means new to Philippine politics, but Marcos used it brilliantly, along with the authority that martial law had given him, to eclipse the elite that had controlled Philippine politics.

Marcos undermined the political structure of the traditional families by cutting off their lines of influence and by breaking their local control. The Congress was disbanded with the declaration of martial law, and the government seized and closed all newspapers and radio and television

stations, depriving Marcos' opponents of much of their voice. The confiscation of guns, disbanding of private armies, and the integration of the local police into the Philippine army centralized local control. Local elections for governors and mayors were abolished, and local representation was reorganized as *barangay* (village) councils. Marcos also made a bid for populist support with promises to democratize wealth and with land reform.[9]

While not destroying the economic bases of his opponents, Marcos was able to effectively threaten them. Through confiscation and forced sale, Marcos acquired much of the assets of the Lopez and Jacinto families almost immediately after the declaration of martial law, and cowed other potential opponents.[10] Most of the remaining elite families, if not supporters of the regime, made their accommodations to it.

The most immediate beneficiary of martial law was the army, which greatly expanded in size, responsibility, and emoluments. The army expanded from about 60,000 at the time martial law was declared to more than 250,000 by the end of 1975. The military budget more than quadrupled between 1972 and 1976. Military officers were given a wide range of administrative and managerial authority, and in many cases sat on the boards of state-owned corporations. Some developmental tasks, such as road building, were transferred to military commands at greatly increased cost. To assure loyalty within the army, Marcos also filled the higher ranks with officers from his home province of Ilocos Norte.

The expansion of the scale of government in the 1970s and particularly the acceleration of public investment expenditures greatly increased the ability of the Marcos government to distribute patronage, both to enrich Marcos' close associates and his own family and to assure loyalty in key sectors. Investment and construction projects were especially well-suited to distributional politics of this sort, as they were highly visible and employment-creating expenditures. Furthermore, construction and the purchase of equipment offered opportunities for padded expenses, inflated prices, kickbacks from suppliers, and even outright diversion of funds. The availability of foreign funds and external borrowing in the 1970s facilitated this process in a variety of ways. Foreign exchange costs were a significant component of the developmental project costs, and the availability of foreign funds increased the scale of such expenditures beyond the level of foreign exchange resources that could normally have been generated by the traded goods sector. Access to credit had been a traditional tool for rewarding political supporters, and foreign borrowing increased these resources. In addition, foreign borrowing tended to concentrate credit allocation in the state; both lending by the multilateral institutions and, increasingly, lending by commercial banks depended on sovereign guarantees. Finally, in an economy with capital controls and a black market exchange rate premium of varying degree, foreign exchange resources offered a particularly attractive way to distribute, and hide, wealth.

The growth of government influence and patronage operations was not merely a function of increasing public expenditure. The extent to which the national government intervened in the operation of the domestic market vastly increased under martial law. Some of this intervention was to advance economic goals, such as price support and stabilization, industrial development, energy supply, and the rescue of firms in financial distress. But much of the intervention involved capturing and channeling economic rents. Monopoly and monopsony positions were created in key industries, particularly in the traditional export sector, exclusive rights were granted to particular firms and individuals, and government power was used to force the transfer of assets from one owner to another. To a real extent, the Philippines under martial law developed a rent-seeking and rent-distributing government, which over time would sap the energy of the domestic economy and which contributed significantly to the economic crisis of the 1980s.

1.9 The Philippine Economy in the 1970s

The new martial law government was the fortunate beneficiary of the worldwide upswing in commodity prices of 1972–74; in the first year of martial law there was a 13 percent rise in the terms of trade, an expansion of exports, and a 9 percent growth of real GNP (table 1.5). Even with the oil shock, Philippine terms of trade improved in 1974, as copper and log prices nearly doubled from their 1970–72 average and sugar and coconut prices tripled.[11] The fortunes of the Philippines reversed in 1975 with the collapse of international commodity prices, and by 1976 the country's terms of trade were 29 percent below their 1970–72 average. Ironically, 1974 would mark

Table 1.5 **Macroeconomic Indicators, 1973–79 (annual percentage change, except where indicated)**

