PITO

PRIVATE INVESTMENT AND TRADE OPPORTUNITIES

ECONOMIC BRIEF
NO. 5

ASEAN COUNTRY PROFILE
THE PHILIPPINES: POSITIONING FOR A TURNAROUND

East-West Center

The *PITO Economic Brief* Series

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ASEAN COUNTRY PROFILE
THE PHILIPPINES:
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The Philippines is a country of 60 million people living in an island archipelago of over 7,000 islands with a total land area of 300,000 square kilometers (Table 1). Fifty-seven percent of its population lives in rural areas and the literacy rate is 86 percent (Table 2). About 38 percent of its population is in the labor force, indicating a youthful population, which is still growing at 2.7 percent each year. Of its labor force, about 46 percent are employed in agriculture, fishery, and forestry, and 10 percent are employed in manufacturing.

The Philippines was a colony of Spain for 300 years and under the rule of the United States for 50 years. The predominance of Roman Catholicism derives from the Spanish influence, though there is a significant Islamic minority in the south. The educational and political system are adaptations of those of the United States. While Filipino is the official language, English is the dominant language in government and in the practice of law and business.

The Philippines is classified as a middle-income developing country, with per capita gross domestic product (GDP) of US$738. Agriculture and manufacturing each accounts for about 25 percent of GDP (Figure 1). The government has always been committed to a free-enterprise economy, though government itself, whose

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operations represent about 16 percent of output, has historically been a ready source of wasteful expenditures and macroeconomic instability.

Table 1 Size of ASEAN Countries in 1989

Country	Population (millions)	Area (1,000 km^2)	GDP[a] (US$m)	GDP[a] Per capita (US$)
Indonesia	179.1	1,919	82,726	471
Malaysia	17.4	330	37,453	2,152
Philippines	60.1	300	44,349	738
Singapore	2.7	1	28,360	10,582
Thailand	55.5	542	69,676	1,225

NOTE:
a. 1988 for Indonesia.

ECONOMIC TRENDS: PAST AND PRESENT

In the 1970s, the Philippine economy grew at 6.1 percent per year (Table 3). This was followed by the lost decade of the 1980s, as the Philippines became a peculiar Asian participant in the international debt crisis. Over the period 1980—1989, the economy's average annual growth rate plummeted to 2.1 percent per year which is below the population growth rate over the same period. The years 1984—1985 saw gross national product fall by 10 percent followed by the overthrow of the Marcos government in February 1986. Part of the stagnant economic performance of

the Philippines was due to a sluggish agricultural sector which had begun to exhibit a secular slowdown in growth before the crisis began in 1983. This slowdown was probably the cumulative result of the antirural policies of the 1970s. The average growth rate of agriculture in 1974—1979 was 5.2 percent. Despite the crisis years of 1983—1985, agriculture was able to maintain a positive rate of growth. The principal explanation behind the slowdown after 1985 is unfavorable weather conditions in 1987 and 1988. The economy could have grown much stronger if agriculture had maintained its trend growth rate.

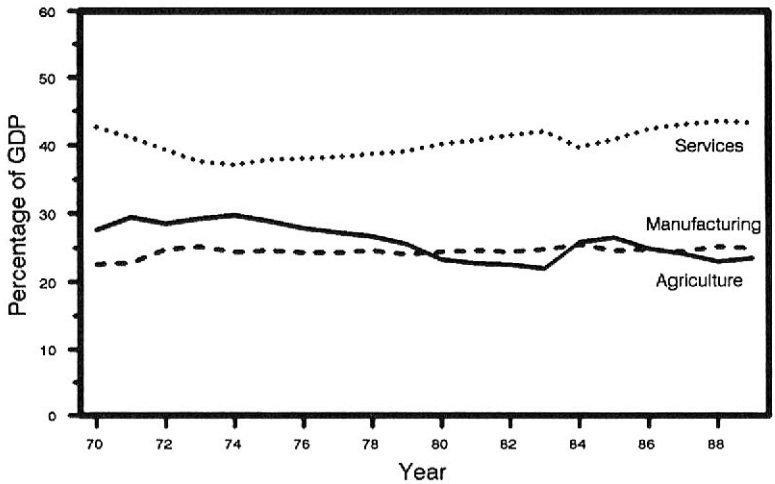
Table 2 Indicators of Social Development in the Philippines

	1960	1988
Life expectancy	53	64
Infant mortality rate (per 1,000 live births)	106	44
Literacy rate	72	86[a]

NOTE:
a. 1985.

