MACROECONOMIC ADJUSTMENT IN THE PHILIPPINES, 1983-85

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The Philippines' most recent balance of payments crisis which erupted in October 1983 is only the fourth since the United States relinquished direct administrative control of the country to a domestic elite in 1946. This paper is an analysis of the adjustment program carried out in response to this most recent crisis.

The first section is a discussion on the main macroeconomic features of the Philippine economy. The second section is an account of the adjustment program carried out from 1983 until the end of 1985. The third section provides an assessment of the adjustment program and the fourth suggests some policy alternatives to the actual adjustment program that had been carried out.

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1.0 Macroeconomic Structure

A brief explanation of the historical basis of the country's economic structure is necessary for the understanding of that structure and the assessment of the efficacy of economic policies implemented within that structure. This capsule history will be organized around the four balance of payments crises that the country has experienced since 1946. Then a brief explanation of the economic structure will be presented.

The 1949 balance of payments crisis marked the exhaustion of the war rehabilitation funds that the Philippines had used to finance a deficit in an international trade dominated by agricultural exports and manufactured imports --- a pattern carried over from the colonial period. The first crisis forced the government to take more responsibility for the management of the economy. A Central Bank was then created and a period of import-substitution---that lasted until the second crisis --- was inaugurated.

1.1 Import-substitution

The import-substitution regime of import controls and high tariffs saw GDP growing by an average of 6.2 percent annually and gross domestic capital formation by an average of 7.0 percent per year. The dominance of finished products in the import structure was replaced by the indispensability of intermediate industrial inputs. The policy created manufacturing sector dominated by

final processing and packing industries, many of these by U.S. corporations under a treaty that extended national rights to U.S. citizens.

Export earnings continued to rely heavily on agricultural and extractive goods while foreign exchange demands actually increased due to heightened demand for imports and the profit remittance requirements of U.S. companies. The 1962 crisis laid bare the unsustainability of the import-substitution strategy as then implemented.

The 1962 IMF adjustment program involved a 50 percent devaluation of the Philippine peso and the dismantling of the import control system. Merchandise exports, now significantly augmented by the exports of mineral products (such as copper concentrates) and logs, grew by 30.8 percent in 1963 and by an average of 4.4 percent per year until 1967 when exports began to stagnate again.

In this period, GDP growth rate fell to 5.1 percent per year while the population growth rate had increased to 3.0 percent per year. Overspending by the government occasioned by the 1969 reelection campaign of Mr. Marcos precipitated the third balance of payments crisis in 1970.

The 1970 IMF sponsored adjustment program required a 43 percent devaluation and the reduction in selected tariff rates. The reforms effectively brought to an end a brief and half-hearted flirtation with export-led growth. The actual reality of

'export-led' growth was the diversification of exports toward other primary products, especially lumber, but not toward labor absorbing manufactured goods.

What was inaugurated in response to the 1970 crisis was a policy regime that was still nominally and even more vocally export-oriented. This could not be avoided since during the period until the next crisis in 1983, the country's economic management was supervised within successive IMF standby arrangements. This was a period however of increasing overvaluation of the peso, which was made possible, ironically, by the consistent support of the IMF and the World Bank to the country's economic management.

The support of these organizations, coupled with the installation of an authoritarian government in 1972, gave the country almost unlimited access to foreign savings in the decade of the 1970s.<1> It would not be inaccurate to say that the country enjoyed a foreign exchange bonanza in the 1970s.

The real effective exchange rate consistently appreciated by a total of 18.1 percent between 1972 and 1982 (see Table 1.1 and Pante [1983]). There was an apparent export diversification as the share of so-called non-traditional exports increased from 18.7 percent in 1983 to 55.4 percent in 1978 and 61.2 percent in 1973 (Table 1.2).

Table 1.1

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES:
PHILIPPINES, 1970-1984
(1973 = 100)

Year	Nominal Effective Exchange Rate Index	Real Effective Exchange Rate Index
1970	85.94	98.89
1971	92.44	L03.64
1972	97.09	L07.18
1973	100.00	L00.00
1974	99.82	83.79
1975	104.87	92.34
1976	103.48	89.03
1977	101.68	86.86
1978	103.60	88.31
1979	105.46	85.84
1980	109.31	87.16
1981	111.05	87.17
1982	I15.68	87.74
1983	145.95	92.66
1984*	196.20*	96.85*

*Using the exchange rates data for 2nd quarter of 1984 and assuming a 50% change in Philippine GDP deflator and a 5% change in the GDP deflator of US, Australia, Japan, France, Germany, Canada, United Kingdom.

Source: Table IV.1 of Lamberte, Montes and others [1985].

Table 1.2

PRINCIPAL MERCHANDISE EXPORTS
1984 TO 1986
PERCENT DISTRIBUTION

I t e m s	At Current Prices			At Constant Prices		
	1984	1985	1986	1984	1985	1986
TOTAL MERCHANDISE EXPORTS	100.00	100.00	100.00	100.00	100.00	100.00
PRINCIPAL MERCHANDISE EXPORTS	73.01	70.34	69.14	70.01	66.06	67.32
1. Semiconductors and electronic microcircuits	23.43	21.44	17.18	26.64	17.29	16.04
2. Garments	11.48	13.76	15.43	11.47	14.42	15.27
3. Crude coconut oil	10.09	7.26	6.93	4.10	5.43	9.63
4. Copper concentrates	2.14	1.87	1.95	4.27	3.18	3.60
5. Centrifugal sugar	5.34	3.22	2.08	7.45	3.70	1.83
6. Lumber	2.03	2.01	2.15	1.27	1.42	1.20
7. Gold from copper ores	1.98	2.21	3.45	0.65	0.83	1.03
8. Iron agglomerates (sinters)	2.01	2.10	1.80	1.03	1.21	0.94
9. Banana	2.27	2.51	2.88	1.88	2.18	2.17
10. Dessicated coconut	2.01	1.67	0.92	0.72	0.72	0.67
11. Copra oil, cake & meal	0.75	0.79	1.57	0.69	0.98	1.61
12. Plywood	0.98	1.03	1.12	0.73	0.83	0.75
13. Canned pineapple	1.67	1.96	1.86	1.26	1.61	1.37
14. Prepared tuna	0.84	1.04	1.11	1.28	1.71	1.65
15. Coffee, not roasted	1.44	1.54	2.56	0.99	1.10	1.35
16. Bars, rods, unworked, copper	2.06	3.70	3.49	4.06	7.86	6.69
17. Shrimps and prawns	0.66	1.38	2.07	0.72	1.09	1.24
18. Logs	1.84	0.87	0.57	0.79	0.50	0.28
Others	26.99	29.66	30.86	29.99	33.94	32.68

Source: National Accounts Staff, December 1986.

This apparent export diversification was not accompanied by changes in the domestic manufacturing sector. Alburo [1985] shows how in the same period, the ratio of manufacturing value added to real domestic product stayed flat at about 23 percent and the real growth rate of manufacturing was falling. The export 'diversification' had depended heavily on products whose domestic value added was very small --- specially in electronic chips and garments.

The extent of capital flight that had occurred during the foreign exchange bonanza became apparent only when the crisis struck in 1983 and only after a thorough accounting had become inescapable. The sum of current account deficits from 1970 through 1983 was $15.3 billion. In September 1983, the officially reported figures for the total foreign debt was $16.3 billion which seemed to account for a relatively small capital flight of only $0.9 billion. The latter figure was also not very far off from an estimate based on the sum of errors and omissions of $1.0 billion from 1970 to 1982.

The fact that the Central Bank had been borrowing heavily on a short-term basis on its account, principally to finance oil imports<2>, became public only in November 1983 when the total external debt of the country was reported to be $24.8 billion. Compared to the sum of current account deficits since 1970, the new figure implies a capital flight of $9.3 billion, about 37.5 percent of the external debt.

Slayton and Thompson [1985] documents how the authoritarian government consistently failed to achieve the IMF program targets during this period. For example, an increase in the tax effort from 13 to 16 percent was a target of the 1976 to 1978 program. In the program period, the government achieved an increase from 13.1 to 13.9. When that program ended, the IMF began negotiating and agreed to a new standby program anyway.

During this period, the recovery of the GDP growth rate to 5.7 percent was driven not by export growth, nor by domestic structural reforms, but by the inflow of foreign debt. For this reason, it is useful to refer to the period after the 1970 crisis and before the 1983 crisis as the period of debt-driven growth.

1.2 Debt-driven Growth

The 1983 balance of payments crisis signalled the end of the debt-driven growth period, an end which can be blamed not only on the drying up of inexpensive international credit, which affected all countries, but also on the failure of the investment strategy in the previous period to carry out internal changes in the economy (see Table 1.3).

The trade surplus experienced in 1973 as a result of the commodity boom in that year turned into deficit immediately in the following year, the year of the first oil shock. The seemingly good export performance in the years when no recessions were occurring in the First World masks the fact that net exports

Table 1.3
Trade Balance Trends

Year	Growth Rate of Merchandise Exports	Imports	Merchandise Trade Balance (Deficit) as Pct to GNP	Terms of Trade Level (1972=100)	Change (Percent
1970	24.3	-3.7	(0.4)	n.a.	
1971	7.0	8.8	(0.6)	n.a.	
1972	-2.7	3.7	(1.3)	100.0	
1973*	70.6	29.8	2.2	113.3	13.3
1974+	44.5	96.9	(2.8)	114.5	1.1
1975	-15.8	10.1	(7.4)	87.8	-23.3
1976	12.2	5.1	(5.9)	77.7	-11.5
1977	22.4	7.7	(3.7)	71.0	-8.6
1978#	8.7	20.9	(5.4)	78.4	10.4
1979	34.3	29.8	(5.2)	86.6	10.5
1980	25.8	25.8	(5.5)	76.7	-11.4
1981&	-1.1	2.8	(5.8)	79.0	3.0
1982	-12.3	-3.5	(6.7)	72.9	-7.7
1983	-0.3	-2.3	(7.3)	60.8	-16.6
1984	7.7	-18.9	(2.1)	59.8	-1.6
1985	-14.2	-15.7	(1.5)	55.1	-7.9

*Commodity boom
+First oil shock
#Second oil shock
&Monetarist recession

Source of basic data: Central Bank of the Philippines

continued to depend heavily on agricultural and primary products. The growth in non-traditional exports induced increased imports of necessary inputs whose domestic production had not been provided for in the earlier import-substitution era.

However, due to the poor investment policies of the Marcos regime (see De Dios, 1984), the accompanying debt inflow did not materially change the structure of the economy from that inherited from the end of the import-substitution period. In fact, prospects for growth had worsened because there was now a higher capital-output ratio (from 4 before 1980 to approximately 10 for 1980-83) and a higher level of foreign debt (4.9 times merchandise exports in 1982). Table 1.4 presents the distribution of the foreign debt of the Philippines when the balance of payments crisis began in 1983.

The outstanding external debt in October 1983 at the start of the 1983 crisis was 72.7 percent of GNP. The debt service ratio at that point in time was 35.7 percent. Of the total debt, 37.4 percent was short-term and 60.0 percent was owed to commercial banks. The public sector had been the borrower for 48.2 percent of the debt and the Central Bank had been the borrower for an additional 16.4 percent.

Table 1.4

TOTAL EXTERNAL LIABILITIES
(In Million US $)

Item	1983 Oct 17	1983 Dec 31	1984 Dec 31	1985 Dec 31	Projection 1986 Dec 31
By Type of Debt	24,095	24,816	25,418	26,252	27,097
Medium- and long-term	15,080	14,412	15,926	17,679	21,671
IMF	1,186	1,166	973	1,232	1,146
Others	13,894	14,246	14,953	16,447	20,525
Short-term	9,015	9,404	9,492	8,573	5,426
Trade	4,469	4,614	5,274	4,854	4,452
Non-trade	4,546	4,790	4,218	3,719	974
By Borrower	24,095	24,816	25,418	26,252	27,097
Non-banking system	16,077	16,521	17,188	17,376	16,606[1]
Public	11,606	11,802	12,341	12,358	. .
Private	4,471	4,719	4,847	5,018	. .
Banking system	8,018	8,295	8,230	8,876	10,491
Central Bank	3,962	3,971	4,113	5,923	7,155
Commercial banks	4,056	4,324	4,117	2,953	3,336[2]
By Creditor	24,095	24,816	25,418	26,252	27,097
Commercial banks	14,427	14,674	14,721	14,474	15,179
Other financial	1,013	1,014	1,089	795	998
Suppliers	2,682	2,885	3,103	3,264	2,541
Multilateral	3,775	3,996	4,090	4,486	4,820
Bilateral	2,058	2,108	2,276	2,860	3,559
Export credit	567	575	656	786	. .
Others	1,491	1,533	1,620	2,074	. .
Others	140	139	139	373	. .

[1] Balances before adjustment of Central Bank assumed liabilities.

[2] Includes rescheduled Paris Club accounts (inclusive of arrears and two-thirds of downpayment on interest payable in 1986 and 1987.

Source: Central Bank of the Philippines, Quarterly Economic and Financial Report, December 1985.

We now briefly describe the structure of the economy.

1.3 Important Characteristics of the Philippine Economy

1.3.1 Output and Demand

Agriculture produces 26 percent of GDP and is dominated by tenancy-based production. Population pressure has also generated significant numbers of landless agricultural workers in the rural areas. Agricultural products are of two kinds: (1) products that are primarily for domestic consumption such as rice, corn, and vegetables and (2) products for exports, notably coconut products and sugar.

In the period leading up to the crisis, agriculture suffered from unfavorable terms of trade vis-a-vis industry (see David [1983] and Table 1.5), low incomes and low productivity growth of peasants.

The country achieved rice self-sufficiency in the 1970s with the diffusion of high yielding (fertilizer and pesticide dependent) rice varieties, but continued population pressure could endanger self-sufficiency in the future. Thus, one might say that the country is only barely self-sufficient in food.

The subsidy coming from agriculture into other sectors was made heavier by the government fertilizer policy which priced fertilizer so that the capital costs of locally produced fertilizer could be recovered. Between 1973 and 1980, farmers

Table 1.5
INDUSTRIES RANKED ACCORDING TO EFFECTIVE PROTECTION RATE (EPR), SHARE OF EMPLOYMENT TO TOTAL MANUFACTURING AND DEGREE OF CONCENTRATION IN METRO MANILA, 1980

Sector	EPR	% of Employment to Total Manufacturing	% of Establishment in Metro Manila
High EPR Industries			
Meat products, canning and preserving of fruits	635.1	2.2	20.1
Articles of pulp, paper and paperboard	158.5	3.8	56.0
Rice, corn and other grain mill products	137.2	4.7	5.0
Softdrinks and other beverages	106.1	2.8	2.9
Soap and other washing and cleansing compounds	98.5	0.5	80.6
Other made-up textile goods	93.3	2.4	7.7
Miscellaneous manufacture	90.7	1.17	23.5
Manufacture of bakery products, cocoa, chocolate sugar confectionary, dessicated coconut, ice, coffee and other manufacturing	72.3	8.3	22.8
Other fabricated metal products	68.4	4.0	19.3
Dairy products	62.3	0.6	17.1
Tobacco products	61.8	1.7	73.3
Batteries and other electric machinery apparatus, appliances and supplies	58.8	4.6	79.2
Glass and glass products	54.6	0.7	66.3
Other non-metallic mineral products	54.3	1.9	11.9
Pulp, paper and paperboard manufacturing	47.5	1.7	71.4
Other chemical products	47.0	3.5	79.1
Plastic materials	44.3	2.0	83.1
Printing, bookbinding and other allied products	39.6	2.1	53.2
Paint, varnishes and related compounds	39.5	1.9	60.3
Non-ferrous metal basic industries	33.6	0.7	16.3
Fats and oils	32.1	0.7	16.3
Manufacture of cement	29.6	0.8	5.0
Manufacture of rubber products	28.7	2.4	19.5
Manufacture of transport equipment	27.0	10.3	40.0
Textile and knitting mill products	26.0	10.3	16.7
Manufacture of machineries except electrical	20.4	2.6	46.2
Basic ferrous metal industries	19.1	1.6	70.6
Manufacture of industrial chemicals	18.6	1.3	62.9
Office, computing and accounting machines (excluding electrical)	12.7	0.20	78.1
Petroleum refineries and other petroleum products	12.4	0.01	-
Sugar milling and refining	1.1	3.4	5.0
Medicinal and pharmaceutical preparations	1.0	2.9	-
Industries with negative EPR, 1980			
Footwear	-3.1	1.0	39.5
Other wood, cane and cork products	-4.6	7.2	12.2
Furnitures and fixtures	-5.2	3.6	21.2
Manufacture of veneer, plywood and other lumber	-10.0	5.3	13.4
Fabricated structural metal products	-10.3	15.0	29.6
Other wearing apparel	-10.5	14.1	22.3
Leather and other leather products except for footwear and other wearing apparel	-10.7	0.4	57.4

$$\frac{\text{Share of Mfg. Employment}}{\text{Total Philippines}} = \frac{1,814,000}{16,434,000} = 11\%$$

Source: Table 1, Department of Economics [1986].

paid about 10 percent over the border price for fertilizer (David and Balisacan [1982]).

In the period leading up to the crisis, export agriculture became heavily monopsonized as the Marcos government introduced government mandated but privately controlled monopoly marketing operations in the coconut and the sugar industries.

Interventions in these industries under the Marcos regime had been publicly justified by the need to improve the productivity in these old export industries. It was hoped that resources raised from monopoly profits and export taxes could be applied to productivity raising programs. The actual experience was that these resources were consolidated by persons close to the Marcos administration to be used for political purposes and for the purchase of existing monopoly enterprises in other economic areas.

In the case of the coconut industry, for example, resources were raised through a 'levy' collected from coconut farmers under the auspices of the government Philippine Coconut Authority and placed into a private fund. Because of the high substitutability against coconut oil in world markets, the incidence of the levy fell on the domestic farmers (see Clarete and Roumasset [1983]). In law, the fund was private and owned by the country's coconut farmers; in practice, only a small group controlled the funds into which a total of ₱9.7 billion (about $1.3 billion at the prevailing exchange rates) had been collected between August 1973 and August 1982.

Of this amount, P2.6 billion was applied to gain monopoly control of domestic milling capacity which was then applied to lowering farmgate prices for copra, further reducing the incomes of coconut farmers. P2.1 billion was applied to various social amelioration projects for coconut farmers and only P1.1 billion went to the planting of hybrid seednuts. Part of the rest went for charity projects but the greater proportion was used to purchase a private commercial bank, which immediately grew to one of the nation's largest because the levy funds were deposited in the bank at no interest. In 1984, the resources of the bank were applied to the purchase of the country's largest private corporation.<3>

The agricultural sector is also characterized by backward production methods, low productivity, and a low rate of reinvestment. In rice, 1984 Philippine yields were 2.5 metric tons per hectare compared to the Asian average of 3.3; sugar yields, 48.1 metric tons per hectare while the international average is 58.0. In 1979, twenty-five percent of palms were over 60 years old and therefore 700,000 hectares were due for replanting.<4>

In the short-run, agricultural production is highly determined by the availability of credit to the sector. This is true for crops for local production and also for sugar.