	1965–72	1973	1974	1975	1976	1977	1978	1979
GNP	5.0	9.3	5.6	5.8	7.4	6.3	5.8	6.9
National government budget (% of GNP)								
Expenditure		14.3	11.7	16.0	15.2	14.9	14.8	13.7
Revenue		13.2	12.2	14.4	13.4	13.0	13.6	13.5
Surplus/deficit	−1.1	−1.2	0.5	−1.6	−1.8	−1.9	−1.2	−0.2
Money supply (M1)	11.3	12.3	24.0	14.5	17.1	23.7	13.4	11.2
CPI	8.4	16.5	34.2	6.8	9.2	9.9	7.3	16.5
Real wages (CPI) (index)[a]	97	75	61	64	67	62	65	69
Export volume	5.2	7.7	−10.7	5.9	28.1	20.6	3.1	8.5
Import volume	3.5	−6.4	17.8	5.0	5.9	−2.8	18.2	8.9
Terms of trade (index)[a]	87[b]	90	91	70	62	56	62	65
Current account (% of GNP)	−0.5	5.0	−1.2	−5.6	−5.8	−3.6	−4.6	−5.1

[a]1965–68 = 100.

[b]1970–72.

the peak of Philippine export prices; despite the inflation of the 1970s and early 1980s, the dollar prices of Philippine exports would never recover their 1974 levels.

Like other oil-importing developing countries, the Philippines was hit by both terms of trade deterioration and a slowdown in the growth of external markets. Since the Philippines exported commodities and was dependent on oil imports for most of its energy, the change in external prices had a severe effect, amounting to a real income loss of 5.6 percent of GNP.[12]

Philippine economic policy in this period was caught up in the transition to martial law. The new government had liberalized foreign investment policy, had declared an end to rice and corn tenancy and started a land transfer program, and had emphasized tax collection and severe penalties for evaders. The four-year economic plan prepared by the Marcos administration called for a substantial rise in the government expenditure share and a doubling of the share of government spending devoted to investment. Government expenditures in real terms rose 17 percent in fiscal year 1973 (July 1972 to June 1973), while outlays for infrastructure rose 50 percent in the same period.

The Philippine government made a deliberate decision after the oil shock to continue with the expenditure plan while accelerating its energy component.[13] The desire to maintain the momentum of martial law certainly entered into the decision. But the decision was also in line with external advice and was widely supported by the country's economic advisers. The mood among policymakers in the wake of the first oil shock was in fact optimistic. The martial law government was just getting started and had had some initial success. More technocrats were being added to the government ministries, and a more rational, development-oriented policy approach had been announced. There was confidence in the ability of the economy to adjust to the external price changes and optimism about the Philippines' export potential. The oil price shock was seen as something of an opportunity, a possibility for making fundamental policy reforms.[14]

The Philippine government responded to the external shock with a huge increase in government expenditures; real outlays in fiscal 1975 rose by 40 percent. The rapid increase in expenditure was reflected in the current account deficit, which rose to over 5 percent of GNP. The Marcos administration sought additional aid flows and direct investment, but the gap was met primarily by external borrowing.

The strategy was successful in maintaining, and even raising, the rate of domestic economic growth—the average GNP growth rate for the remainder of the decade was 6.2 percent per year, a higher sustained growth rate than the Philippines had had since the initial import substitution phase in the early 1950s. The expansion was led by domestic investment, which increased by 35 percent in real terms between 1974 and 1976. The share of domestic expenditure devoted to investment jumped to almost 30 percent and stayed at

that level for the remainder of the decade. As indicated in table 1.6, the primary reason for this was a huge increase in government investment expenditures, although private investment also increased in the initial years of martial law.

Philippine exports grew at a rate of 13 percent per year from 1974 to 1980, placing the country in league with the most rapidly growing Asian exporters.[15] The decade also saw a transformation in the product composition of Philippine exports. In 1970 over 90 percent of Philippine exports were primary commodities or slightly processed commodities. By 1979 the share of these products in Philippine exports had fallen below 50 percent. In their place were several nontraditional, labor-intensive, manufactured export products, the most important of which were garments, semiconductors, and integrated circuits. There was a high import content to Philippine manufactured exports, and the domestic investment boom kept capital goods imports high. So, despite the rapid growth of export earnings, the current account deficit hovered around 5 percent of GNP.