Despite the slowdown in agriculture, there followed two years of strong growth (1987—1988). This recovery was fueled in part by a significant boost in the consumption expenditures of the Philippine government. The increase in government spending was partly the result of a rise in aid flows. From 1986, the Philippines

Figure 1 Major Sectors of the Philippines' GDP



Sources: Asian Development Bank, Key Indicators of Developing Member Countries of ADB, various issues.

experienced an increase in official development assistance (ODA) commitments, as Japan's ODA capabilities expanded from their 1985 levels and as other governments and multilateral institutions rushed to assist the new Aquino government.

The recovery of 1987—1988 was also stimulated by a surge in inflows of direct investment in the latter half of the 1980s. In 1987, the Philippines promulgated the Omnibus Investment Code (Executive Order No. 226) to improve the investment incentives system. Under the code, enterprises that qualify for the incentives were entitled to exemptions from duties and taxes on imported capital equipment, a tax credit on domestic capital equipment, a 5-year tax holiday, and deductions from taxable income of 50 percent of the increase in labor expense for the first five years.

Although the incentives offered by the new code are only competitive with respect to firms serving the domestic market, it has been estimated that Philippine incentives to exporting firms are still more generous than those offered by neighboring countries. From 1986 levels, there was a sixfold increase in the level of net direct foreign investment (DFI) to about US$0.75 billion in 1989.

Table 3 Basic Economic Statistics of the Philippines

	1960—1969	1970—1979	1980—1989	1988	1989	1990[a]	1991[a]	1992[a]
Growth of real GDP	4.9	6.1	2.1	6.4	5.6	3.1	1.9	4.7
Export growth	5.8	20.4	6.2	24.5	10.3	2.0	4.8	7.0
Import growth	10.1	20.2	6.9	22.1	28.1	5.1	4.7	3.7
Inflation rate	4.7	14.6	14.9	8.8	10.6	13.4	15.6	8.3
Debt service ratio (period average)	na	18.8	22.0[b]	26.7	na	na	na	na
DFI inflow (US$m) (period total)	-11[c]	569	1,579	935	na	na	na	na

NOTES:
na = Not available.
a.Estimate/projection of real GNP growth.
b.1980—1988.
c.1966—1969.

Still another factor contributing to the recovery were favorably high export prices and expansion of export revenues. Merchandise exports recovered from just below 14 percent of GNP in 1985 to almost 20 percent of GNP in 1989. The growth of

exports relied upon strong growth in exports of semiconductors, shrimp, and prepared tuna.

The private sector also responded to the government-initiated recovery mainly with construction investment for residential and commercial purposes. However, in 1990, with export prices falling and oil prices rising, a devastating earthquake in the north, a destructive typhoon in central Philippines, and rising political uncertainty sparked by a major coup attempt in December 1989, annual growth fell to 3.1 percent while the trade deficit doubled.

SOCIAL AND POLITICAL DEVELOPMENTS AND OUTLOOK

After the overthrow of Ferdinand Marcos, who ruled through a constitutional authoritarian government in 1972—1986, the Aquino government in 1987 sponsored the drafting and the ratification of a constitution that restores the U.S.—style of political system that was in place from 1946 to 1972. The democratic foundation of the political structure is based on the system of checks and balances between three branches of government——the executive branch, the legislative branch, and the judiciary. Within the Congress, there is a lower house composed of representatives elected in local districts and a senate of representatives that are elected nationally.

Practically all of the officials that were elected under this constitution will end their terms in 1992. The most likely scenario is that the terms of local officials and possibly of the lower house will be extended for a year (the Congress has to pass a law to

provide for the needed extension), while presidential elections will occur as scheduled in May 1992 with the new president taking office in June of the same year.