Industry accounts for 34 percent of GDP. Industrial firms, heavily dependent on intermediate imports, typically enjoy oligopolistic positions in domestic markets. Such a structure had been inherited from the golden years of import substitution. The oligopolistic structure has been reproduced through tax incentives, quantitative restrictions and exchange rate appreciation.

Using estimates based on the 1974 input-output tables, the range of effective protection rates varies greatly from 49 to 200 percent (Tan 1979). Using an index of 100 for the least protected sector, agriculture and primary products had an index of 100, manufacturing an index of 489, and all sectors had an index of 400. Within the manufacturing sector, final consumption products had an index of 481 while construction had an index of 100. If exportables have an index of 100, then non-exportables would have an index 1525.

Bautista [1981] studied the correlation between the effective protection rate (EPR), percent of employment to total manufacturing, and within industry concentration, the latter measured indirectly from the proportion of establishments in Metro Manila (Table 1.5). Meat processing, for example, has an EPR of 635.1 while employing only 2.2 percent of manufacturing employment. Fabricated metal products has a negative EPR of 10.3 percent while employing 15 percent of manufacturing workers.

Notable export-oriented exceptions are garments and semiconductor manufacturing. As noted earlier, the domestic value-added in these products are minimal. Moreover, garments have been subject to quotas in the U.S. market which has not only bred local oligopsonists in the industry but has also prevented a dynamic response to exchange rate incentives in this labor intensive sector. Export-oriented mining contributes about 1 percent to GDP.

Because of the long history of finished products protection, the greater part of industrial output cannot be classified as tradeables. Gonzalez [1984] estimates that in 1982, 71 percent of gross domestic product would be classified as non-tradeables, 12.3 percent would be exportables and 16.7 percent as importables (Table 1.6).

For example, five companies were producing cars under a progressive car manufacturing program. In studies conducted at the Tariff Commission, however, it has been seen that, especially for Japanese cars, these companies were using imported components so that in the computation of the total costs, these cars cost more than the imported finished cars themselves because shipping the knocked down parts costs more and also, possibly, because of some overpricing for kickbacks.

The services sector contributes almost 40 percent of GDP and is dominated by low productivity jobs in trade in transportation. A significant proportion of the workforce, about 800,000 workers at the peak from a labor force of 21 million, are employed

Table 1.6

PERCENT DISTRIBUTION OF REAL AND NOMINAL
GROSS DOMESTIC PRODUCT, BY SECTOR, 1967-1982

	Non-tradables		Exportables		Importables	
Year	Real	Nominal	Real	Nominal	Real	Nominal
1967	76.3	72.2	15.4	15.6	14.3	12.2
1970	70.0	68.0	15.4	17.1	14.6	14.9
1973	67.7	65.8	15.1	16.8	17.2	17.4
1976	69.7	67.3	14.3	13.4	16.0	19.3
1979	70.1	66.5	13.7	14.7	16.2	18.9
1982	71.0	71.4	12.3	11.1	16.7	17.5

Source: Gonzales (1984). Table 3.

abroad. The officially recorded remittances of these workers have been sensitive to the black market premium of the foreign exchange rate.

Foreign trade is a significant proportion of output. Imports account for about 25 percent and exports for 20 percent of GNP.

Merchandise imports averaged about $7.5 billion a year in the period leading up to the crisis while exports could manage about $5.5 billion in a good year. Since the second oil crisis, the order of magnitude of the annual trade deficit exhibited a rising trend from about $1.5 to about $2.0 billion.

Consumer goods constitute about 7 percent of imports. The most critical import items are raw materials and intermediate good imports which constitute about 40 percent of the total and capital goods imports which constitute about 23 percent. As the experience in the crisis has brought out intensely, the evolution of imports is dominated by 'noncompetitive intermediates and, as such, enter into prime cost' (Taylor [1981]).

Raw material and agricultural exports (coconut products, logs and lumber, copper concentrates) contribute about 46 percent of total exports and the country has relied on these exports since the colonial period. Non-traditional exports (garments, semiconductors, furniture, shrimps) have been growing in importance but are plagued by high import content, unreliable supply of domestic inputs (for example, furniture exporters have

a difficult time obtaining wood locally), and high dependence on working capital financing.<5>

On the demand side, consumption constitutes 63 percent of GNP. Government expenditures represent about 12 percent of output.

The investment ratio averaged 29.3 percent between 1974 and 1983 with the government taking an increasing role. Investment in the 1970s had been fueled by the inflow of government guaranteed foreign debt as can be seen indirectly in Table 1.7.

In the year 1979, the government began a big push into corporate investments as in its much heralded 'countercyclical policy' so that the increase in government savings was matched by an increase in 'corporate' savings. The extension of government guarantees through its large financial enterprises, the Philippine National Bank and the Development Bank of the Philippines, spurred corporate investment, especially in new 'conglomerates' owned by individuals close to the Marcoses.

1.3.2 Prices and Cost Formation

For agricultural exports, the Philippines is almost wholly a price taker. The swings in terms of trade shown in Table 1.3 mimic the recessions and booms in the OECF countries because of the importance of agricultural exports in the country's trade. Increases in the peso prices of coconut oil have exerted pressure on domestic prices of cooking oil in the past but these pressures

Table 1.7
Investment, Savings, and the Investment-Savings Gap
(in percent of GNP*)

Year	Net Savings to GNP Ratio: Households	Corporations	Gov't	Capital Consumption Allowance	Gross Savings	Gross Investment	Investment Savings Gap
1974	8.2	2.5	4.6	8.6	23.8	25.1	1.3
1975	8.5	2.8	3.1	9.9	24.3	29.6	5.3
1976	10.9	3.1	1.8	9.6	25.4	31.3	5.9
1977	10.6	2.4	3.0	9.5	25.6	29.0	3.3
1978	8.4	2.9	3.9	9.5	24.7	29.0	4.3
1979#	6.5	5.7	5.1	9.4	26.8	31.0	4.3
1980	6.0	5.5	5.0	9.3	25.7	30.7	5.0
1981	6.5	5.3	3.8	10.1	25.7	30.7	5.1
1982	3.4	4.4	3.0	10.3	21.2	28.8	7.6
1983	2.2	4.3	3.7	10.3	20.6	27.5	7.0
1984	-0.8	2.6	3.8	10.2	15.9	18.6	2.8

*Totals may not add up due to rounding errors
#Start of "countercyclical policy"

Source: National Economic and Development Authority (NEDA)

were not so strong in the adjustment period because of the generally depressed demand for coconut products.

With respect to key agricultural products for domestic consumption, notably rice which is the staple, the country had a price control program before the crisis. The price control program consisted of mandated price ceilings for these products and did not involve subsidies from the government budget. The government rice buying program was principally directed at stabilizing prices, even though it gradually began to control an increasing proportion of the domestic trade from an initial participation of about 10 percent of the market.

Because of the import content of fertilizer prices, however, it was necessary to adjust rice and corn prices in response to the devaluations and this was another channel of inflation. Between June 1983 and December 1984, the support price for unmilled rice had to be increased by 97.1 percent and this induced a 72.6 percent increase in the price of milled rice.<6>

Starting in the last quarter of 1984, however, the government seized the opportunity by starting to remove price controls on basic commodities (also in response to IMF pressure). In September 1985, in anticipation of the rice harvest, price controls on rice, the last item to be decontrolled, were removed.

Prices in the industrial sector are determined principally as the adding up of costs: importation costs plus tariffs plus production costs plus markup (though it is difficult to point to

some study providing direct evidence). Declines in demand during the adjustment did not reduce the real prices of these products, though it did induce the closure of many of the enterprises producing them including the domestic car firms.

Minimum wages are set by 'tripartite bargaining' but are unenforceable in the great majority of firms (Tidalgo and Esguerra [1984]). Unions, even while successful in obtaining increases in the legislated minimum wage, had been too weak under the martial law regime to demand local enforcement.

Mariano's [1985] monthly inflation model provides some 'clues' about the relative strengths of these influences on domestic inflation (see Table 1.8). This one-equation model is a forecasting equation, and not a structural one.

In the long-run, the strongest influence on inflation in the Philippines is some function of the relationship of total monetary liquidity to real output. In the short-run, however, it is the local currency prices of imports, fuel and non-fuel, that have the biggest impact on inflation, followed by 'the' interest rate. Wages, export prices, liquidity, food prices, and the black market premium ('a proxy for the inflationary effects of developments in the political scene and the scarcity of foreign exchange', Mariano [1985, p. 8]) have smaller impact in the short run.

Table 1.8
The Inflationary Process(1

Variable	Short-Run(2) Elasticity	Long-Run(3) Elasticity	Coefficient	T-statistic(4)
Peso price of oil	0.176	0.553	0.634	3.20
Foreign exchange black market premium	0.017	0.055	0.042	0.84
Peso import price for non-fuels	0.192	0.603	7.232	4.20
Total liquidity(5) over real GNP	0.060	0.750	5.413	5.81
Interest on 91-day treasury bills	0.138	0.434	0.925	5.82
Peso export price index	0.075	0.237	0.029	3.04
Legislated minimum wage	0.144	0.454	0.609	3.08
Price ceilings on food index	0.020	0.062	0.984	2.04
CPI lagged one month			0.975	16.65
CPI lagged two months			-0.293	-5.29
Dummy for 1985			18.886	6.40

(1) Based on the Monthly Single Equation Inflation Model of Mariano [1985. of the consumer price index. The equation is estimated from January 1972 to March 1985 with a dummy variable for 1985.

(2) This is the elasticity of the annual inflation rate which is computed for any explanatory variable X as (dCPI/(CPI-CPI(-12)))/(dX/X)

(3) The long run rate is that for which CPI = CPI(-1) = CPI(-2)

(4) On the hypothesis that the coefficient is equal to zero

(5) The actual variable is the sum, over the last four months, of the ratio of total liquidity each month to semestral GNP

Source: Mariano [1985], Tables 2 and 10.

2.0 Actual Adjustment Strategy

2.1 Toward the 1983 Crisis

In 1979, after the second oil shock it was the stated policy of the government to engage in 'countercyclical policy' which practical terms meant pushing up the investment rate through an increased rate of foreign borrowing under government guarantee. The huge increases in the budget deficit was financed primarily through the incurring of foreign, mostly short-term debt, as international credit became increasingly scarce.

Concurrent with the shift to short-term borrowing, there was a more pronounced dependence on commercial bank, variable interest, accomodation after 1980.

As early as 1981, large investment projects to favored groups of the Marcos regime started to fail (de Dios [1984], Montes [1986]).

The large budget deficits that began to appear in 1980 can be traced in most part to increasing budgetary contributions from the national government to government financial institutions which had started to fail because on one hand many of the private sector projects that these financial institutions had lent to had started to fail and on the other hand they were maintaining the servicing of their own foreign liabilities up to date.

These contributions to government corporations to enable them to maintain the service on their foreign obligations generated tremendous pressure on the government budget. Table 2.1 shows how much smaller the government budget deficit might have

been had these budgetary contributions not been made to government corporations. In the years immediately preceding the crisis, 1981 through 1983, there would have been government surpluses of about 1.5 percent of GNP if these contributions could have been avoided (Table 2.1).

These government budget deficits in turn translated into current account deficits as shown in Table 2.2. In the period from 1975 to 1982, the government budget deficit peaked at 4.7 percent of GNP and the current account deficit at 7.6 percent of GNP (Table 2.2). In the same period, the total external debt doubled to $26 billion between 1979 and 1983.

2.2 The Adjustment Strategy

When the 1983 balance of payments crisis struck the Philippines was operating within an IMF standby program. In this program a target of $800 million for the balance of payments deficit for the year 1983 had been set. By June of 1983, the balance of payments deficit had reached $562 million and it was clear that the country would not fulfill its IMF commitments by yearend.

The peso was devalued in June 1983 from P9 to the dollar to P11 but this did not change the increasing difficulty the country was experiencing in rolling over its existing short-term credits with the commercial banks. The Aquino assassination on 21 August 1983 triggered a torrent of closures of commercial credit lines to the country. At that time, it seemed to the Marcos government that the principal problem was the restoration of trade credits. To do this, the government turned to the IMF and began to renogotiate its adjustment program.

Table 2.1
Effect on the Budget Deficit
of Contributions to Government Corporations

Year	Total Budget Deficit (P_million)	Contribution to Government Corporations (P_million)	Hypothetical Budget Surplus (Deficit) without Contribution Level (P_million)	As % of GNP (Percent)
1975	1,403	807	(596)	(0.5)
1976	2,349	2,196	(153)	(0.1)
1977	2,852	2,498	(354)	(0.2)
1978	2,167	2,877	710	0.4
1979	342	3,869	3,527	1.6
1980	3,387	5,244	1,857	0.7
1981	12,146	8,426	(3,720)	(1.4)
1982	14,405	9,308	(5,097)	(1.7)
1983	6,422	5,407	(1,015)	(0.3)
1984	8,714	10,248	1,534	0.4
Total	54,187	50,880	3,307	(0.1)

Source of Data: Amatong and Others, [1985], Tables 4.4 and 4.5.

Table 2.2
Budget and Current Account Deficits
(in million pesos and percent)

Year	Budget Surplus (P_million)	Budget Deficit to GNP Ratio Deficit to GNP (percent)	Current Account Balance (P_million)	Current Account to GNP Ratio (percent)
1975	-1,403	-1.2	-6,071	-5.3
1976	-2,349	-1.8	-7,920	-5.9
1977	-2,852	-1.8	-4,872	-3.2
1978	-2,167	-1.2	-8,385	-4.7
1979	-342	-0.2	-9,763	-4.5
1980	-3,387	-1.3	-13,536	-5.1
1981	-12,146	-4.6	-15,338	-5.1
1982	-14,405	-4.7	-25,339	-7.6
1983	-6,422	-1.9	-26,394	-7.0
1984	-8,714	-2.3	-14,756	-2.7

Source: Amatong (1985), pp. 17-18.
NEDA Statistical Yearbook, 1985.

On 17 October 1983 the government devalued the peso from P11 to P14 to the dollar and announced: (1) that it was declaring a moratorium on the payment of principal on its debt and (2) that it was negotiating a new program with the IMF. These negotiations were not completed until a new program was agreed upon in December 1984.

There were many factors behind the long delay in reaching an agreement with the IMF. After negotiations commenced around October 1983, there seemed to have been an excellent chance to reach an agreement by December 1983. The leaking to the public regarding the Central Bank's overstatement of its international reserves - it turned out since 1981 - by as much as $800 million led to a breakdown in talks with the IMF in December 1983.

Unconfirmable rumors attribute the leaking of the information to the international commercial banks which had started balking at increasing their Philippine exposure. This would have been quite comprehensible to a disinterested observer since it had been the commercial banks whose exposure had been rapidly increasing since 1980. In fact, their recent generosity with short-term, variable interest syndicated loans for the Central Bank had been an important factor behind the capability of the Marcos government to avoid seriously wrestling with the adjustment problem.

In the meantime, there was a sharp runup in money supply starting in December 1983 from many different contributory factors. The devaluation of October forced the Central Bank to honor the forward exchange cover commitments it had entered into

in the previous period as a strategy to increase foreign financing inflows. The sharp increase in money supply in the last quarter was also caused by the the contribution the Central Bank made to the Development Bank of the Philippines so that it could service the guarantees it had extended to foreign creditors.

By January 1984, the campaign for the national assembly for the May elections had begun in earnest. The Marcos regime saw this exercise as its first opportunity to prove to the world that it was in firm control. It took until July 1984 when the regime saw fit to directly address the balance of payments problem again.

In order to ration the foreign exchange through this period, the Central Bank imposed exchange controls, imposing a limit of $50000 per month per client. Until December 1984, the government (and the country) operated with almost no foreign financing for its international trade and the Marcos government resorted to various stopgap measures.

Until trade credits could be restored and except for oil and a few essential commodities, the cutoff in international trade credit meant importations were allowed on a no dollar basis'. Under this system, no documentation was required regarding the source of the foreign exchange used to import goods. This in effect meant that private businessmen could import as long as they used their own foreign exchange funds.

The government also obtained emergency USAID financing to import fertilizer for the planting season. The government managed to obtain a total $2.2 billion from official sources in 1984 and 1985. In 1984, it received $1 billion composed of more than $300

million from the World Bank and the Asian Development Bank, $425 million in credits from the U.S. Eximbank and the Commodity Credit Corporation and almost $200 million from Japan.

As an indication of the government's desperation, for one year until December 1984, the government allowed firms with foreign participation to apply the cost of their importations toward equity in those firms.

One might say that at this point the IMF changed its posture from that of a doting parent to that of a vengeful god. It seemed as if the IMF had made the judgement that the authoritarian government had finally put itself in such a helpless position that it would have to accede to giving government technocrats who had attempted vainly in the past to carry out its suggested reforms a decisive influence over public management.<12>

The train of events that were set in place by this change in approach diverged significantly from IMF expectations. The authoritarian government was powerful enough to do two normally contradictory things at the same time: to protect the interests of its supporters and to carry out an adjustment program, even within an IMF program, at the same time.

This strategy by the authoritarian government, however, led to its increasing isolation especially in the urban areas and in the business sector and led to a result that neither the IMF nor the United States government expected: the overthrow in February 1986 of the regime they had been working with for a long time. It is probably accurate to say that neither the IMF nor the U.S. government would have been anxious to claim credit for this

result at the moment that it happened.

The Marcos government's analysis of the crisis focused primarily on the loss of trade financing. The government's negotiating strategy was premised on such an analysis. Under this framework, the return of commercial credit was the ultimate objective and in the situation it was necessary to obtain the necessary IMF blessing. The government sought and eventually obtained: (1) an IMF standby agreement of SDR 615 million and (2) a rescheduling with the Paris Club of $0.8 billion in official payments.

These agreements formed the basis for the new accomodation from the private commercial banks with three key elements: (1) a rescheduling of principal payments due within the two year period ending 31 December 1986, (2) $925 million new money, and (3) the establishment of a $3 billion trade facility. The level of the trade facility approximated their trade financing exposure to the country in October 1983. Both the IMF and the commercial bank new money were designed to augment the Central Bank's international reserves.