With the rise in the current account deficit after the first oil shock, the country's foreign debt grew rapidly, nearly tripling between 974 and 1978 (table 1.7). The public sector did most of the borrowing and held two-thirds of the foreign debt of the nonbanking sector by the end of the decade. The Philippines borrowed increasingly from banks in the form of loans with floating interest rates. But this was true of all LDC borrowers during the 1970s, and the shifts toward commercial terms and floating rates were less pronounced in the Philippines than in most borrowing countries. The country's policymakers managed the debt carefully during the 1970s, lengthening maturities and refinancing when better terms were available. As a result, the debt service ratio (interest and amortization payments as a percent of exports) increased only slightly, reaching 21 percent by 1980.

Few of the problems that the Philippines would face in the 1980s were evident in 1979. The Philippines had significantly increased its external indebtedness, but had also raised its export and GNP growth rates. At the

Table 1.6 Investment and Savings Shares in GNP, 1970–79

	1970–72	1973	1974	1975	1976	1977	1978	1979
Investment	21.9	21.9	26.7	30.6	31.3	29.0	29.1	31.0
Fixed investment	16.9	15.8	18.5	23.7	25.1	23.8	23.9	25.8
Private	15.3	13.6	15.1	19.4	18.6	16.9	16.7	18.5
Government	1.6	2.3	3.4	4.3	6.6	6.9	7.2	7.3
of which: Public Corporations	0.2	0.2	0.5	0.6	3.3	3.5	4.6	4.0
Construction	6.1	6.1	7.6	10.2	13.3	13.3	12.8	14.0
Durable equipment	10.8	9.7	10.9	13.5	11.8	10.5	11.0	11.8
Savings[a]	21.7	27.0	25.4	25.3	25.4	25.8	24.4	26.6

Source: NEDA, National Accounts Section.

[a]Including capital consumption allowance.

Table 1.7 **Philippine External Debt (in millions of U.S. dollars)**

	1970	1974	1978	1980	1982	1983	1984	1985	1986	1987
Total external debt	2,297	3,755	10,694	17,252	24,677	24,816	25,418	26,252	28,256	28,649
Nonmonetary debt	2,088	2,726	8,189	12,318	17,601	19,468	20,211	21,270	25,668	26,702
Medium & long term	1,779	2,395	6,932	9,770	13,141	15,412	15,926	17,679	22,878	24,857
Short term	359	331	1,257	2,548	4,460	4,056	4,285	3,591	2,790	1,845
Monetary sector debt	159	1,029	2,505	4,934	7,076	5,348	5,207	4,982	2,588	1,947
Memorandum items:										
Debt/GNP (%)	33.2	25.5	44.5	49.0	62.8	72.7	80.6	81.7	92.9	84.1
Debt/Exports of goods, services	174	106	218	215	308	305	317	332	328	311
Debt service ratio[a]	29.2	14.6	20.1	20.8	38.1	38.2	43.4	36.9[b]	34.0[b]	35.3[b]
Short term as % of total external debt	22.6	36.2	35.2	43.4	46.7	37.9	37.3	32.7	19.1	13.2

Source: Philippine central bank, Management of External Debt and Investment Accounts Division, and central bank, Financial Plan Data Center.

[a]Total interest payments plus amortization of total medium- and long-term debt as a percentage of exports of goods and services.

[b]After rescheduling.

end of 1979, the Philippines had a debt/GNP ratio comparable to that of Korea. Its debt service ratio was higher than Korea's, but was well below that of most Latin American borrowers.

1.10 The Second Oil Price Shock and Its Aftermath

The Philippine economic situation deteriorated rapidly after the second oil price shock in 1980. The government again tried to counter the growing domestic recession by raising expenditure, and announced an ambitious program of energy and industrial investment. As a result, the public sector deficit rose sharply, from 3 percent of GNP to 5.4 percent, and the current account deficit widened to 8 percent of GNP (table 1.8).