With 1992 only months away, there is now considerable competition over the political succession to the Aquino government. Outside of the electoral process, one contending faction is a group of young military officers who led the military mutiny against the Marcos government and who have made at least two serious attempts to topple the Aquino government. Another set of contenders are the senators, congressmen, and former politicians who plan to run for office in the planned 1992 elections.

The highly unequal distribution of agricultural assets is a combined legacy of the two colonial experiences, and land reform has proved extremely difficult. Popular frustration over the unequal distribution of land and over the stall in the industrialization drive have provided the ground for a Communist-led insurgency nationwide and for separatist movements among the Muslims in the south and tribal groups in the north. Labor unions are also impelled by the general situation to pursue political demands and to participate actively in questions of economic policy.

Since the beginning of this century, the Philippines has hosted the U.S. military bases in the region. The extension of the bases agreement with the United States has recently become a source of domestic controversy, with many key sectors calling for their closure. Last year, the United States announced its intention to withdraw from these bases over the next decade. It is unlikely that the agreement will be finalized soon. The United States and

the Aquino government will probably agree to provide for an extended period of withdrawal of these facilities.

THE PHILIPPINE ECONOMY: WHAT LIES AHEAD?

The development goals expressed in the 1987—1992 Medium-Term Philippine Development Plan are: (1) alleviation of poverty, (2) generation of more productive employment, (3) promotion of equity and social justice, and (4) attainment of sustainable economic growth. An employment-oriented, rural-based development strategy is the mechanism by which government planners intend to achieve these objectives. The rationale for this strategy is the predominantly rural nature of the population and the high incidence of poverty in the rural areas.

The set of policies designated to help achieve these objectives can be broadly described as follows:

1. A stable set of investment policies
2. Privatization and deregulation of trade including tariff reform, the abolition of monopoly incentives, and import liberalization
3. Price reform with increased reliance on market forces to determine exchange rates and interest rates
4. Minimal government intervention except in the provision of public goods such as infrastructure, marketing, and communications facilities.

For both agriculture and industry, the medium-term development plan clearly identifies liberalization policies as the main instrument of development.

The World Bank has classified the Philippine trade regime as moderately inward-looking and the country has been implementing a wide-ranging trade liberalization program since 1980, beginning in the last five years of the Marcos administration. This program was suspended during the balance-of-payments crisis of 1984–1985, but the Aquino government restarted the program immediately upon its takeover.

During the final five years of the Marcos government, the average tariff rate was cut from 43 percent to 28 percent, the maximum tariff rate was reduced from 100 percent to 50 percent, and the number of categories was reduced from seven to six. The Aquino government has striven to complete the import liberalization components of the Marcos trade liberalization program. There was a rapid removal of import restrictions during the first years of the new government: 1,299 items between 1986 and April 1988, an additional 94 items in December 1988, an additional 63 items by July 1989, and another 30 items in September 1989.

However, there has been only limited progress in the reform of protection for key industrial sectors, such as the automobile industry. In September 1990, the Department of Finance proposed to reduce the number of tariff categories down to four and to narrow the gap between the lowest and highest tariff rates. These reforms have been suspended due to objections from the business sector and Congress, but it is reasonable to expect further market-oriented reforms in the next few years.

The Philippines depends on oil for 64 percent of its energy requirements; of its oil-based energy requirements, it has to import

98 percent. The increase in crude oil prices sparked by the Middle East crisis created additional foreign exchange pressure to an already difficult situation. Moreover, a significant proportion of the Philippines' 1 million overseas workers are based in the Middle East. In 1990, the uncertainty in the region actually induced unexpected repatriation of overseas assets; if the crisis continues, there are expected to be losses in terms of overseas remittances.

These foreign exchange pressures complicate an already fragile foreign exchange situation stemming from the foreign debt overhang, the servicing of which claims almost one-third of export earnings. In November 1990, the Philippines devised an 18-month stabilization plan with a technical team from the International Monetary Fund that is designed to restrain the government deficit through new tax measures and the dismantling of the subsidy on the retail price of oil products. The IMF program will lay the basis for disbursements of official development assistance in 1991.