It is important to point out that because the analysis focused primarily on the need to restart trade financing, the Marcos government's approach was inherently short term. This short-term and commercial orientation was strongly confirmed when J. Laya, a former academic who had been the governor of Central Bank since 1981, was replaced in January 1984 by J. Fernandez, a principal owner of one of the country's largest commercial banks, as a result of the international reserve overstatement scandal.

It is also important to note that because the chosen

negotiating strategy made IMF support indispensable, the Marcos government felt that it had to attain all the agreed upon targets to the letter, irregardless of its impact on the economy. In this period, powerful individuals in the Marcos government seemed to be acting in the belief that this time the government had at least to humor the IMF.

The country's 'adjustment' program was prosecuted first in the year 1984 while the country was negotiating with the IMF and then in 1985 under the new, the 18th, standby agreement.

That the government was operating under the aegis of the IMF even before the actual program began in January 1985 was widely known. The dimensions of the implicit adjustment program in 1984 can be deduced from a table entitled 'A Framework for Adjustment' that the Central Bank produced in November 1984.<7> The numbers from this table and the subsequent actual figures are given in Table 2.3.

Under the December 1984 agreement, the Philippine government had undertaken the following prior action measures: (1) 'the reduction in reserve money,' (2) 'the float of the exchange rate,' (3) abolition of the foreign exchange 'surrender requirement and the priority allocation system introduced after 17 October 1983 and the reform of the foreign exchange system,' (4) 'increase in interest rates on Central Bank bills and Treasury bills to approximately 40 percent at the time of the float, together with increases in several other lending and deposit rates,' (5) 'implementation of a significant tax package involving structural changes to broaden and strengthen the tax

Table 2.3
November 1984 Framework for Adjustment
versus Actual

	1983	1984 Proj.	1984 Actual	1985 Proj.	1985 Actual	1986 Proj.	1986 Actual
External objectives							
Current account deficit (US$ bn.)	2.8	1.5	1.3	1.1	--	0.6	-0.9
(Percent of GNP)	8.1	5.2	3.9	4.1	--	2.3	-3.1
Exports (percent change in US$ value)	-0.3	5.9	7.7	10.0	-14.1	11.0	1.6
Imports (percent change in US$ value)	-2.3	-23.0	-18.9	-1.6	-15.8	3.4	-7.5
Trade balance (US$ bn.)	-2.5	-0.5	-0.7	0.1	-0.5	0.5	-0.1
Net international reserves(1) (change in U.S. dollars)	-0.5	-0.4	0.5	2.5	2.8	...	--
Arrears (US$ bn., end-period)	1.6	1.9	2.7	--	--	--	--
			(In percent of GNP)				
Savings and investment							
Gross domestic investment	27.1	22.0	19.2	22.5	16.2	23.0	14.0
Total savings	27.1	22.0	19.2	22.5	16.2	23.0	14.0
Gross national savings	19.0	16.8	15.3	18.4	16.2	20.7	n.a.
Foreign savings	8.1	5.2	3.9	4.1	--	2.3	n.a.
			(Percentage increase)				
Money (end-period)							
M3	19	10	7	13	10	12	5.0(2)
Reserve money	49	15	12	11	8	10	21.0(2)
GNP and prices							
Real GNP	1.1	-6	-6.8	--	-3.8		0.1
Consumer price index (end-period)	26.1	40-45	50.8	10-15	5.7	8-10	-0.3
Consumer price index (average)	10.0	45-50	50.3	20-25	23.1	10	0.8
Public compensation per employee	9.5	18	20.3	22	34.4	...	n.a.

(1)Inclusive of external arrears
(2)Up to September only.

Source: Central Bank, Economic Memorandum, November 1984, Table A, p. 17 and Quarterly Economic and Financial Report

base,' and (6) 'increases in administered prices to reflect market conditions,' and (7) 'formulation of the domestic counterpart peso deposit scheme covering foreign currency obligations designed to support the attainment of monetary aggregates'.<8>

Except for item number 7, these prior action measures can only be interpreted as classic IMF adjustment measures. Item number 7 was a scheme by which the Philippine debtors, particularly the government corporations such as the National Power Corporation, would pay for their debt service to the Central Bank in pesos. The Central Bank would in turn assume the dollar liability. The reason why the scheme could be said to be 'designed to support the attainment of monetary aggregates' is precisely because the financial payments being ultimately raised either from tax revenue (which are transformed into the national government contributions to these companies) or from the 'increases in administered prices' ended up being sterilized with the Central Bank.

The latter scheme has been a significant factor in drastically increasing the effective marginal propensity to save by the government sector which has a contractionary short-term effect (Krugman and Taylor [1978]).

An examination of Table 2.3 shows that the government more than fulfilled the program targets deemed most critical by the IMF. The actual current account deficit of 1984 was $1.3 billion (3.9 percent of GNP) compared to the target $1.5 billion (5.2 percent of GNP). In 1985, the first year of the official IMF program, instead of the planned current deficit of $1.1 billion

(4.1 percent of GNP), there was actually a slight current account surplus 8 million dollars (about zero percent of GNP). In 1986, mostly under a new government but with the level of activity already depressed, instead of a current account deficit of $0.6 billion, there was another surplus of $0.9 billion.

For 1984 and 1985, all the monetary growth targets are more than fulfilled (Table 2.3). Only in 1986, with the change in government, were these monetary ceilings exceeded.

There was also an overachievement with respect to the inflation targets in 1985, the first year of the official IMF program, 5.7 percent actual by yearend compared to 10-15 percent in the program (Table 2.3). In 1985, the forseen inflow of foreign savings worth 4.1 percent of GNP did not materialize even under the IMF program.

Within this framework, the government carried out a monetarist adjustment program which provided for requirements of the regime and its followers at the same time that it drastically reduced the current account deficit through the reduction of credit to the private sector.

The nature of this approach is documented in Table 2.4 which provides details in the annual rates of changes in reserve money for each quarter from 1980 to 1985. We can now explain the Marcos cum IMF approach using the data in this table.

The first requirement of the regime was the maintenance of its grip on political and military power. Given the key role that the United States had always played in national politics through its moral authority over the armed forces, political control was

secured, in the first instance, through election exercises. Since the onset of the crisis, there were two elections of crucial importance to the authoritarian government: one in May 1984 for members of the parliament and the snap election for president in February 1986.<9>

An examination of the credits to the public sector by the Central Bank for the quarters 1983.4, 1984.1, 1984.2 corresponding to the period before the first election reveals significant increases in lending to the government at the same time that credits to the deposit banks were being decreased. The same thing can be said for the quarters 1984.3 and 1984.4 before the February 1986 election.<10>

The Marcos regime provided for the requirements of its immediate followers by many different means. The most important means was through Central Bank and national government contributions to the Development Bank of the Philippines (DBP), and the Philippine National Bank (PNB) that prevented these companies from going under while failing to collect on its receivables from favored groups and individuals. As of end-1985, 58.2 percent of PNB and 87.0 percent of DBP assets were classified as 'non-performing'. The values of these assets totalled P41.4 billion (about $2.2 billion) for PNB and P65.2 billion (about $3.4 billion) for DBP.

The exchange controls that had been reinforced upon the onset of the crisis favored groups and individuals close to the government. As the banking crisis worsened, the speed of the bailouts became dependent on neutrality with respect to, if not closeness to the regime. In one case, fund releases from World

Bank credits to a private development bank had been held up unnecessarily reportedly because its president was active in the opposition.<11> The election exercise of May 1984 provided a means by which government resources could be transferred to supporters of the regime at the local levels.

At the overall level, however, the IMF targets could only be attained by redirecting resources away from the private sector as a whole toward the government and the private sector allied to Marcos. Thus the general strategy required that while resources were increasing for the defense of the authoritarian government, overall financial resources were being kept constant in nominal terms and actually being reduced in real terms, because of the concomittant inflation, in order to meet the IMF targets.

The private sector, in general, did have a claim to some insurance of its resources at the start of the crisis from the forward cover that had been provided by the government earlier. In Table 2.4, the item that changes the most drastically from 1983 onward is 'other' claims. During the crisis, this item was dominated by revaluation effects and increases in claims on the Central Bank based on forward exchange cover previously provided. These increases were induced by the devaluations in June and October 1983.

To have honored all of these claims, as the Central Bank had started to do in the last quarter of 1983, would have violated the implicit IMF ceilings for 1984.

The initial intervention of the Central Bank was to 'block' the peso credits created by these liabilities which turned up as

Table 2.4
Control of Monetary Base
(Annual rates of change, percent)

Quarter	Reserve Money	Net Foreign Assets	Net Domestic Assets	Net Claims on: Public Sector	Net Claims on: Deposit Banks	Net Claims on: Other
1980.1	15.7	-3.6	32.6	-22.2	36.1	-128.3
.2	12.4	-3.2	30.3	-10.9	42.9	-62.6
.3	9.9	-4.0	19.2	-8.2	128.7	-305.9
.4	10.7	-38.0	41.3	53.6	64.0	-227.3
1981.1	-2.4	-108.3	64.7	125.7	57.1	-428.7
.2	16.6	-111.3	125.0	536.6	71.1	-117.9
.3	15.5	-171.3	116.0	460.1	64.1	23.0
.4	9.9	-214.8	72.0	96.2	30.9	343.3
1982.1	16.3	-1743.0	71.5	130.6	34.2	-319.3
.2	6.0	1205.3	57.1	75.9	13.8	128.0
.3	4.0	-245.4	46.9	104.6	4.4	288.4
.4	4.8	-349.2	68.3	49.4	1.7	590.2
1983.1	8.0	-138.5	53.2	15.4	5.6	832.3
.2	2.5	-220.7	79.8	1.3	-17.4	3481.1
.3	16.1	-195.5	89.9	-1.9	-38.8	2386.0
.4	48.7	-92.5	70.3	33.4	-38.1	207.6
1984.1	45.4	-77.1	62.0	48.3	-87.5	259.5
.2	68.6	-78.6	74.9	56.5	-47.2	145.1
.3	62.5	-61.0	62.4	6.2	14.2	94.7
.4	20.6	-48.4	36.1	-37.7	-42.6	76.5
1985.1	22.9	-56.7	42.7	-11.2	137.9	69.2
.2	16.7	5.3	2.5	-27.9	-58.9	18.1
.3	13.8	-28.2	23.2	20.8	-53.2	35.2
.4	13.6	-63.7	44.0	109.4	24.3	37.6

Source: Central Bank of the Philippines

'blocked credits' with the Central Bank. In this way, while the balance sheets of the affected financial enterprises were not impaired, the financial system was also rendered incapable of utilizing these resources. A 'blocked credit' was a balance with (an obligation of) the Central Bank.

The other intervention of the Central Bank turned to be the more powerful and destructive. This was the sale of Central Bank bills at interest rates that peaked at 43 percent in October 1984. In the nature of these bills, locally known as 'Jobo Bills '<13>, their rate became the interest on 'fully secured' loans. These bills had maturities as short as thirty days; the longest maturity sold was for 270 days.

In conjunction with this strategy which was tantamount to the Central Bank directly borrowing from the financial system, the so-called reverse repurchase agreements also.became a key financial instrument. The 'reverse repurchase agreement' was applied to maturing Central Bank obligations. On the maturity of such obligations the Central Bank would have had to repurchase the obligation. The reversal of this repurchase was tantamount to rolling over the obligation at a new interest rate.

The strategy turned into a full scale attack on the financial system as the private banks were beseiged by preterminations of time deposits by depositors seeking to transfer their assets into Central Bank instruments. Small thrift banks and the largest savings bank in the country failed. A World Bank estimate has the total real deposits falling by 29.2 percent and total real loans outstanding falling by 53.8 percent for the commercial banking system in two years between 1983 and

1985. In the two years between 1982 and 1984, M2 as a fraction of GNP declined from 23.5 percent to 20.4.

Manufacturing operations shut down or scaled down as the opportunity cost of financing working capital became prohibitive, compared to the return available on a fully secured Central Bank bill or a Treasury bill. Capacity utilization ratios of 40 percent in many of the mainline industries, such as appliance manufacturing, became typical well into the year 1986. Commercial bank loans with maturities lasting over a year disappeared. The yearend nominal value of loans outstanding of the commercial banking system to the manufacturing sector fell by 9.2 percent in 1984 and by 31.9 percent in 1985. The decline in real value terms of these variables would be much more in view of the 50 percent 1984 inflation rate.

Even the agriculture sector was not spared from the withdrawal of credit. The outstanding loans of commercial banks to agriculture in nominal terms fell by 35.9 percent in 1984 and by 0.3 percent in 1985.

As net external financing to the national government fell and the Central Bank was compelled to reduce the growth rate of reserve money under the IMF program, the government had to increase its borrowing from the private sector even while its deficit was falling from 4.3 percent of GNP in 1982 to 1.8 percent in 1984. Between December 1983 and December 1985, the growth rate of the stock of government securities held by the private sector exceeded 50 percent per year.

While the national government was appearing to successfully

approximate the public sector borrowing requirement targets that had been set in the adjustment program, the Central Bank was effectively taking up the deficit burden through its sales of CB bills at very high interest rates. Table 2.5 provides a summary of the whole deficit, in percent to GNP that might be attributed to the whole government sector for the years 1983-1985.

The overall government deficit actually increased in 1984 from 8.2 percent of GNP to 8.3 percent (Table 2.5). This occurred inspite of the slight drop in the national government deficit and the large drop in the deficit of the large government corporations. It was the Central Bank whose deficit actually exceeded the public sector borrowing requirement, which took up the slack. Its deficit of 5.2 percent of GNP in 1984 was mostly traced to losses incurred from the interest payments on the CB Bills that it had floated in that year to reduce monetary base and liquidity.

In 1985, the public sector borrowing requirement was actually just as large as the Central Bank deficit (Table 2.5). In 1985, it was the deficits of the government financial institutions that almost doubled from 1.6 percent to 3.1 percent of GNP. These deficits could only have meant that private sector resources were being withdrawn to service the requirements of the government and its need to meet IMF program targets. The year 1985 was a particularly difficult year since in that year no net foreign savings was received.

The immediate effect of the strategy was the steep rise in nominal domestic interest rates (Table 2.6) accompanying the huge shift of financial resources from the private sector to the

Table 2.5

CONSOLIDATED GOVERNMENT SECTOR DEFICIT
(as Percent of GNP)

	1983	1984	1985
National government deficit	-1.95	-1.86	-1.88
Monitored[1] corporations deficit	-3.53	-2.20	-1.36
National government transfers to monitored corporations	1.32	1.08	0.61
Public sector borrowing requirement	-4.16	-2.98	-2.64
Deficit of government financial institutions (GFI)	-1.40	-1.62	-3.11
Net income of Central Bank	-3.64	-5.24	-2.61
Others[2]	0.16	-0.04	0.15
National government transfers to GFIs and other corporations	0.82	1.58	2.10
Consolidated public sector deficit	-8.22	-8.30	-6.11

[1] "Monitored" under the IMF adjustment program.

[2] Including other nonfinancial government institutions, local government, and the social security system.

Table 2.6

Interest rates, Inflation, and Wage Rates
(Annual Growth Rates)

Quarter	91-day T-bill	90-day MLA REF rate	CPI Inflation	Real Wage	Nominal Wage
1983.1	14.044	14.717	6.3	-6.3	0.000
1983.2	13.861	14.589	7.3	-7.3	0.000
1983.3	14.021	15.129	9.2	-9.1	0.061
1983.4	14.902	16.266	26.1	-26.0	0.133
1984.1	16.392	17.434	39.3	-39.2	0.079
1984.2	18.260	19.016	49.2	-49.1	0.091
1984.3	35.301	24.643	63.6	-63.5	0.131
1984.4	42.189	36.005	50.8	-50.7	0.065
1985.1	32.048	26.653	39.8	-39.8	0.031
1985.2	34.074	24.759	27.7	-27.7	0.000
1985.3	25.643	19.831	12.7	-12.7	0.000
1985.4	16.898	13.857	5.7	-5.7	0.000
1986.1	23.894	15.625	-	-	0.000
1986.2	16.255	14.562	1.1	-1.1	0.000
1986.3	13.974	11.000	-1.4	1.4	0.000
1986.4	-	-	-	-	-

government and the Central Bank.

The monetarist strategy worked as powerfully as its supporters claim it could work. The speculation against the currency was brought to a full stop.

The tightness of credit induced a contraction in the economy that 'solved' the external financing problem. The most telling evidence that the domestic macroeconomic management was more restrictive than might have been necessary is the fact that by yearend 1985, $1.74 billion of the $3.0 billion trade credit that had been arranged under the IMF program remained unused.

The effect of the monetarist program was certainly an adjustment, especially in the current account. The path to the adjustment, however, involved (1) a shooting up of inflation from 8 percent before the crisis to a peak of 63 percent before it was controlled and, notwithstanding the induced inflation, (2) a fall in real output of 6.8 percent in 1984 and 3.8 percent in 1985.

The first effect, inflation, drastically reduced income levels for almost all the population (except for those who had the liquidity to move into Central Bank and Treasury bills). This precipitous fall in real income plus the disappearance of credit even for exports induced the fall in income and output.

The rapid fall in income levels, in turn, wiped out domestic demand which later solved the inflation problem itself.