Despite the sharp jump in government investment expenditure, the Philippines was not able to ride out the second oil shock. Real growth rates dropped each year after 1979. Here the Philippines was in sharp contrast to neighboring Asian countries, which, although most suffered a terms of trade shock during the same period, were much more successful in restoring rates of economic growth and in generating exports (table 1.9).

The dollar value of Philippine exports hit a peak in 1980 and then fell at an average rate of almost 5 percent per year through 1983, the result not only of weak international prices, but also falling commodity export volumes.[16] Slower domestic growth and higher world real interest rates severely affected major domestic firms, many of them highly leveraged. A domestic financial crisis in 1981 brought about the failure of several large firms, many of which were bailed out by the government. Industrial failures continued to proliferate, leaving the government, which had guaranteed the foreign borrowings of many of these companies, with nonperforming assets with a book value in the billions of dollars. This in turn led to an increasing fiscal burden on the national government, as it was forced to absorb the losses of the two government-owned financial institutions, as well as of several government nonfinancial corporations.

Philippine external borrowing accelerated in the early 1980s, and total foreign debt nearly doubled between 1979 and 1982. Borrowing increased under the pressure of a swollen current account deficit, but capital flight also accelerated sharply in the early 1980s, and may have reached 5 percent of GNP in 1981 and 1982. Net foreign direct investment inflows slowed to a trickle, as growing disinvestment offset direct investment inflows.

The cautious borrowing policy of the 1970s disappeared in the early 1980s. The most abrupt change was the increasing use of short-term borrowing. This was particularly true of the public sector, which accounted for two-thirds of the increase in short-term debt outside the monetary sector. The central bank also borrowed heavily between 1980 and 1982 and encouraged other banks to do the same by providing swap arrangements.[17] Despite this borrowing, central bank reserves fell by $2 billion (two-thirds)

Table 1.8 **Philippine Macroeconomic Indicators (percentage of GNP)**

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Real GNP (% change)	5.0	3.4	1.9	1.1	−7.1	−4.1	2.0	5.9	6.7
Investment share GNP	30.7	30.7	28.8	27.5	19.2	14.3	13.2	15.4	18.2
Government fixed investment	6.9	8.0	7.2	6.1	4.1	3.7	N.A.	N.A.	N.A.
National government budget									
Expenditure	14.4	15.8	15.7	14.0	12.7	13.5	17.8	17.0	N.A.
Revenue	13.1	11.8	11.4	12.0	10.8	11.5	12.8	14.6	N.A.
Surplus/deficit	−1.3	−4.0	−4.3	−2.0	−1.9	−1.9	−5.0	−2.4	N.A.
Consolidated nonfinancial public sector									
Investment	8.2	10.4	9.0	8.2	6.9	6.4	6.2	N.A.	N.A.
Surplus/deficit	−3.0	−5.7	−5.4	−3.2	−2.8	−2.2	−3.6	N.A.	N.A.
Current account balance	−5.4	−5.4	−8.1	−8.1	−3.5	0.0	3.3	−1.6	−1.9
M1 (% change)	19.6	4.4	−0.1	38.3	3.5	6.5	19.0	22.2	13.9
Inflation rate (CPI)	17.6	12.4	10.4	10.0	50.3	24.9	0.7	3.8	8.7

Note: N.A. = not available.

Table 1.9 **Comparative Growth Rates for Selected Asian Countries, 1974–84**

	GDP Growth Rates						Terms of Trade Shock[a]
	1974–79	1980	1981	1982	1983	1984	1979–82
Philippines	6.5	5.2	3.9	2.9	0.9	−6.0	−5.8
Indonesia	6.9	9.9	7.9	2.2	4.2	5.8	+35.9
Malaysia	7.1	7.8	7.1	5.6	6.3	7.6	−8.9
Thailand	7.8	5.8	6.3	4.1	5.8	6.2	−6.3
Korea	9.7	−3.0	7.4	5.7	10.9	8.6	−3.8
	Growth of Dollar Export Earnings						
Philippines	11.9	28.0	7.6	−7.1	1.6	−1.4	
Indonesia	15.8	43.0	11.9	−14.5	−6.4	11.4	
Malaysia	21.3	19.5	−8.6	2.4	13.7	17.7	
Thailand	15.6	28.7	9.8	−2.0	12.9	−1.0	
Korea	29.5	15.6	20.8	4.0	7.2	10.8	

Source: Philippines: NEDA and the central bank. Others: Asian Development Bank, *Key Indicators of Developing Members Countries*, and IMF, *International Financial Statistics*.