The 1987—1992 medium-term development plan sets a GNP growth target of 6.5 percent per year. The goal is the recovery of the highest per capita income achieved by the economy in 1981 by the year 1991. This growth target was only met in 1988. The prospects for growth during the remainder of the development plan period, 1991—1992, will depend on: (1) the attainment of a new IMF program, (2) the depth of the slowdown in the U.S. economy, and (3) the stresses induced by the political succession struggles.

Prospects on the attainment of the new IMF program depend very much on the implementation of prior actions by the Aquino

government on budgetary reform. Foremost among these is the cessation of the subsidy on retail prices of oil. The government raised the price of oil products by more than 60 percent in the first week of December 1990. This sparked strikes on the part of labor unions and salaried workers, and there will certainly follow a period of wage adjustments.

The government has postponed capital expenditures and salary increases for civil servants and ordered a 10-percent reduction in expenditures for all agencies. The government has also promised to implement a market-determined, peso-dollar exchange rate (officially, this is already the case, but the promise is being reiterated). An 18-month IMF standby program with revisions in August 1991 and February 1992 is in place.

This program presents severe restrictions on the growth of domestic credit. Inflation is forecast at between 13—17 percent, a rate which will continue to exacerbate social tensions.

The medium-term future of the Philippines is clouded with political and economic uncertainty. For those with well-focused and long-term business objectives, the country, which has a long tradition of private enterprise and a skillful labor force, will continue to provide opportunities for fruitful investment as it has for many foreign enterprises since the 1950s. As a consequence of the stabilization program launched in December 1990 which has involved a 9 percent levy on all imports, the economy will manage a growth rate of 1—2 percent in 1991.

Privatization to revitalize business

Soon after its takeover, the Aquino government embarked on an ambitious privatization program, designed to free the national government from its money-losing enterprises. Because of its unwavering commitment to private enterprise as an engine for growth, the program is best called a "reprivatization." Under this program, the 121 enterprises which had fallen into state control but could not service their debt obligations were to be transferred to private sector control. Among these companies are the Manila Hotel and a few other top-flight hotels, the Philippine Air Lines, various companies in the oil industry, and about four private banks.

Progress in the privatization effort has since slowed down as a result of the need to reconstitute the assets of the companies being sold, legal challenges from previous owners, and conflict between potential investors and the government on valuation which arises from the determination of how of the enterprises' debt obligation will be accepted by the new owner. A recent success has been the sale of a major nickel mining company to a private group that had prior involvement in the industry. In this case, the World Bank subsidiary, International Finance Corporation (IFC), took a 20-percent equity share in the enterprise.

Reforms in trade and investment regulations

As explained above, the Philippines has been undertaking a wide-ranging trade liberalization program. In August 1991, the most recent set of tariff reforms were promulgated under Executive

Order No. 470. The order simplifies the tariff structure by reducing the number of tariff rates to four and provides some movement toward reducing the differences in the nominal rates between finished goods and intermediate inputs.

The most recent reform is the passage in June 1991 of the Foreign Investment Act of 1991 (Republic Act 7042) which virtually reverses the former approach to foreign investment. Instead of requiring potential foreign investors to obtain permission from the Board of Investments, all foreign equity investments up to 100-percent equity is now permitted (except for investment in industries in a "negative list" which is to be formulated by the National Economic Development Authority [NEDA]). All that prospective foreign investors need to do is to register with the Securities and Exchange Commission (SEC) and fulfill the requirements of any other equity investment. For industries on the negative list, foreign investors will still be allowed to invest up to a maximum of 40 percent of equity. However, there is a transitory period of three years, though even at the outset, the intent is that the negative list will be kept to a minimum. The implementing guideline of this new law is expected to be published by November 1, 1991.

TABLE SOURCES

Table 1: Asian Development Bank. 1990. Key Indicators of Developing Asian and Pacific Countries, July; International Monetary Fund. 1990. International Financial Statistics, Yearbook 1990 and December 1990; World Bank. 1990. World Development Report 1990.

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Table 3: International Monetary Fund. Various years. Balance of Payments Statistics, Vols. 27—40; Various years. International Financial Statistics, Yearbooks 1987, 1989, and 1990; Victucio, F. K. 1990. The Medium Term Outlook of the Philippine Economy. National Economic Development Authority. 24 October; World Bank. 1990. World Debt Tables 1989—1990.

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