Table 2.7 attempts to depict the drastic fall in economic activity and income in the tight credit regime of 1984. In this table only data, used by the planning office for monitoring purposes, from 200 largest corporations are shown so that it

Table 2.7
Annualized Monthly Growth Rates of
Value of Production, Employment,
Consumer & Wholesale Prices

	Prodn Value	Compen-sation	Employ-ment	CPI	WPI	Prodn Value -WPI
1983	17.2	8.4	-2.8	10.9	18.0	-0.8
1	4.1	8.4	-5.5	4.7	10.5	-6.4
2	13.6	3.5	-6.0	6.5	11.6	2.0
3	16.9	3.0	-8.1	6.3	9.7	7.2
4	12.5	5.8	-2.3	6.2	9.7	2.8
5	15.4	6.6	-1.4	6.0	9.5	5.9
6	19.0	6.0	-1.4	7.5	10.9	8.1
7	12.8	5.4	-0.9	8.4	14.3	-1.5
8	18.3	10.9	-1.5	8.7	14.2	4.1
9	25.3	10.3	-0.8	8.7	13.4	11.9
10	24.5	12.0	-1.6	11.7	23.3	1.2
11	19.2	11.1	-1.8	22.4	34.9	-15.7
12	25.1	18.0	-2.3	32.3	50.4	-25.3
1984	41.8	25.2	-5.5	49.2	66.6	-24.8
1	37.8	17.2	-2.9	37.5	52.7	-14.9
2	39.2	20.7	-2.2	40.0	54.3	-15.1
3	28.3	17.8	-2.9	40.6	54.0	-25.7
4	37.9	18.2	-4.1	40.7	55.9	-18.0
5	44.5	20.3	-6.0	43.3	60.4	-15.9
6	43.4	24.2	-8.3	52.5	76.9	-33.5
7	57.4	35.6	-8.0	58.3	78.3	-20.9
8	44.8	29.7	-6.0	60.5	78.1	-33.3
9	40.4	27.8	-7.5	62.9	86.8	-46.4
10	54.1	27.9	-6.1	58.9	79.9	-25.8
11	42.9	32.5	-5.7	51.6	68.3	-25.4
12	31.3	30.2	-6.5	42.9	52.4	-21.1
1985						
1	18.3	36.4	-3.8	37.5	46.0	-27.7
2	8.7	25.3	-6.4	34.9	41.7	-33.0
3	12.9	27.5	-7.1	34.6	42.6	-29.7
4	17.8	24.0	-11.2	32.9	39.3	-21.5
5	6.4	29.5	-7.8	30.9	33.4	-27.0
6	-2.5	20.3	-7.3	22.2	18.1	-20.6
7	-9.3	9.9	-7.1	16.8	13.1	-22.4
8	-3.4	9.0	-8.7	13.6	9.9	-13.3
9	-1.0	14.2	-8.0	11.5	5.2	-6.2
10	-6.5	13.2	-9.2	12.2	1.0	-7.5
11	-1.3	12.0	-10.1	10.8	-1.1	-0.2

Source:
PIDS Monograph no.8
Phil. Development, third Quarter 1986

hides the larger adjustments that were carried out in smaller enterprises. The level of employment which had already been falling in 1983, fell by as high as 8 percent in June and July, 1984 for these large companies. The rate of decline of employment levels peaked at 11 percent in May 1985.

The last column of Table 2.7 subtracts the rate of growth of the wholesale price index from the value of production as a measure of real output declines in these top 200 corporations. In October 1984, the rate of decline in real output of these companies peaked at 46 percent. For all the months in 1984 and 1985, there was a consistent fall in real output from the same month in the previous year.

2.3 Supply Side Adjustment Policies

To do a just evaluation of the IMF program we must discuss the other interventions that were part of the adjustment package that were directly related to the demand substitution and the supply side aspects of the program.

First, let us discuss the foreign trade and foreign exchange aspect of the program. In 23 June 1983, the government devalued the peso by 7.8 percent, to P11 to $1. The government seemed determined to defend this rate for the rest of the year, until the Aquino assassination occurred. On 5 October 1983, it was forced to devalue to P14 to $1.

The initial response of the Marcos regime to the onset of the crisis in 1983 was to attempt to ration foreign exchange. In November 1983, the government created foreign exchange pool for priority import payments by requiring all banks to surrender 100

percent of their foreign exchange receipts; this requirement was reduced to 80 percent in June 1984. The government set priorities in the allocation of foreign exchange to crude oil imports, raw materials, supplies, inputs of export products, essential grain imports, and raw materials for 'vital' domestic industries. The government also imposed ceilings for payments and new import letters of credit.<14>

On 6 June 1984, the government was forced to devalue again to P18 to $1. In preparation for the IMF agreement in December 1984, the government abolished the foreign exchange priority program in 15 December 1984 and gradually permitted private banks to keep an increasing percentage of their foreign exchange receipts.

It was in the nature of the authoritarian regime that just as it was officially liberalizing the foreign exchange market, it had managed to impose its will on the foreign exchange blackmarket. This was carried out reportedly under the supervision of the former trade and industry minister, who is now facing tax evasion charges in connection with the operation under the new Aquino government. The government guaranteed to the large traders the wherewithal with which to ship the foreign exchange out to Hong Kong.<15>

In exchange, the government dominated the determination of the exchange rate. A January 1987 investigation has revealed that five government corporations under the control of the ministry of trade and industry experienced huge losses in connection with the operation to control the foreign exchange blackmarket.

As part of its revenue raising efforts (since trade taxes are relatively easy to collect), new trade taxes were imposed in the beginning of the crisis. An additional ad valorem duty on imports which started at 3 percent and peaked at 10 percent by June 1984 was imposed. The additional import duty alone accounted for the P2.6 billion out of P6.9 billion, 38 percent and the largest, additional tax measures in 1984.

Additional export duties were imposed on exports the greatest of which was an economic stabilization tax of 30 percent in addition to existing export duties in June 1984. A foreign exchange transaction tax of 1 percent was imposed on 15 October 1984, just as the governm ıt was ostensibly freeing the foreign exchange market.

The export taxes were later suspended in preparation for the IMF agreement at the end of December.

Thus, as the crisis was beginning and devaluations became unavoidable, the government was actually increasing the ad valorem tax rates on imports and exports and engineering a redistribution of income from the private sector to the government. Krugman and Taylor [1978] have earlier illustrated the contractionary influence of devaluation with ad valorem trade taxes.

As the data will show in the next section, devaluations sparked an unprecedented inflationary process at the start of the crisis. This prevented real devaluation from taking place. In addition, the government's import control program provided additional impetus for import speculation, which fueled inflation even more. On top of this, the additional import taxes were being

passed on directly to local consumers.

It is difficult to defend the position that the nominal devaluations had gone any distance to reduce the overvaluation that had characterized trade policy before the crisis. Because of the import surcharges and the inflation at the beginning, it was only until June 1984 that the devaluation was some, though slight, advantage to exports and import substitutes. At this point, there was a 50.9 percent net effective change in the exchange rate while the GDP deflator had changed by 46.7 percent and the compensation rate index had changed by 23.4 percent.

In 1985, with the IMF support well in hand, the exchange rate actually appreciated in real terms. In an oligopolistic market setting, devaluation plus import controls is inflationary; but appreciation of the currency will not be deflationary. The deceleration of inflation in 1985 was mostly induced by the deep internal recession and helped by the slow recovery of output.

The adjustment period also saw many changes in the price control programs of the government. At the end of the program, the price control programs on basic commodities had been eliminated.

The authoritarian government characteristically had a significant program of socialized pricing. Thirteen 'basic' commodities, including rice, chicken, eggs, and milk were subject to price ceilings. In addition, prices of petroleum products were regulated.

The initial response of the government to the inflation was to attempt to aggressively revise price ceilings on basic

commodities. The pressures to revise ceilings were coming from suppliers, who would withdraw supply in response to delays in price increases, and the pressures were irresistable after each peso devaluation. As we noted in Section 1, rice and corn prices had to be immediately adjusted to devaluation because peso fertilizer prices went up in response.

Finally, in October 1984, also in preparation for the IMF program the government removed all price controls except for rice. The rice ceiling was removed in anticipation of the rice harvest in 1985. The removal of the price control program on basic commodities did not induce further inflationary pressures in 1985 because of the depressed state of demand and employment in that year.

As we showed in Section 1, the peso prices of petroleum products have an immediate and large scale effect on domestic inflation. The increases in peso oil prices in the period up to end of 1984 were due to the devaluations and the import surcharges that the government imposed in an effort to raise tax revenue. About 39 percent of the gasoline price, for example, was contributed by government tax and price stabilization interventions. Between July 1983 and December 1984, the average peso price of petroleum products increased by 129.7 percent.

In 1985, even as world crude prices were beginning to soften, the peso price of petroleum products remained constant. In fact, it was in 1985 when the shift of taxation on petroleum products to ad valorem basis provided new revenue in the amount of P2.1 billion. Thus, because of fiscal considerations, the government, operating as any domestic oligopolist and justified

by the objective to studiously attain the goals of the IMF program then in its first year of official operation, did not pass on the effect of a steadier exchange rate and lower world prices to domestic petroleum prices. A passing on of lower oil prices would have had a non-inflationary reflationary effect in 1985.

As part of the IMF program, government administered prices were increased. The utility programs of the government were its most significant foreign borrowers and there was a long term need to improve the internal cash generation of these utilities. The price increases that had been implemented in the program were however more directly related to increases in petroleum and other costs induced by the devaluation. Average water tariff rates were increased by 50 percent, while average power tariff rose by 64 percent in the period. The government did start a long term program to reduce the electric tariff subsidy to small users but did not make significant headway because of an abrupt adjustment would have caused large price increases for poor urban users.

We can say that the positive aspect of these changes in the price control program is that the government had finally, by force of circumstances, shed off its obligation to control the prices of basic commodities.

With respect to petroleum and utility prices, the interventions here were inflationary and, because of circumstances, did not result in a better set of relative prices.

In the case of wages, the government increased minimum wages three times in 1984, by a total of 77 percent in nominal terms

between the end of 1983 and the end of 1984. By November 1984, because of the inflation, the real minimum wage in 1978 prices had fallen slightly from P17.78 per day in December 1983 to P17.13 in Manila.<16>

In normal times, minimum wages apply only to the formal private sector, which would include no more than 15 percent of the employed labor force. The degree of compliance has been poor. Based on inspections, and inspections are not evenly carried out, 9 percent of establishments were found violating minimum wage legislation between 1976 and 1979. To compound the problem, the labor ministry approved 57 percent of 340 applications for exemption from minimum wage legislation on the ground that the crisis had made these companies distressed.

In the financial sector, the Philippines has had a long history of anti-usury ceilings on interest rates. A financial liberalization program that began in July 1981 when interest rate ceilings were lifted on all types of deposits and loans, except for short-term loans. Interest rate ceilings on short-term loans were lifted in January 1983. Thus, as far as the appearance of 'liberalization' was concerned the government had undertaken significant steps.

However, the very same liberalization program was biased towards bigness, a feature that had been suggested by the World Bank design team itself. The program involved increases in minimum capital requirements, justified as permitting banks to exploit economies or scale (a rather dubious proposition) and to provide banks with a larger base for intermediation into long term lending. It was also a feature that specialization of

financial functions would be sacrificed in favor of large 'universal banks' that could internalize the intermediation process.

The financial liberalization program was also accompanied by the quantum leap in rediscounting activities of the Central Bank. Rediscounts were made available for many different types of projects: sugar trading, small and medium scale industries, metal financing, manpower exporting, coconut milling, and so on. Between 1981 and 1984, the amount of rediscounting the commercial banks achieved was more than twice the amount in the previous ten years.

The overall effect of the liberalization program was a more pronounced oligopolistic structure (and a more irresistable constituency against free entry) and, before the start of the crisis, minimal increases in the deposit rate. Loan rates did not seem to be materially affected since even before liberalization, banks had been quite agile in charging going interest rates by tacking on service charges to loan agreements.

At the start of the crisis, the Central Bank was forced by circumstances to shut down its extensive rediscounting operations and concentrate its rediscountring resources to vital projects. In January 1984, the Central Bank finally achieved the situation in which the rate on rediscounting was based on the current cost of credit.

The financial crisis that began in 1981 and exacerbated by the adjustment program left six major banks under the control of the government. In some of these banks, government deposits are

being maintained to keep their operations; in others loans had been converted into equity. These problems have exacerbated the national government's demand for financing.

Thus the adjustment period had the positive effect of dismantling the byzantine rediscounting operation of the Central Bank. Because of the high interest rates in 1984, deposit rates for small depositors had finally increased to as high as 15 percent as commercial banks were forced to defend themselves from withdrawals by depositors attempting to move into Central Bank bills.

The negative effects of a weaker and more oligopolistic financial sector have been more pronounced. The real sector of the Philippine economy is still trying to extricate itself from the rise in the intermediation spread, which for large commercial banks was in the range of 7 to 8 percent in 1985, that was induced by the crisis, even as nominal interest rates on secured loans fell to the 13 percent in 1986.

In many of the relative price issues we have discussed above, the problem of government financing had swamped efforts to address supply side issues in the adjustment. Table 2.8 reproduces the government revenue program in the crisis. In 1984, 26 percent of tax revenue came from income/wealth taxes, 33.5 percent from trade taxes, and 33.3 percent from excise and sales taxes. There is a pressing need to carry out long term reforms to reduce the reliance of the tax system on trade and sales taxes.

In the nature of the situation, however, income and wealth taxes are the most difficult to raise in the short period of an adjustment. An examination of Table 2.8 shows that while this

Table 2.8

GOVERNMENT REVENUE PROGRAM

	1983	1984	1985
1. Increase in specific tax on petroleum products based on July 1983 to June 1984 measures	90.6	753.7	
2. Additional export duty	44.9	433.0	
3. Economic stabilization tax		282.0	
4. Additional import duty	1,732.9	2,635.5	3,298.0
5. Increase in specific tax on alcoholic beverages		276.0	655.0
6. Increase in specific tax on distilled spirits			111.0
7. Imposition of ad valorem tax on fermented liquors		100.0	1,034.0
8. Increase in percentage tax on services			515.0
9. Increase in documentary stamp tax		100.0	640.0
10. 1 percent tax on foreign exchange		450.0	2,900.0
11. Removal of exemptions on interest income		294.0	2,014.0
12. Shifting of some elements of specific tax to an ad valorem basis on petroleum products		209.0	2,131.0
13. Increase in ad valorem tax on domestic crude oil		107.0	209.0
14. Increase in specific tax on imported coal and coke		16.0	16.0
15. Rationalization of customs duties on corn, coal and coke		31.0	36.0
16. Imposition of ad valorem tax on cigarettes and increase in specific tax on the same		250.0	881.0
17. Increase in tax rates on private motor vehicles		45.0	457.0
18. Increase in airport passenger fees		30.0	150.0
19. Withdrawal of tax exemptions on government corporations		383.0	1,100.0
20. Withdrawal of preferential tax treatment of certain business enterprises		200.0	1,590.0
21. Change in inventory valuation procedures		40.0	120.0
22. Improvement in sales tax administration		100.0	
Total	1,868.4	6,935.2	17,857.0

program had been worked out with the IMF and while we have to admit that the IMF recognizes the need for long term tax reform, these reforms could not be carried out in the adjustment.

In fact, the tax program is extremely regressive for the basic reason that regressive taxes are easiest to impose politically (even, it turns out, in a dictatorship) and the easiest to collect. For example, a tax on interest income of 17 percent penalized heavily small depositors whose income tax rates would typically not exceed ten percent; however, the tax was easily collectible from the banking system. As Table 2.8 shows, taxing all interest income at a fixed rate provided a revenue increase of P2.0 billion in 1985 alone.

An example of a failed attempt to rely more heavily on income and wealth taxes was the proposal by the government in 1984 to change the assessment basis for the real estate tax from 1978 values to 1984 values. The middle class successfully resisted this proposed tax. The new Aquino government announced the same - 1984 basis - policy at the end of 1986 and found itself in January 1987 having to suspend its implementation.

3.0 Impact of Adjustment Measures

We now discuss the results of the adjustment measures undertaken by the Marcos government on the Philippine economy.

3.1 The Path of Adjustment

Data in Tables 3.1 and 3.2 provide the levels of important variables in the recent adjustment. These data, converted to annual growth rates, form basis for the graphs on which the subsequent discussion is based.

The crisis began in the third quarter of 1983 when GNP was growing at 1.8 percent per year (see Chart 1 for the graph of GDP and GNP growth rates). GNP growth rate plunges to almost 12 percent per year in the third quarter of 1984. Real GNP growth rate remains negative until the first quarter of 1986. It plunges again in the second quarter of 1986 with the change in government. The actual IMF adjustment program begins in the first quarter of 1985, but the recovery to positive growth shows a decided recovery even before this. GDP growth rate is negative until the third quarter of 1986.

The rates of growth of total investment are depicted in Chart 2. Under the monetarist program, real investment spending has been declining consistently since the third quarter of 1983. Private construction spending has been pacing the fall in investment (Chart 3) with declines of over 30 percent per year in

Table 3.1
Prices and Monetary Variables

Year.Month	Consumer Price Index (1972=100)	Exchange Rate (Pesos per US Dollar)	Interest on 91 Day Treasury Bills	Money Supply (P Million)	Total Liquidity (M3) (P Million)	Money Multiplier (Liquidity/ Money Supply)
1982.01	353.0	8.2542	13.036	21424	80896	3.77597
1982.02	355.5	8.2830	13.378	21721	82295	3.78875
1982.03	357.2	8.3405	13.579	22330	85493	3.82857
1982.04	359.5	8.3792	13.591	22614	85783	3.79341
1982.05	360.5	8.4161	13.980	22990	87189	3.79244
1982.06	362.6	8.4502	14.014	22471	87596	3.89815
1982.07	369.1	8.4878	14.188	21313	87371	4.09944
1982.08	371.6	8.5293	13.765	21134	88308	4.17852
1982.09	373.3	8.6380	13.922	20963	89636	4.27596
1982.10	373.9	8.7664	13.935	21114	89449	4.23654
1982.11	374.5	8.8752	14.004	21259	91704	4.31370
1982.12	374.7	9.0594	14.027	23525	95298	4.05101
1983.01	377.0	9.2865	14.043	22246	94731	4.25838
1983.02	378.9	9.4644	14.047	22012	95476	4.33739
1983.03	379.8	9.6057	14.043	22165	96775	4.36614
1983.04	381.7	9.8693	14.043	22412	97418	4.34673
1983.05	384.4	10.0316	13.988	23537	98710	4.19386
1983.06	389.0	10.3553	13.561	23040	99789	4.33105
1983.07	398.3	11.0017	13.704	22690	99250	4.37414
1983.08	405.5	11.0016	14.061	23061	99548	4.31676
1983.09	407.2	11.0018	14.299	23503	100723	4.28550
1983.10	412.3	13.7016	14.577	26432	103607	3.91973
1983.11	437.6	14.0020	15.038	28306	107851	3.81014
1983.12	472.4	14.0020	15.382	32518	112962	3.47381
1984.01	502.5	14.0020	15.500	30673	112153	3.65641
1984.02	517.7	14.0020	16.400	28997	112497	3.87961
1984.03	529.2	14.0020	16.500	30176	116259	3.85270
1984.04	537.2	14.0020	16.600	31727	116248	3.66401
1984.05	546.2	14.0020	18.400	31470	114928	3.65199
1984.06	580.5	17.4020	25.400	31500	112036	3.55670
1984.07	632.5	18.0020	31.600	34950	111303	3.18464
1984.08	650.2	18.0020	33.500	33242	110349	3.31957
1984.09	666.1	18.0020	37.800	31528	108246	3.43396
1984.10	675.4	19.1482	42.000	30722	108165	3.52077
1984.11	702.7	19.9590	43.000	30796	110911	3.60147
1984.12	712.5	19.8593	42.200	33633	121215	3.60405
1985.01	730.0	18.9794	35.200	30935	122298	3.95339
1985.02	736.7	18.2557	31.000	29493	122907	4.16733
1985.03	739.7	18.4778	33.300	29632	120247	4.05801
1985.04	736.2	18.4930	34.000	29859	120496	4.03550
1985.05	737.4	18.4900	33.400	29098	118733	4.08045
1985.06	741.2	18.4650	30.600	29067	121251	4.17143
1985.07	751.4	18.6660	25.000	28393	117297	4.13119
1985.08	753.3	18.6050	19.800	28462	119826	4.21003
1985.09	750.7	18.6400	17.900	28999	123396	4.25518
1985.10	748.2	18.7550	17.000	28751	122695	4.26750
1985.11	750.1	18.7580	16.600	29347	122733	4.18213
1985.12	752.8	19.0320	16.400	35827	121152	3.38158