[a]Terms of trade shock equals percentage change in terms of trade multiplied by the share of merchandise imports in GNP.

from the end of 1980 to mid-1983, although this was not known at the time. By 1982 the share of short-term debt, including monetary sector debt, in total debt rose to 47 percent, a much higher share than in other LDC debtors. The Philippines first considered declaring a moratorium in late 1982. However, Marcos demurred, apparently unwilling to have the Philippines compared to Latin American debtors. When a moratorium was finally declared in October 1983, Philippine foreign exchange reserves were nearly exhausted.

The adjustment period that followed was severe. Domestic industry was limited by the extreme shortage of foreign exchange, and capacity utilization rates below 40 percent were common. Investment fell by more than half. Per capita incomes fell back to their level of the mid-1970s, erasing the gains from the rapid growth period. And inflation soared to over 50 percent per year, only to be rapidly reduced through monetary policy so severe it forced many firms and several financial institutions to the wall. Although many factors were responsible for the election defeat of President Marcos in 1986, the wrenching adjustment process was an important contributor. By the end of 1986 the legacy of the martial law economic policy would be 1974 income levels, a foreign debt almost equal to GNP, and a fragile new democracy.

The crucial question for the Philippines is how things could have changed so rapidly. How could a country that substantially raised its investment and growth rates, had transformed its export structure toward manufactured goods, and was often mentioned as one of the next generation of East Asian tiger economies, collapse so quickly in the space of four years?

1.11 The Role of External Shocks

The Philippines' real income position and its ability to sustain its level of foreign indebtedness were diminished by the two oil price shocks and the accompanying industrial country recessions. The second oil price shock had a much more severe effect than the first. This time, income loss from the change in the terms of trade was larger, equivalent to 6.9 percent of GNP. In addition, the terms of trade deterioration was coupled with a rise in real interest rates of almost 12 percentage points, adding another 3.5 percent of GNP to the income loss.[18] Thus, the external shock totaled about 10 percent of GNP, which was among the largest for major LDC debtors.

1.12 Philippine Policy and the Debt Crisis

Although the Philippines was hit more severely by external shocks than most debtor countries, the debt crisis that occurred was not simply a result of the second oil price shock and the rise in world real interest rates. The Philippines had developed a borrowing momentum that could not be sustained, and the country would have eventually come to an external crisis even if the shocks of the 1980s had not been there to hurry along the process.

There were two fundamental economic difficulties. First, the Philippines failed to develop self-sustaining growth that would have eased the burden of servicing its external debt. Second, the country failed to shift resources toward the traded goods sector, as was required both by its increasing debt burden and by its declining terms of trade. In more concrete terms, the problems were poor returns from investments, difficulties in mobilizing domestic resources to fund investment, and the maintenance of a trade regime that did not sufficiently encourage exports. In addition, the Marcos government created a political-economic environment that discouraged independent investment, led to capital flight, and eventually crippled much of the productive economy.

1.12.1 Investment Efficiency

In retrospect there were several weaknesses in the economic growth that the Philippines achieved in the 1970s. The first was its heavy dependence on the flow of investment expenditure as a source of aggregate demand. As indicated in table 1.10, the expansion in the rate of fixed investment accounted for more than 40 percent of the increase in real domestic output between 1974 and 1979, while the rise in construction expenditure alone contributed almost 30 percent. Much of the increase in investment came from the public sector, despite a very small initial public sector investment share.

Table 1.10 **Sources of Philippine Real GDP Growth, 1974–79**

	Growth Rate	Contribution to GDP Increment	Share of 1974 GDP
Personal consumption	5.0	52.2	69.0
Government consumption	3.5	5.3	10.5
Gross fixed investment	13.3	41.8	17.7
of which: Construction	21.4	27.7	6.2
Exports	9.2	23.6	15.7
Imports	8.5	−26.5	19.4
GDP	6.5	100.0	100.0
Memo:			
Private fixed investment	10.4	25.9	14.8
Government fixed investment	24.8	15.9	2.9

Source: NEDA, National Accounts Section.

There is nothing inherently wrong with expanded investment as a source of aggregate demand growth. But if it is to be the basis of a higher rate of secular income growth, the investment level must be maintained, and it must generate sufficiently high growth in other sectors of the economy. Although difficult to assemble and somewhat sketchy, the evidence here is that the efficiency of investment in the Philippines was lower than in surrounding countries and, in turn, the failure of investment to pay out was an important contributor to the debt crisis of the early 1980s.

The simplest measure of the efficiency of investment in the aggregate is the ratio of the resulting growth rate to the amount of investment that takes place. This is normally represented by its reciprocal, the ratio of the share of investment in GDP to the GDP growth rate, known as the incremental capital output ratio, or ICOR. The lower a country's ICOR, the smaller is the increase in the capital stock necessary to produce a given increase in output and, therefore, in a sense, the more efficient is investment.[19]

In table 1.11 we compare investment ratios, GDP growth rates, and ICORs for the Philippines and selected Asian developing countries. As is clear from the table, the Philippines has achieved a high rate of domestic investment, but has been less successful in translating that investment into economic growth. The table also shows an increase in the ICOR from the pre–oil shock period. This was not unique to the Philippines, but occurred in all countries listed in the table except Thailand. A significant part of this increase was caused by a shift of investment toward more capital-intensive industries in the 1970s, in part caused by higher oil prices.[20] We investigate in chapters 3 and 4 some of the reasons for the higher ICOR in the Philippines. Here we will simply stress its importance for the real income position of the country. Had the Philippines had the median ICOR of the countries in the table (Malaysia's), its growth rate from 1974 to 1980 would have been 8.3 percent per year, and real GDP in 1980 would have been almost 12 percent higher.

Table 1.11 Comparative Investment/Growth Rates

	Investment Rate[a]		GDP Growth Rate		Ratio (ICOR)	
	1967–72	1974–80	1967–72	1974–80	1967–72	1974–80
Philippines	20.5	29.3	5.27	6.26	3.88	4.68
Indonesia	12.8	20.0	8.20	7.42	1.56	2.70
Malaysia	18.2	25.8	N.A.	7.26	N.A.	3.55
Thailand	24.3	26.1	6.46	7.48	3.77	3.48
Korea	25.2	29.8	10.0	7.67	2.53	3.89

Sources: Philippines: NEDA, National Accounts Section. Others: IMF, *International Financial Statistics*.
Note: N.A. = not available.
[a]Gross domestic capital formation as a percentage of GDP.

1.12.2 Resource Mobilization

The second weakness of Philippine economic policy was the continued dependence on foreign borrowing to fund domestic investment. To maintain economic growth in the face of external recession, the Philippines increased government expenditure and borrowed abroad in 1975. But the current account deficit never narrowed and was still about 5 percent of GNP in 1979. By 1982, after the second oil shock, the deficit had risen to over 8 percent of GNP. In large part this continued deficit came from the inability of the Philippine government to close it budgetary gap. The expansion in the size and expenditure of the national government was not matched by a corresponding increase in revenue generation (see table 1.4). This was true despite a number of external program requirements to raise the government revenue share and repeated tax measures enacted by the Philippines.

While the increase in the government budget deficit shown above in table 1.5 is not dramatic, it covers only the national government. Much of what took place on the fiscal side in the Philippines was the movement of government expenditure and government borrowing to the accounts of state-owned corporations. No consolidated figures exist before 1978, although the increase in the activities of the state-owned firms may be judged from the investment expenditures given in table 1.4. By 1978 the consolidated budget deficit of the nonfinancial public sector had reached 3 percent of GNP, and this deficit ballooned in the 1980s.

1.12.3 Trade and Exchange Rate Regime

What now appears crucial to sustaining a large external debt is a concomitant expansion of export capacity. Here the Philippine record is highly mixed. Nontraditional manufactured exports grew rapidly and increased their share of total exports from 6 percent in 1970 to 50 percent by 1980. But the overall growth of exports was insufficient given the high investment, high foreign borrowing strategy the country pursued. The share of merchandise exports in GDP was nearly the same at the end of the decade

as it was at the beginning. This was in sharp contrast to neighboring countries, where significant export deepening took place (see table 3.2 below).