Table 3.2
Real Variables
(Constant 1972 Pesos)

er	Personal Consumption	Government Consumption	Gross Dom. Capital Formation	Fixed Capital Formation	Total Construction	Government Construction	Private Construction	Exports	Imports	G D P	G N P
.1	14265	2199	7237	5751	2956	1274	1682	4352	4815	24265	24157
2.2	15519	2262	6415	5875	3326	1488	1838	4585	4800	24967	24616
2.3	15741	2290	6852	6213	2980	1252	1728	4336	4980	22927	22468
2.4	18010	2394	5763	5848	3259	1345	1914	4477	4972	26820	26290
3.1	14837	2276	6981	5873	3148	1234	1914	4459	4344	25251	24838
3.2	15898	2311	7098	6426	3832	1708	2124	5090	4968	25706	25763
83.3	16087	2197	5378	5578	2423	533	1890	4819	4913	22960	22878
83.4	16256	2004	5572	5135	2545	900	1645	4317	4966	26151	25288
84.1	15021	2242	4653	4732	2968	990	1978	4621	3940	24519	23707
84.2	16073	2117	4563	4477	2817	924	1893	5048	4323	25314	24822
84.3	16241	2003	3286	3767	1929	482	1447	5482	4821	20655	20165
84.4	18698	1893	3349	3565	1732	589	1143	5695	5091	23728	23239
85.1	15144	2055	3446	3400	1986	678	1308	5088	3224	22725	21994
985.2	16088	2027	3502	3793	2432	837	1595	4880	3678	23818	23520
985.3	16240	2052	2719	3280	1842	617	1225	4823	3791	20479	19750
985.4	18690	2071	2898	2241	648	210	438	4560	3302	23422	23143
986.1	15343	2131	3261	3192	1794	879	915	5114	3634	22549	22164
986.2	16174	1976	2177	2362	948	415	533	6516	4432	23196	22679
986.3	16248	2103	2741	2861	1407	767	640	6127	4220	20660	20086
986.4	18913	2170	2507	2284	834	283	551	5846	4193	24200	23593

Chart 1

GNP and GDP growth rates

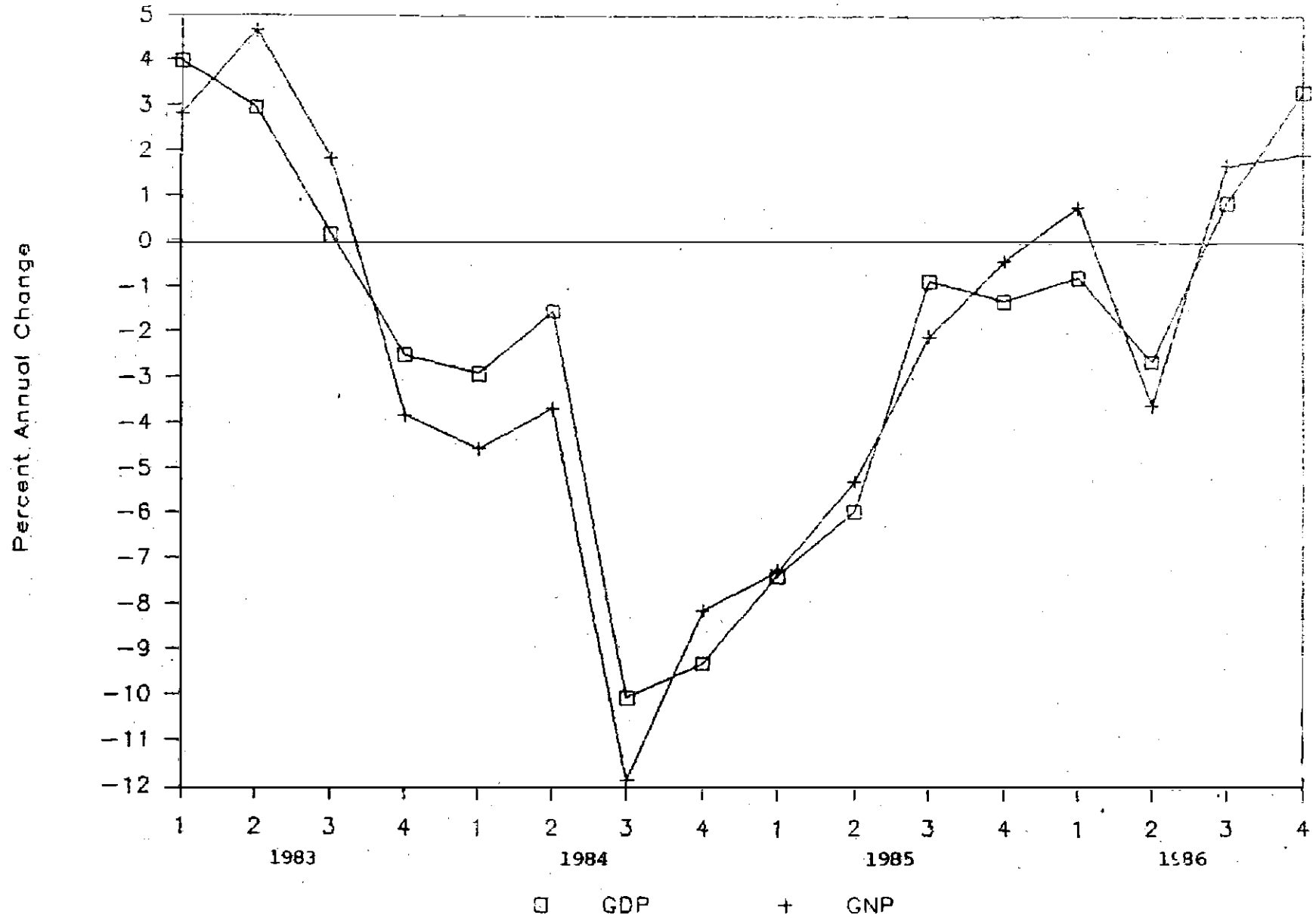
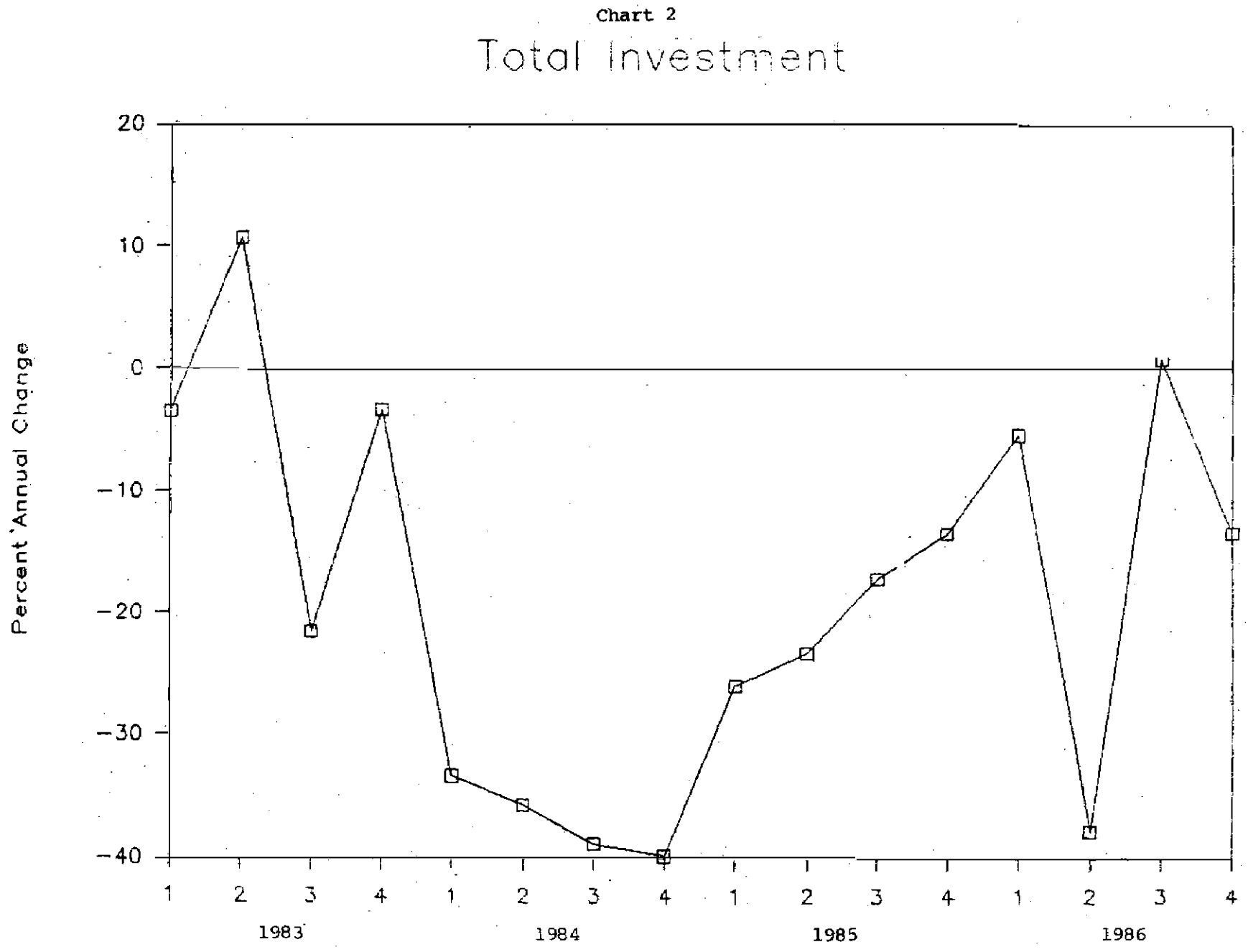
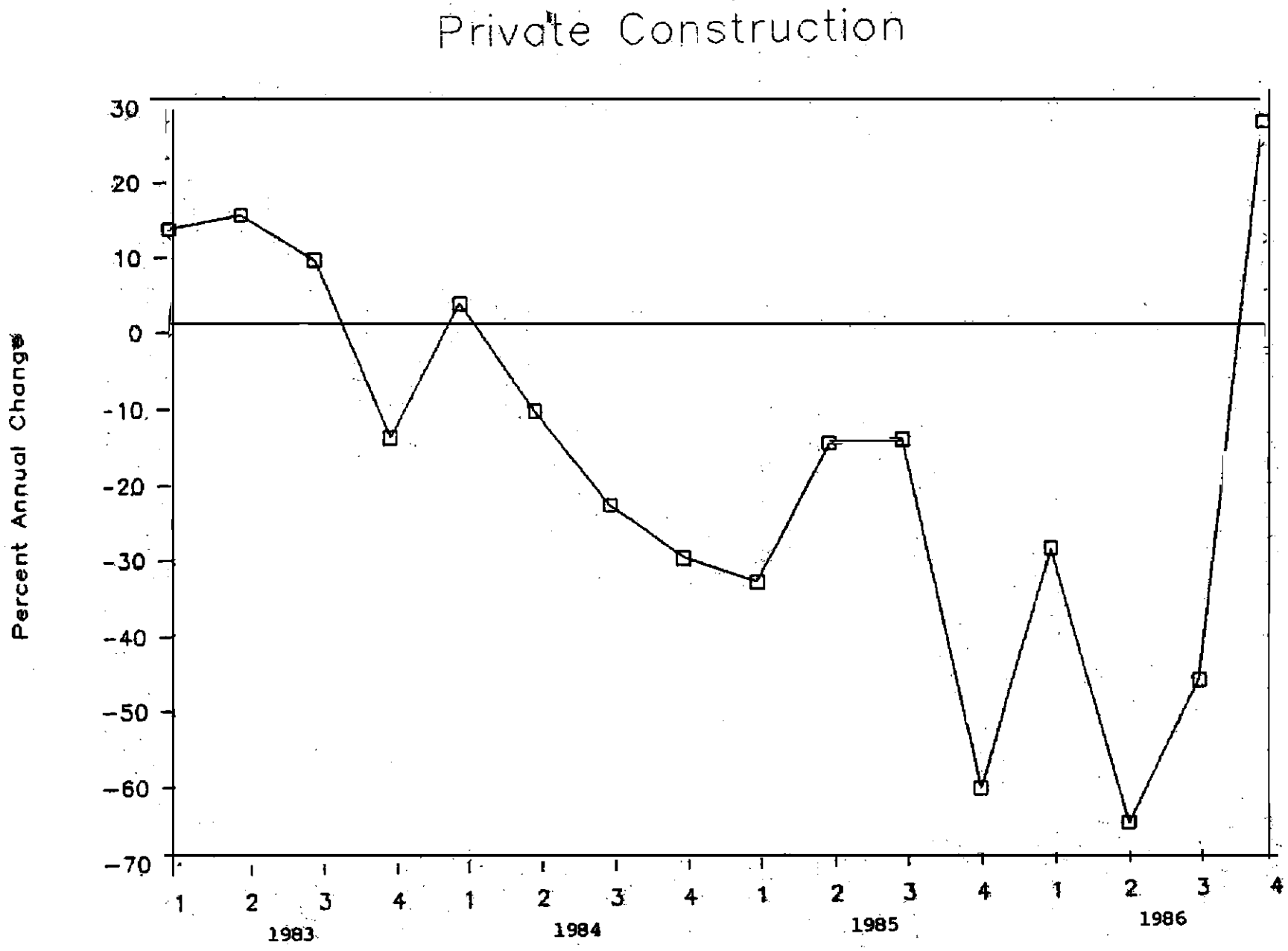


Chart 2


Total Investment
Percent Annual Change
20
10
0
-10
-20
-30
-40
1
2
3
4
1983
1984
1985
1986


Private Construction
Percent Annual Change
30
20
10
0
-10
-20
-30
-40
-50
-60
-70
1
2
3
4
1983
1984
1985
1986

1984 and over 60 percent in 1985, the first 12 months of the IMF program.

With the high cost of financing, real imports have been falling, and they fell most precipitously in 1985, the first year of the IMF program (Chart 4). Exports (Chart 5) showed a recovery in 1984 with U.S. trade deficit financed world export boom in that year, but fell deeply, to as low as minus 19.9 percent in the fourth quarter of 1985. This fall is attributable to declines in world prices of traditional products such as coconut oil, the fall in semiconductor chips exports due to the worldwide fall in demand, and the loss of export markets which began in 1984 as domestic exporters found packing costs financing to be prohibitive at the prevailing interest rates.

Before the onset of the crisis, the annual inflation rate as measured by the consumer price index was running at 7.3 percent. A look at Chart 6 reveals that during the period of the adjustment, the inflation rate shot up to a peak of 63 percent before settling back down to around 5 percent per year by the end of 1985. Thus a severe inflationary period characterized the adjustment process in the Philippines.

Chart 6 provides an indication that the exchange rate, a factor that is predicted as inflationary in both the monetarist and structuralist models had at least a simultaneous relationship with inflation during the period. The first steep rise in the inflation rate that occurred between the third and fourth quarters of 1983 coincided with the first steep (nominal)

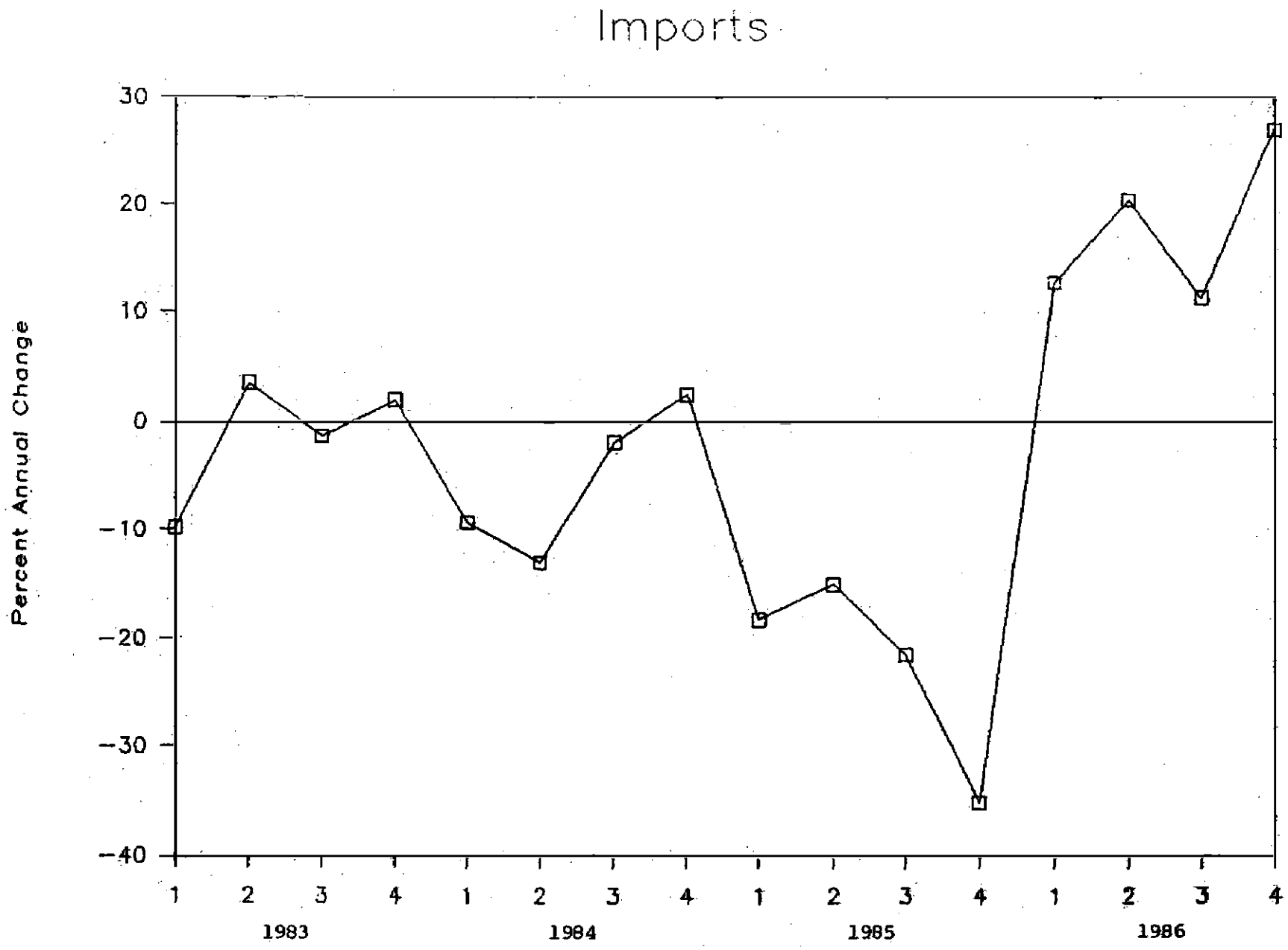

Imports
Percent Annual Change
30
20
10
0
−10
−20
−30
−40
1
2
3
4
1983
1984
1985
1986

Chart 5

Exports

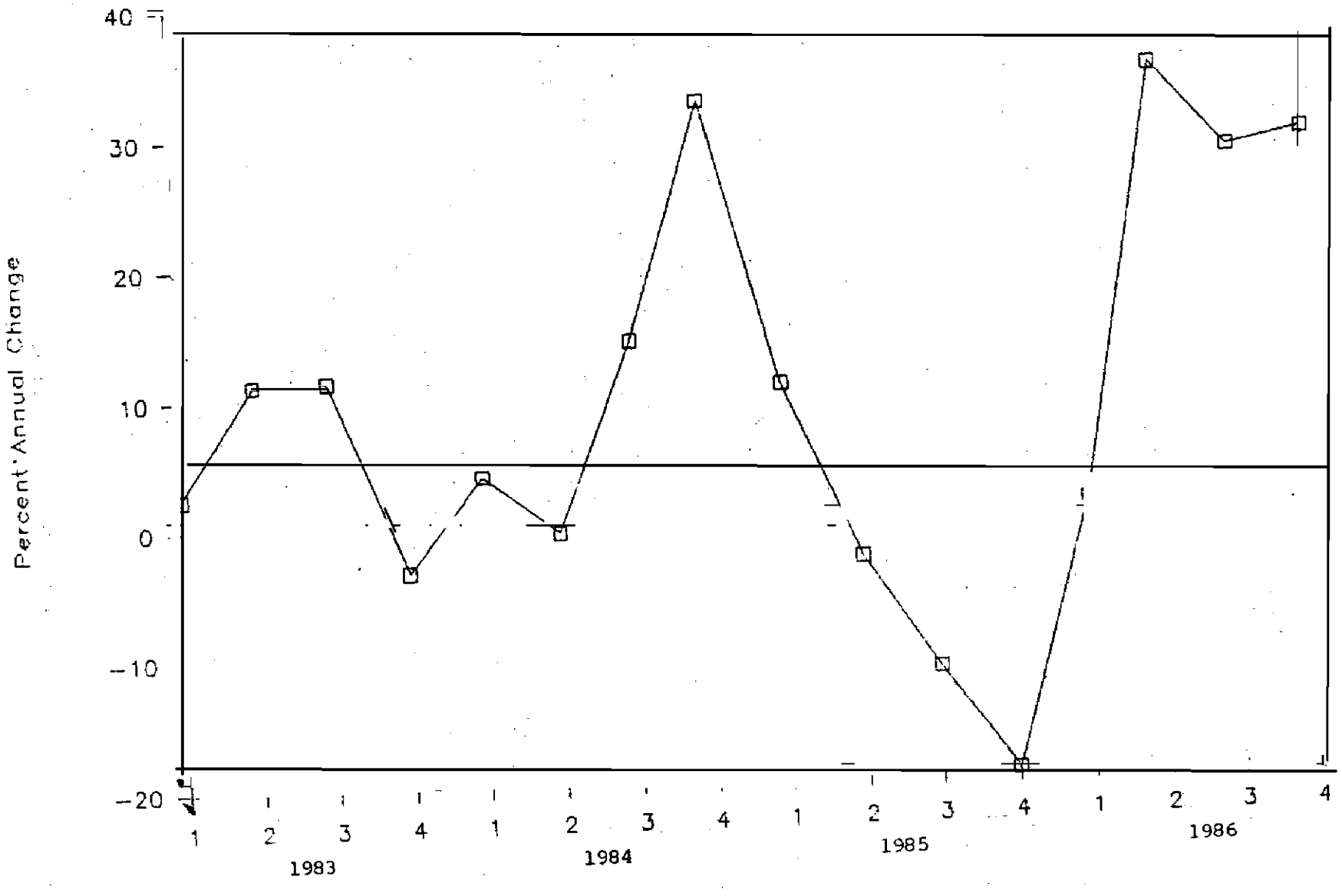


Chart 6

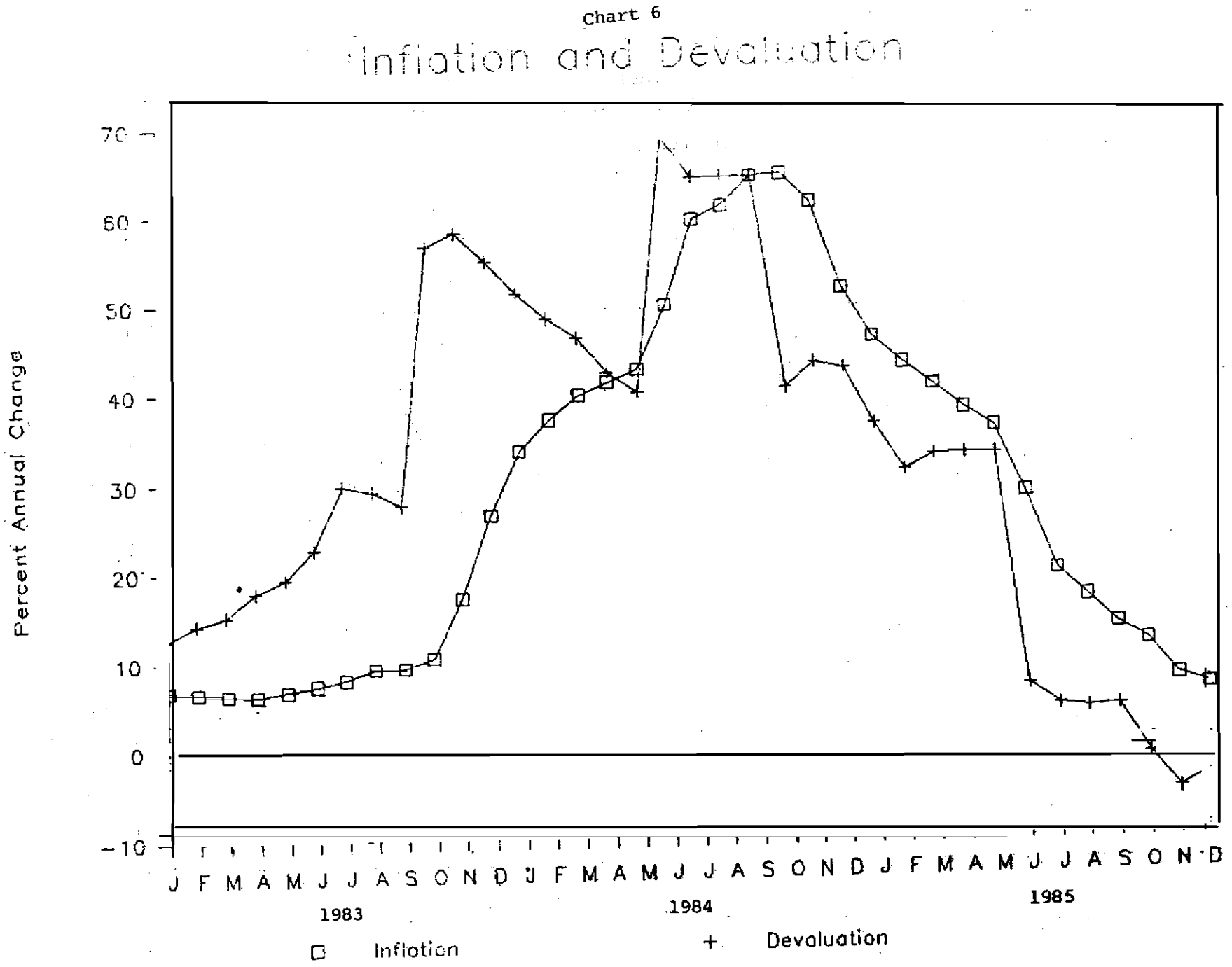

Inflation and Devaluation
Percent Annual Change
70
60
50
40
30
20
10
0
-10
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
1983
1984
1985
Inflation
Devaluation

Chart 7

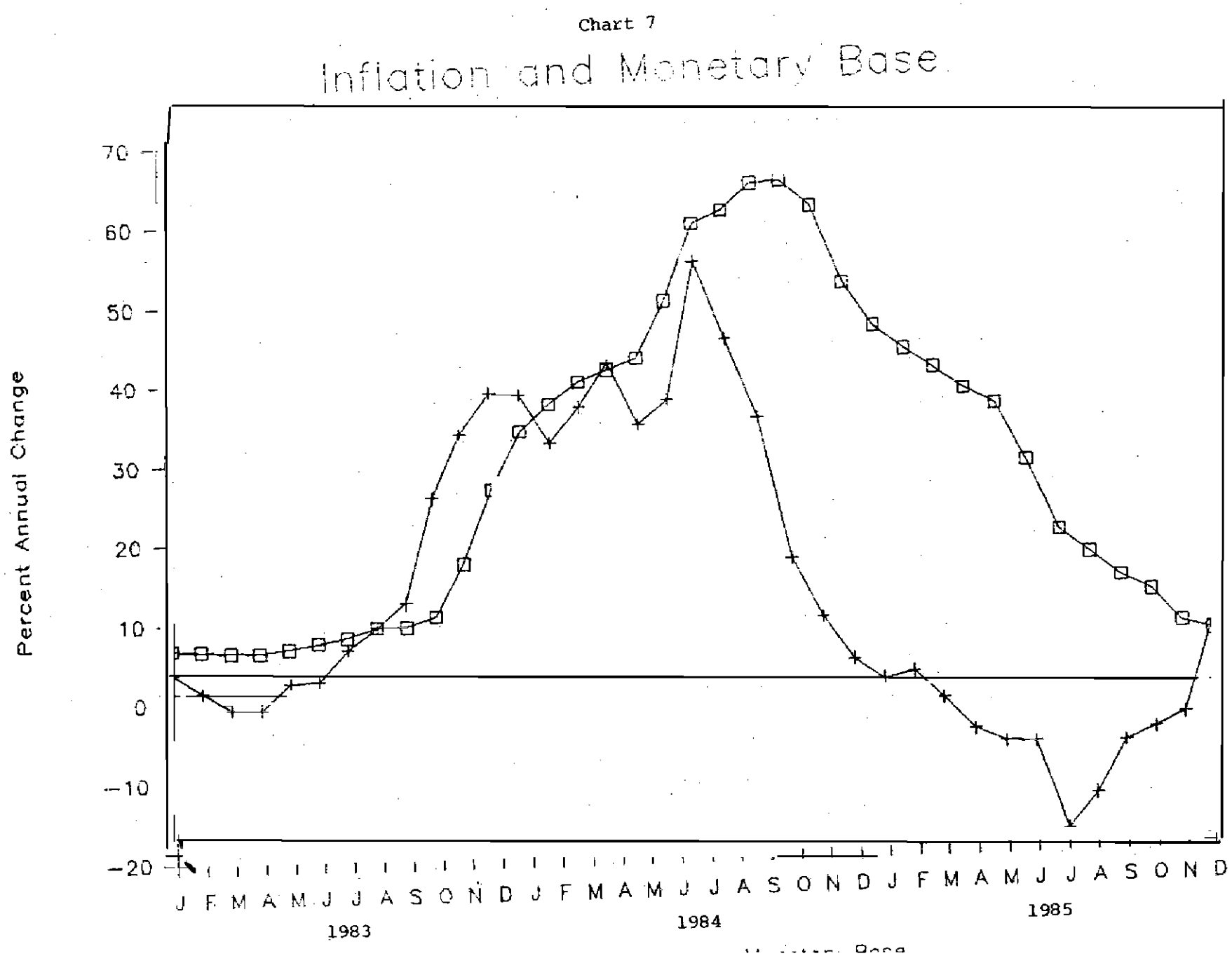

Inflation and Monetary Base
Percent Annual Change
70
60
50
40
30
20
10
0
-10
-20
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
1983
1984
1985

Chart 8

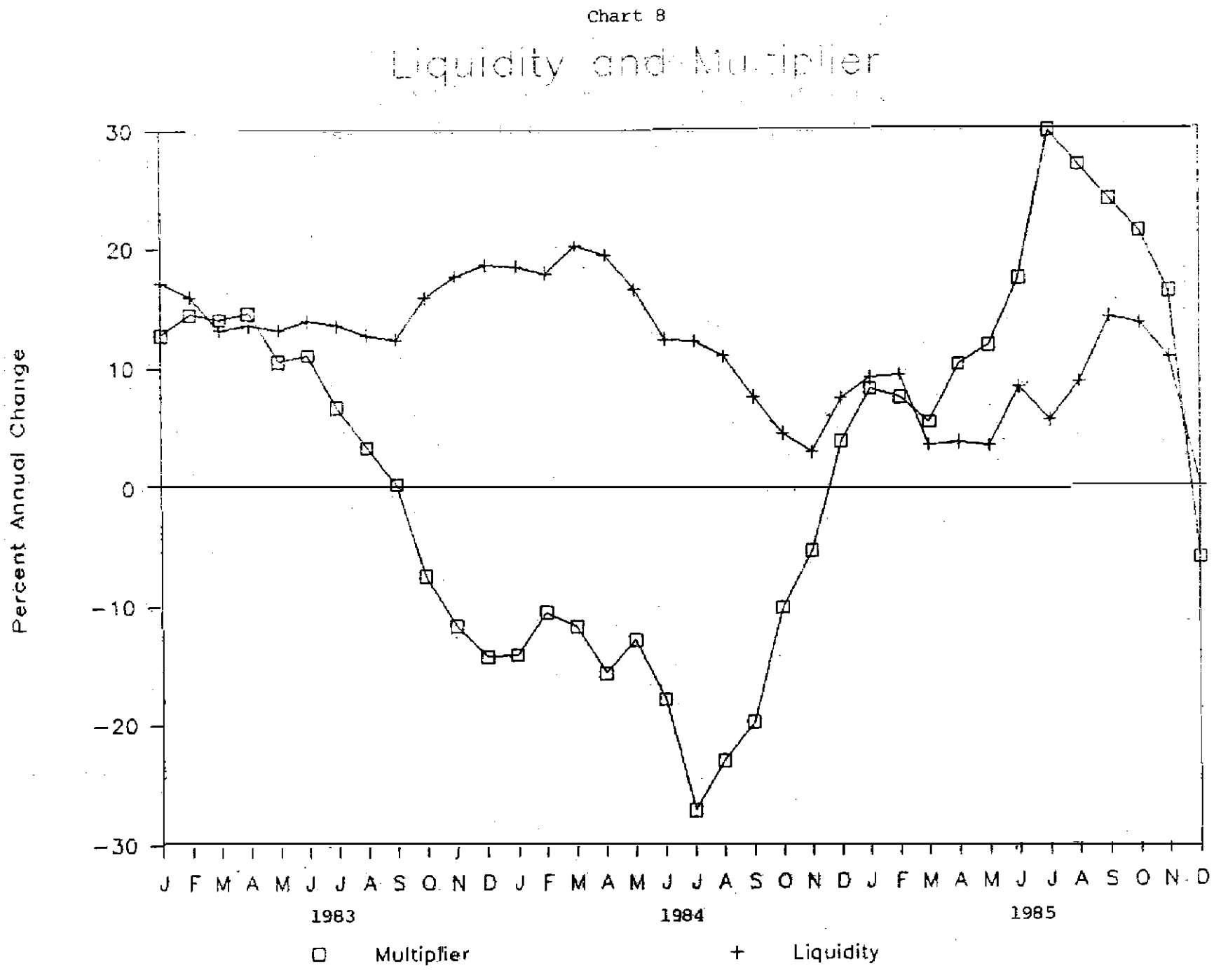

Liquidity and Multiplier
Percent Annual Change
30
20
10
0
-10
-20
-30
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
1983
1984
1985
Multiplier
Liquidity