Both fiscal policy and trade and exchange rate policy played key roles in the continued borrowing of the Philippines and in the country's inability to respond quickly enough to the abrupt change in world product and capital markets in the 1980s. But in addition to these two, there were other features of the Philippine business and policy environment that exacerbated the problems that the country had in maintaining growth and avoiding debt difficulties. These include "crony capitalism"—government intervention and monopolization of domestic industry—as well as weakness of the financial system and weaknesses in the system of debt management and control over capital outflows.

1.12.4 The Martial Law Business Environment: Crony Capitalism

An integral part of the operation of the Philippine economy during the period of rapid debt buildup was the development of crony capitalism—the fostering, through a variety of means, of a small group of Philippine businessmen, including the president and his family. This included the standard measures of awarding government contracts, padding expenses, and providing kickbacks. But crony capitalism went well beyond simple graft. The most important aspect was the creation of monopolies, either through direct intervention to control an industry or through granting exemptions or exclusive privileges to favored individuals.

The corporate empires of the cronies were built on a mixture of corporate extortion and high financial leveraging. Outright expropriation was done only at the outset of martial law. Later, less visible pressure was brought to bear on profitable firms to sell out to Marcos family members or to cronies. The cronies borrowed heavily, either receiving funds directly from government-owned financial institutions or borrowing from the private market on the strength of their association with Marcos. With the decisively changed financial atmosphere in the 1980s, both in the Philippines and externally, the crony groups proved extremely vulnerable.

Crony capitalism took a significant toll on the behavior of the private sector not associated with the Marcos government. Businessmen became less willing to invest and expand in the Philippines for fear of attracting attention and instead moved their money outside the country. By the early 1980s this movement had become a flood.

1.12.5 Financial Sector and Debt Management

The Philippine financial sector played a number of supporting roles in the buildup to a debt crisis in the Philippines. The first was the failure of the system to mobilize sufficient resources in financial form. Despite the high rate of investment in the Philippines, the country had one of the lowest rates

of financial mobilization among East Asian countries. The second was the high degree of government participation in the financial sector and the extent to which financial flows were channeled to projects or individuals favored by the martial law government.

But it was a series of financial crises starting in 1981 that accelerated the collapse of the Philippine economy and made the stabilization period more severe than it otherwise would have been. A collapse in the commercial paper market in 1981 led to the first round of business failures and the beginnings of the government's expanding bailouts of the private sector. During the recession of 1984–85, credit to key sectors almost disappeared, forcing the collapse of many private firms and growers. By 1986, after years of gyrations, financial institutions in the Philippines were almost unwilling to do any intermediation.

The debt management system of the Philippines also contributed to the crisis that the country faced in 1983. This system worked well in the 1970s, screening foreign borrowing requests, limiting total external borrowing, and refinancing existing loans when better terms were available. However, the debt management system broke down badly in the 1980s, leaving the country with one of the highest percentages of short-term borrowing among all LDCs and little or no foreign exchange reserves. The inability to control capital flight, particularly in the early 1980s, accelerated the speed with which the Philippine debt crisis arrived.

1.13 Conclusion

The following chapters take a more detailed look at each of the issues discussed in section 1.12. Public sector expenditure and revenue mobilization, including that of the government corporate sector, are examined in chapter 2. In chapter 3 we deal with the trade and industrial policy regime in the Philippines and investigate further the sluggish performance of much of the country's industry. Crony capitalism and the effect that it had on domestic economic performance is the subject of chapter 4. In chapter 5 we examine the financial system and its role in the crisis. The debt management system and the growth of capital flight are covered in chapter 6.

After the debt moratorium was declared in October 1983, the Philippines went through a successful, but very severe, stabilization period. In chapter 7 we look at that adjustment and the negotiations that the Philippines had with the IMF and its external creditors. Finally, in chapter 8 we examine the first three years of the Aquino government and the prospects for the Philippines.