Chart 9

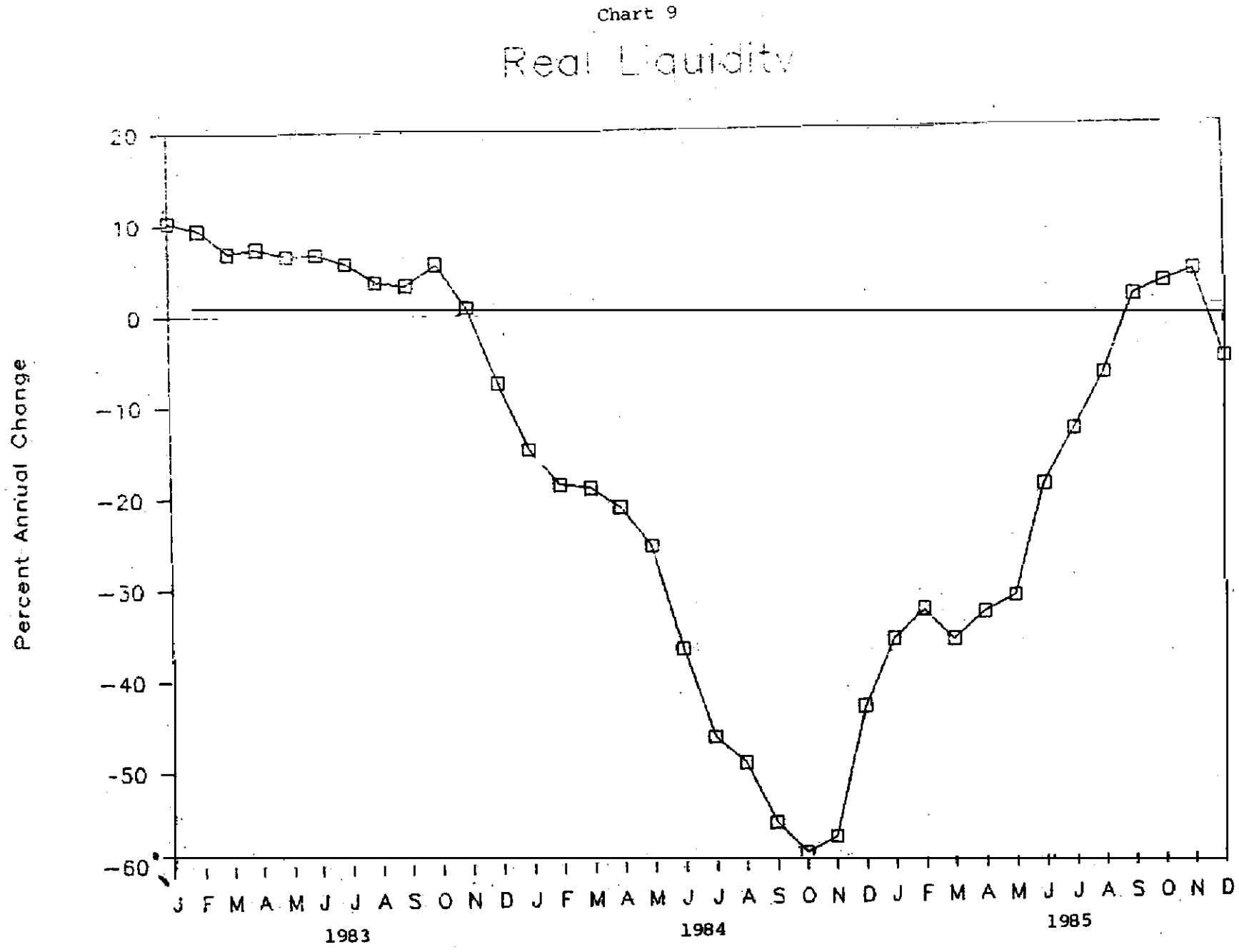
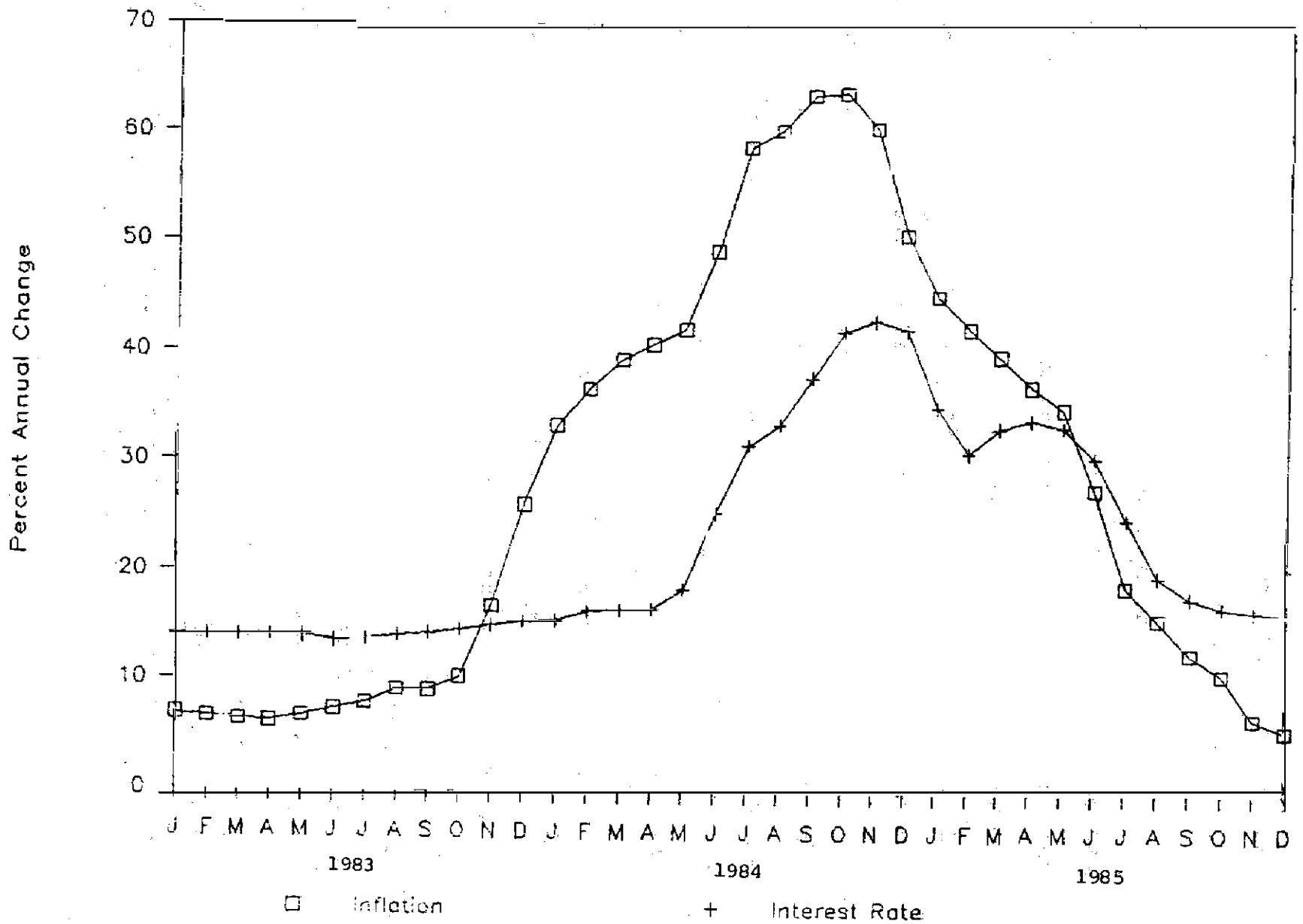

Real Liquidity
Percent Annual Change
20
10
0
-10
-20
-30
-40
-50
-60
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
1983
1984
1985

Chart 10

Inflation and Interest Rates



devaluation that occurred in the same period. A casual examination of Chart 6 shows the leading role that devaluation has played on inflation in the recent adjustment.

The important role of the monetary sector in the adjustment period is shown in Chart 7 which shows the annual growth rate in the monetary base graphed along with the inflation rate. The monetary base seems to exhibit a coincident relationship to the inflation rate until July 1984 as Philippine authorities were forced by circumstances and their imperatives for survival to finance their immediate requirements, especially in connection with the May 1984 parliamentary elections. Beyond that, the monetary base is completely consistent with either prior action commitments or with IMF program targets. In this case monetary base has a decidedly negative trend.

One of the more notable features of the recent adjustment is that reserve money does not seem to have a positive relationship with output. The explanation is found in Charts 8 and 9. It is total liquidity and the cost of credit that has a positive relationship to real economic activity. The growth rate in nominal liquidity has been falling since January 1984, inspite of the fact that monetary base had been increasing until July 1984, as noted earlier. The decline in liquidity growth had beer engineered through the drastic fall in intermediation and this is shown in Chart 8 as the drastic fall in the ratio of tota liquidity and monetary base, the 'multiplier'. Real liquidity shown in Chart 9, practically follows the pattern of real GDP

For these reasons, the recent adjustment program in the Philippines has to be called monetarist.

Chart 10 graphs the inflation rate against the rate of interest and the real GNP growth rate. In this this case the series that is graphed is the level of the interest and not changes in the level of interest. Beginning in the first quarter of 1984, the interest rate starts to mimic the inflation rate reaching a coincident peak with the inflation rate in the third quarter of 1984. On the basis of current nominal interest rate minus current consumer price index inflation rate, the real interest rate is negative from the start of the crisis until the second quarter of 1985. This development is at least consistent with the disintermediation strategy of the government.

3.2 Actual Results of Adjustment

On the basis of the most commonly used indicators, the Philippines had successfully completed a macroeconomic adjustment by the end of 1985, six months ahead of the completion of the then current IMF program.

Beginning from current account account deficits of $3.1 billion in 1982 and $2.5 billion in 1983, representing 7.9 percent and 8.1 percent of GNP in the respective years, the country had achieved by 1985 a current account surplus of $8 million. Inflation, which had peaked at 63 percent per year in 1984, had declined to 5.7 percent per year by December 1985. The Philippines had also paid off all the arrears in the servicing of

its foreign liabilities that had arisen as a result of the crisis - except for those that had been explicitly restructured in accordance to the adjustment program.

The unqualified success in achieving the balance of payments targets is shown in Table 3.3. By 1984, in one year's time, the merchandise trade deficit had been reduced from $2.5 billion to $0.6 billion, by 72 percent. Even before exceptional financing, the Philippines reduced its overall balance of payments deficit between 1983 and 1984 by 33 percent, from a $2.2 billion to $1.5 billion.

As we had pointed out earlier and as the IMF itself noted, much of the painful stabilization measures had actually been put in place in 1984 as prior action commitments.

The final success of the 'adjustment' for a program that was supposed to have ended in June 1986 is embodied in the February 1986 3.8 inflation rate and the $8 million current account surplus achieved for the year 1985. For the year 1985 the actual end-period inflation rate was 5.7 percent versus the target of 10-15 percent. The 1985 target for the current account according to Table 2.3 was a deficit of 1.1 billion dollars!

Did actual adjustment, in terms of an improvement in the current account that provides the basis for recovery, take place? The answer has to be no if one analyzes the record which I have attempted to summarize in Table 3.4.

Table 3.3
Balance of Payments
(in million $)

Item	1982	1983	1984 Before Exceptional Financing	1984 After Exceptional Financing	1985 Before Exceptional Financing	1985 After Exceptional Financing
Merchandise Trade	-2,646	-2,482	-679	-679	-482	-482
Exports	5,021	5,005	5,391	5,391	4,629	4,629
Imports	7,667	7,487	6,070	6,070	5,111	5,111
Non-Merchandise	-1,040	-740	-975	-975	111	111
Inflow	2,983	3,127	2,626	2,626	3,288	3,288
Outflow	4,023	3,867	3,601	3,601	3,177	3,177
Transfers, net	486	472	386	386	379	379
Current Account	-3,200	-2,750	-1,268	-1,268	8	8
Long-term Loans	1,548	1,347	-271	258	-784	2727
Inflow	2,533	2,336	730	1,259	670	4181
Outflow	985	989	1,001	1,001	1,454	1,454
Direct Invest, net	17	112	6	6	-9	-9
Short-term Cap, net	-263	-618	18	549	-1,526	-1,398
Errors & Omissions/ Gold Monetization/ Reval. Adjustments	277	-254	60	53	771	771
Capital Account	1,579	587	-187	1,068	-1548	2091
Unremittable arrears/ adjustments	-	-	-	-	-	698
Overall Balance	-1,621	-2,163	-1,455	-200	-1,540	2,789
Change in net Int'l Reserves	n.f.	-1,011	446	446	991	991
Decrease in non-Monetary Arrears	n.f.	-1,152	-646	-646	1,798	1,798
Exceptional Financing	n.a.	-	-1,255	-	-3,631	-
Unremittable Arrears/Adj.	n.a.	-	-	-	-698	-

n.f. = no figure available
n.a. = not applicable

Source: Central Bank of the Philippin

In the first place, export volumes consistently decreased during the two years of the adjustment. The year 1984 was a boom year for developing country exports, but value of Philippine exports grew by only 7.7 percent (against a target of 10 percent) and volumes fell by 2.6 percent. The poor export performance in 1984 is blamed by many exporters on their inability to maintain supply to their foreign customers because of the high cost of credit (which could not be compensated by the real devaluation in that year) and the uncertain political climate.

The volume decline of exports in 1985 reflects the cumulation of the strains introduced in 1984, the continued high cost of credit, and the actual appreciation of the peso in that year (last line of Table 3.4).

Actual adjustment was achieved through a fall in imports mainly in industrial inputs and capital goods. The fall in capital goods imports is reflected in the 36.7 percent and 20.7 percent fall in capital formation for 1984 and 1985 respectively while the fall in industrial inputs is reflected in the 10.9 percent and 10.5 percent fall in real industrial output in those two years.

Merchandise import value fell by 18.9 percent in 1984 and 15.5 percent in 1985 bringing about an adjustment in the current account inspite of the poor export performance. In 1985, the value of merchandise exports actually fell by 14.2 percent but nevertheless a current account surplus was achieved in that year through the fall in imports.

Table 3.4
The Adjustment: The Way and the Truth

	Change from Previous Year	
	1984	1985
Merchandise Exports		
Value (US $)	7.7	-14.2
Volume (see note 1 below)	-2.6	-4.6
Merchandise Imports		
Value (US $)	-18.9	-15.7
Volume (see note 1 below)	-31.9	-13.9
Non-oil industrial materials imports		
Value (US $)	-12.2	-15.5
Capital goods imports Value (US $)	-32.3	-31.1
Gross National Product, Real	-6.8	-3.8
Output from		
Agriculture	2.5	3.2
Industry	-10.9	-10.5
Services	-2.3	-1.0
Expenditures on		
Personal consumption	1.5	0.2
General government consumption	-6.1	-0.6
Capital formation	-36.7	-20.7
Reserve Money (End-June level)	68.5	16.8
Net foreign assets	-78.6*	5.3
Net domestic assets	74.9	2.5
Central bank credits to		
Central government	56.5	-27.9
Deposit money banks	-47.2	-58.9
Others (see note 2 below)	195.4	15.4
Reserve Money Net of Other Credits (End-June level)	-188.3	-20.4
Interest Rate on 91 day Treasury Bills	42.2	16.5
Consumer Price Index (December level)	50.8	5.7
Real Exchange Rate (Pesos per foreign currency)	21.8	-7.2

*Level in December, percentage points

The heavy reliance on monetarist adjustment, authoritarian government style, is shown in Table 3.4 as nominal reserve money net of 'blocked' other credit fell by 188.3 percent in 1984 and 20.4 percent in 1985. Even monetarists would probably consider a fall in reserve money available to the financial system as a real measure of credit tightness during the period.

At the end of the adjustment period, the exchange rate, which had been consistently overvalued in the seventies and which embodies the country's inadequate long-run adjustment, has begun to appreciate again. A reversal of this trend will be necessary to set the stage for growth.

4.0 Alternative Adjustment Strategies

Irrespective of one's political attitude, the fall of the Marcos government in the midst of an adjustment program, 13 months into an official IMF program, must be interpreted as an indirect indication of the innappropriateness of the macroeconomic strategy that it pursued.

This section discusses some possible alternative adjustment strategies that might have been pursued. These suggestions would have all the disadvantages of being made in hindsight particularly since the government to which these suggestions are being made has been consigned to the dustbin of history. It is entirely possible that the policies implemented by the fallen regime were the only actions it could have undertaken.

However, the fact that, upon its assumption of power in February 1986, the new Aquino government saw fit to retain the Central Bank governor who had had the prime responsibility for carrying the most destructive of those policies suggests to us that the lessons from that period have not been learned and there is still some value to providing some patently hypothetical suggestions to the unlamented authoritarian government at this late stage.

4.1 Political Parameters in the Adjustment Program

At this point, let us first identify the immediate constraints within which the authoritarian regime had to operate.

First, the dictatorship had to re-establish a good working relationship with the IMF and the international banks if it were not to lose the support of the government in the United States and other governments in the Western alliance.

Second, the dictatorship had to deflect public criticisms of these governments' support for the regime by carrying out and winning in open election exercises. The Aquino assassination had created a wide rift within the ruling classes. Election exercises were necessary to legitimize the regime in the eyes of the world. These election exercises were also serving the purpose of laying down the moral basis for cracking down on those members of the ruling classes which opposed the dictatorship.<17>

Third, the dictatorship had to maintain the resources of its band of supporters and maintain its capability to reward and punish materially in the face of the domestic political challenge that it faced.

4.2 Adjustments Since 1980

All the suggestions that we make here have to be evaluated in the light of these constraints.

The first suggestion that must be made with respect to the Philippine experience is that economic adjustment should have

commenced in 1980 in response to the looming domestic financial crisis that laid bare the innapropriateness of the previous investment strategy.<18> After 1980, the Philippines was basically borrowing short-term to sustain payments on medium and long term debt. Almost half the national debt was incurred between 1980 and 1983.

The dictatorship did seem to attempt to implement various programs that would normally be classified as adjustment oriented. The most important of these were the structural adjustment loans with the World Bank that combine import liberalization with financing to key manufacturing sectors, such as the the textile industry, to make these more export competitive. These programs, however, did not succeed in significantly inducing adjustment.

In the first place, the Marcos regime did not have the political capability to carry out these programs as they were intended. The country did meet the schedule of reducing the (arithmetic) average tariff rate from 43 percent in 1980 to 28 percent in 1985. In the meantime, however, the currency continued to appreciate in real terms and the program to remove quantitative restrictions was being subverted through the mechanism of increasing the participation in the import trade of government corporations and private companies operating under incentives and protection, many directly provided for by presidential decree.

Moreover, a more aggressive exchange rate stance would have induced, significant loss of the support from the ruling classes (something that eventually happened after the Aquino assassination and the subsequent election exercises). Furthermore, the removal of the quantitative restriction system would have contradicted the regime's program to enrich its allies. An import control system has the advantage that it can be directly applied to favoring some economic actors as opposed to others. In any event, what happened was that the Bretton Woods agencies did not abandon the regime in 1980 when there were more resources for an orderly adjustment but finally did so in 1983.

In the second place, the adjustment program might not have succeeded even if it had been implemented as 'designed'. The country did not have much access to foreign financing, except in the short term, to finance the investment that would have been required for such an adjustment. The investment climate was so poor the funds that had been received for the textile industry program were not even half utilized. The country's growth consistently decelerated from 1980 until the crisis struck.

3.3 A Gradual Stabilization Starting 1983

Let us now discuss some alternative strategies assuming that adjustment could only have begun in 1983. In these suggestions we assume that an overall program could have been designed and implemented, with or without the support of the Bretton Woods agencies. The following elements seem to be important.

1. As we have shown above, the government's budget deficits that had started to explode before the crisis had been principally caused by its need to finance the servicing of foreign debt that had been incurred by its financial and non-financial corporations. A solution to this problem would have been a project for which the Bretton Woods agencies would have been eminently qualified to have lent support.

A solution to this problem would have been the real key to the 1983 balance of payments crisis. When the crisis began, the economy was being operated by encouraging the inflow of short term debt in order to service previous commitments on the foreign debt. This strategy conditioned all the macroeconomic policies that were being pursued. No truly adjustment oriented policies could have been seriously considered unless this problem was first addressed.

There are a few policies that would have been indispensable in this effort.

1.1 The government should have begun a serious effort to collect all debt payments overdue from private borrowers to government financial institutions.

The political enormity of this task stems from the reality that the effort would have required the regime to ask its strongest supporters to remit part of their foreign assets back to the country. Given that eventually the Marcos dictatorship was toppled from power, the inability of the Marcos group to stage a

return of foreign assets is an example of time inconsistent behavior.

1.2 The government should not have viewed the problem as solely that of the reopening of trade credits but should have begun a serious renegotiation of foreign debt service and guarantee liabilities. As part of this strategy, the government should have been prepared to declare a debt service moratorium until the negotiations had been completed to its satisfaction. The unacceptability of negative growth would have been a key element in such a position.

In the meantime, as the negotiations might have proceeded, the country might have declared that its debt service would not exceed a given proportion of its exports.

We must comment on the difficulties involved in this proposal. As we said above, it was in the nature of the Marcos government that it was seeking support from U.S. and the international business community. Moreover, in 1983 and most of 1984, Mexico was still the darling of international community for having carried out a swift IMF-sponsored adjustment program (which eventually unraveled). It did not seem fashionable then to carry out a nonradically inspired analysis of any country's inherent capability to service its accumulated foreign debt.<19>

As a counterargument, it must be pointed out that the Philippines lived through 1984, Mexico and all, with no commercial financing and in 1985 the projected foreign fund inflow did not materialize (see Table 2.3). Instead of working

with a mendicant stance on rrnancing that was not available anyway, the country could have taken a more aggressive debt negotiating stance.<20>

1.3 The government should have reduced unecessary and avoidable expenditures. Expenditures related to defense and the election exercises would have been of immediate impact. Of longer term effect but even more important a program to privatize the nonperforming corporations whose debt obligations had been taken over by the government should have been started without delay.

2.0 The government (and its sponsor, the IMF) should have seriously addressed the problem of credit expansion to those sectors whose expansion would have been consistent with economic adjustment. This applies particularly to manufactured exports and small domestic import-substituting industries. In the face of the reduction of credit, it might have been most effective to channel it to these industries through a selective credit program. This would have permitted exporters to retain their overseas customers and exploit the 1984 world export boom and import-substituters to take advantage of the devaluations.

In fact, the credit program that was put in place during the period was directed at removing special credit accommodations. The Bretton Woods agencies viewed the crisis as the opportunity for completing the domestic financial liberalization program, an attitude that stemmed from their long experience in the recalcitrance of the government. These special accommodations

were heavily biased in favor of the large, non-tradeable projects.<21>

3.0 The government should have pursued a policy that combined a devaluation, say back to 1978 real exchange rate level, and temporary export subsidies. A gradual depreciation back to 1972 real levels should have been undertaken only when sufficient international reserves had been built up.

The devaluations of October 1983 and June 1984 brought the exchange rate back to 1972 levels in one year and induced inflation. A brief experiment with a crawling peg in 1981 had been interpreted as a failure as it was soon overtaken by currency speculation.<22> This experiment had, however, been carried out in the context of a large, and growing, government budget deficit. A more gradual devaluation might have been effective in conjunction with the first policy suggestion of finding a solution to the large government budget deficit.

4.0 Instead of the punitive IMF ceilings, which actually required that reserve money be restored to its level before the May 1984 elections, a growth in reserve money consistent with a 1.0 percent real growth should have been implemented in 1984.

Higher monetary ceilings would have been quite acceptable to the Marcos government. However, given the past experience, attainment of the higher ceilings would not have ensured that the additional resources could have been applied to adjustment, especially as would be required in policy suggestion number one.

This political judgement, which the IMF probably does not seek to have a reputation of even being capable of making, would still not have justified the ceiling based on pre-May 1984 levels, especially if it was true, as it was, that the inflation in 1984 was more immediately caused by the nominal devaluations, and not by the increase in liquidity. The high interest rates and massive sales of Central Bank securities in the third quarter of 1984 were the only recourse if the prior action commitments could be met in time for an IMF standby agreement by December 1984.

5.0 The disintermediation that characterized the adjustment could have been avoided. There should never have been any significant issue of interest bearing bills by the Central Bank and interest rates should not have been allowed to shoot up to astronomical levels. These policies might have seemed unavoidable to the Marcos government when the inflationary process had been started and the monetary targets had to be met before the end of 1984. In such a situation, a government that had had more confidence in its domestic support might have chosen not to meet the implicit IMF targets for 1984.

In hindsight, an economic management that permitted the nominal interest rate to be two points higher than actual beginning in 1983 and peaking at 20 percent in the last three months of the same year would have been an effective policy, as we shall show in the simulations that we report below. It is true that, after 20 years of domestic interest rates pegged on anti-usury ceilings, the crisis revealed the power that interest rate policy could have in monetary management.

All of these suggestions point toward a more early and more gradualist stabilization program, with the view that adjustment will have to be undertaken over a more extended period.

We present here some calculations using on a small model of the economy in order to illustrate a more gradualist stabilization program. Because of the experience that large macro models existing for the Philippine economy have been unable to reproduce developments in the economy after 1983, we decided to estimate a macroeconometric model based only on data from 1982 to 1985, the data in Tables 3.1 and 3.2.

The model specification (and the specification search) was heavily influenced by the discussion in section 2 about the actual adjustment experience from 1983-85. The model is estimated on monthly data from 1982.10 to 1985.12. For the data on gross domestic product, for which only quarterly data is available, the data for the quarter is assigned for the three months in that quarter.

The estimated model, mostly estimated by two stage least squares, is presented in Table 4.1. For each equation in Table 4.1 we also present the within sample root mean square error of the equation obtained from simulating the whole model dynamically within the sample period. Serial correlation was a problem in the data set.

The first equation determines the price level. Price level declines as output six months ago increases. It increases, in

Table 4.1

WITHIN PERIOD SIMULATION MODEL

Behavioral Equations:

(1) $P_t = \underset{(162.27)}{-215.89} \underset{(0.0038)}{-0.0065}\, q_{t-6} + \underset{(19.19)}{81.13}\, r_t + \underset{(1.83)}{41.45}\, e_t$

Estimated by TSLS

$\bar{R}^2 = 0.96$ N = 39, 1982.10 to 1985.12
DW = 0.94 F = 282.3
SEE = 32.04 Mean of dependent var = 567.4
W/in sample RMS percent error: 6.1

(2) $q_t = \underset{(4556.85)}{22253.40} + \underset{(0.15)}{0.25}\left(\frac{b_t}{P_t}\right) - \underset{(176.18)}{203.74}\left(\frac{i_t}{P_t}\right)$

Estimated by TSLS corrected for serial correlation by Cochrane Orcutt method, $\rho = \underset{(0.15)}{0.54}$

$\bar{R}^2 = 0.47$ N = 39, 1982.10 to 1985.12
DW = 1.49 F = 12.4
SEE = 1379.17 Mean of dependent var = 23965.2
W/in sample RMS percent error: 7.2

(3) $e_t = \underset{(0.94)}{-4.27} + \underset{(0.001)}{0.015}\, P_{t-3} + \underset{(0.018)}{0.075}\, i_t + \underset{(0.00004)}{0.00034}\, b_t$

Estimated by TSLS

$\bar{R}^2 = 0.96$ N = 39, 1982.10 to 1985.12
DW = 1.07 F = 285.7
SEE = 0.81 Mean of dependent var = 14.97
W/in sample RMS percent error: 6.6

(4) $r_t = \underset{(0.41)}{4.26} - \underset{(0.012)}{0.018}\, i_t$

Estimated by OLS corrected for serial correlation by Cochrane-Orcutt method, $\rho = \underset{(0.13)}{0.84}$

$\bar{R}^2 = 0.68$ N = 36, 1983.01 to 1985.12
DW = 1.20 F = 38.2
SEE = 0.20 Mean of dependent var = 3.94
W/in sample RMS percent error: 8.3

(5) $m_t = \underset{(1168.74)}{-1010.73} + \underset{(0.033)}{0.221}\, q_{t-6} - \underset{(55.27)}{13.05}\, e_t$

Estimated by TSLS corrected for serial correlation by Cochrane-Orcutt method, $\rho = \underset{(0.12)}{0.82}$

$\bar{R}^2 = 0.84$ N = 39, 1982.10 to 1985.12
DW = 1.79 F = 66.1
SEE = 260.22 Mean of dependent var = 4325.6
W/in sample RMS percent error: 10.4

Variable Definitions

P_t = consumer price index, 1972 = 100
q_t = gross domestic product in constant 1972 pesos
r_t = credit multiplier, liquidity/money supply
e_t = nominal exchange rate, pesos per U.S. dollar
b_t = monetary base, in million pesos
i_t = interest rate on 91 day Treasury Bills
m_t = imports in constant 1972 prices

monetarist fashion, when the money multiplier, a measure of general credit availability increases. Devaluation exerts significant upward pressure on the price level. The nature of the latter effect has been discussed extensively in Taylor [1983] and Bruno [1979].

The second equation gives short-run output, measured by quarterly gross domestic product, as function of real monetary base and the real interest rate. In this model, monetary base and the interest rate are treated as exogenous variables, independent of each other. The justification is the recent experience in which the Central Bank had been able to lead in interest rate determination through the sale of its interest bearing bills. Furthermore, as shown in the Section 2, the evolution of the money supply had become completely tied to the program ceilings.

The third equation expresses the exchange rate as a positive function of three variables, all highly significant statistically: the price level three months previous, the interest rate, and the monetary base. The first and the third variables have standard signs. Attempts to estimate the exchange rate as a negative function of the interest rate, to embody the Central Bank operation of raising interest to defend the exchange rate, failed.

The fourth equation embodies all of the monetary sector for the model and says that the money multiplier is a negative function of the rate of interest. The justification is again that in the adjustment period, the interest rate was used to contro

total liquidity. Thus, total liquidity is implicitly determined from this equation along with the exogenous variable monetary base. Because of this equation, equation two is really a statement that output in the short run depends on real liquidity available in the economy.

The fifth equation is intended as an import demand equation with standard signs. An increase in the exchange rate reduces real imports. That it is output six months previous that is the activity variable for imports, current output and shorter lags having exhibited the negative sign, reflects the intense speculation in and the high financing cost of imports during the period.

We do not have the luxury of explaining the many other alternative specifications that had been tried. We suggest the model to be one that embodies the important parameters in the economy during the 1983-85 adjustment and one that fits the limited data available adequately.

The operation of the main part of the model begins with equation 2 which determines current output from the availability of current financing. Current prices are then determined through equation 1 from demand elements ultimately related to liquidity through the money multiplier, cost of imported inputs through the exchange rate, and supply of output six months earlier. It is implicit in the interdependence of the equations of the model that output depends on imports which in turn depends on the availability of financing.

There is a distinctly negative relationship between output and prices that is embodied in the model in line with the short-run stabilization experience.

The gradualist counterfactual experiment that is reported here assumes that serious stabilization policy would have begun in January 1983, the month when a new IMF program had actually begun.

The policy instrument used here is the interest rate which is pegged two percentage points higher than actual in the beginning of 1983 and is allowed to rise to 20 percent nominal in the last three months of 1983. Subsequently, it is brought down gradually to nine percent nominal by December 1985. Chart 11 provides a comparison of actual nominal and the proposed interest rates over the simulation period.

Based on the model, the immediate effect of the policy would be on the money multiplier and implicitly on total liquidity. Chart 12 shows that under the proposed policy the multiplier would be slightly below the base run values for the model until April 1984. Beyond this month, the proposed multiplier would stay relatively stable at around a value of 4.

In this simulation, the actual values of the money supply, which had been, in the main, consistent with the IMF program targets during the period, have been used. Thus, it would be the values of total liquidity that would be inconsistent with the IMF program targets. Chart 13 provides a comparison of the actual and

Chart 11

Interest Rates

Actual and Alternative

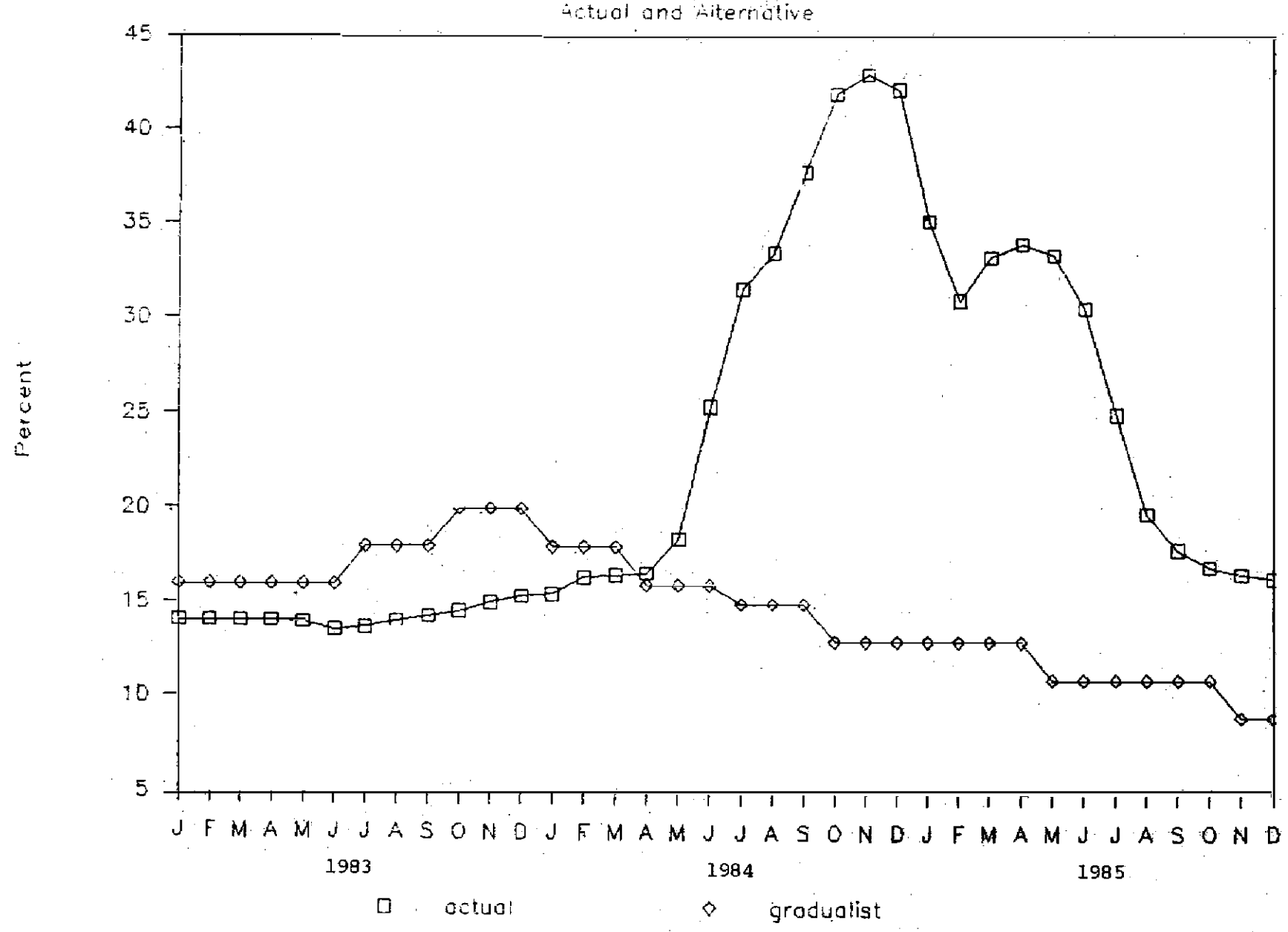
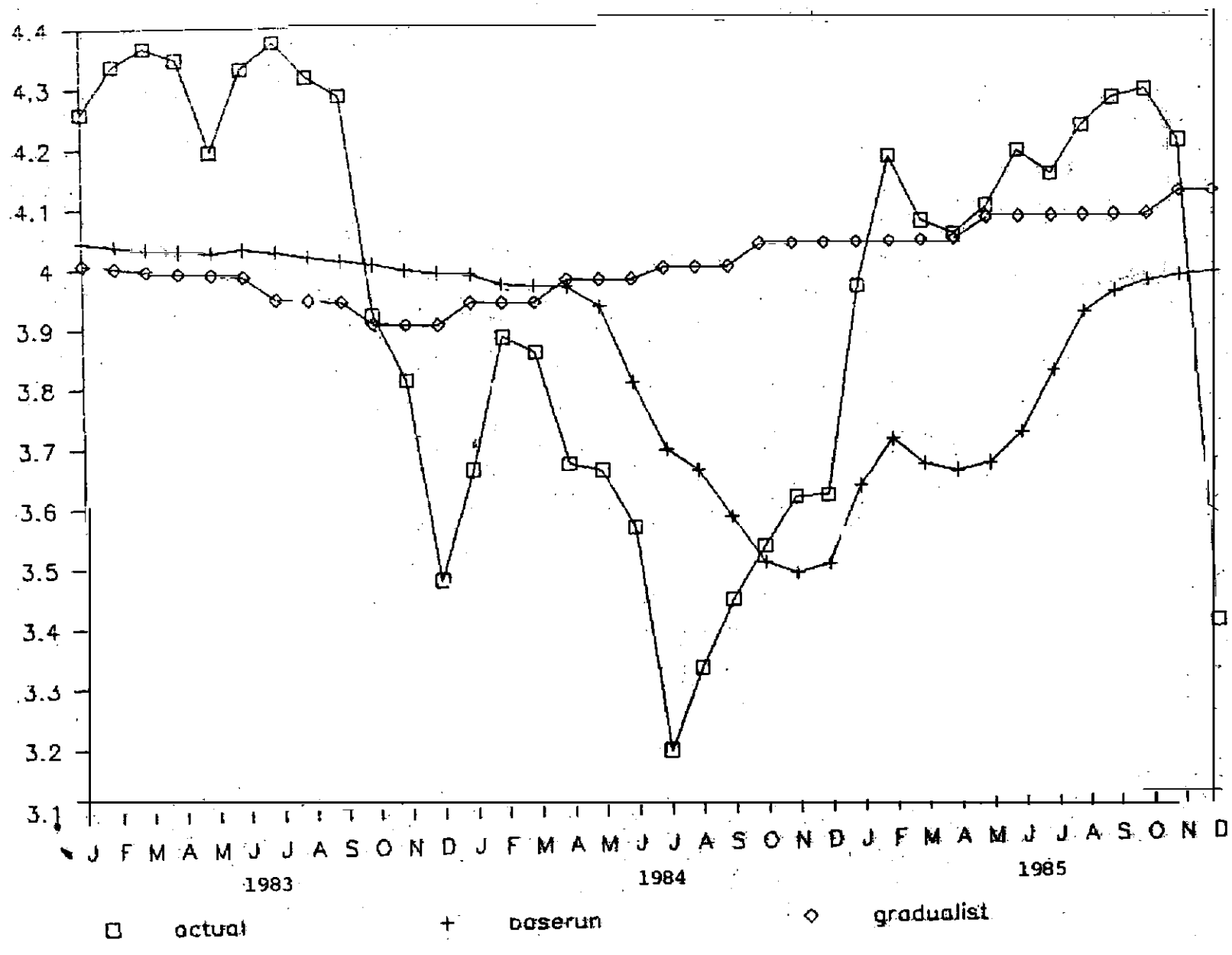


Chart 12

multiplier



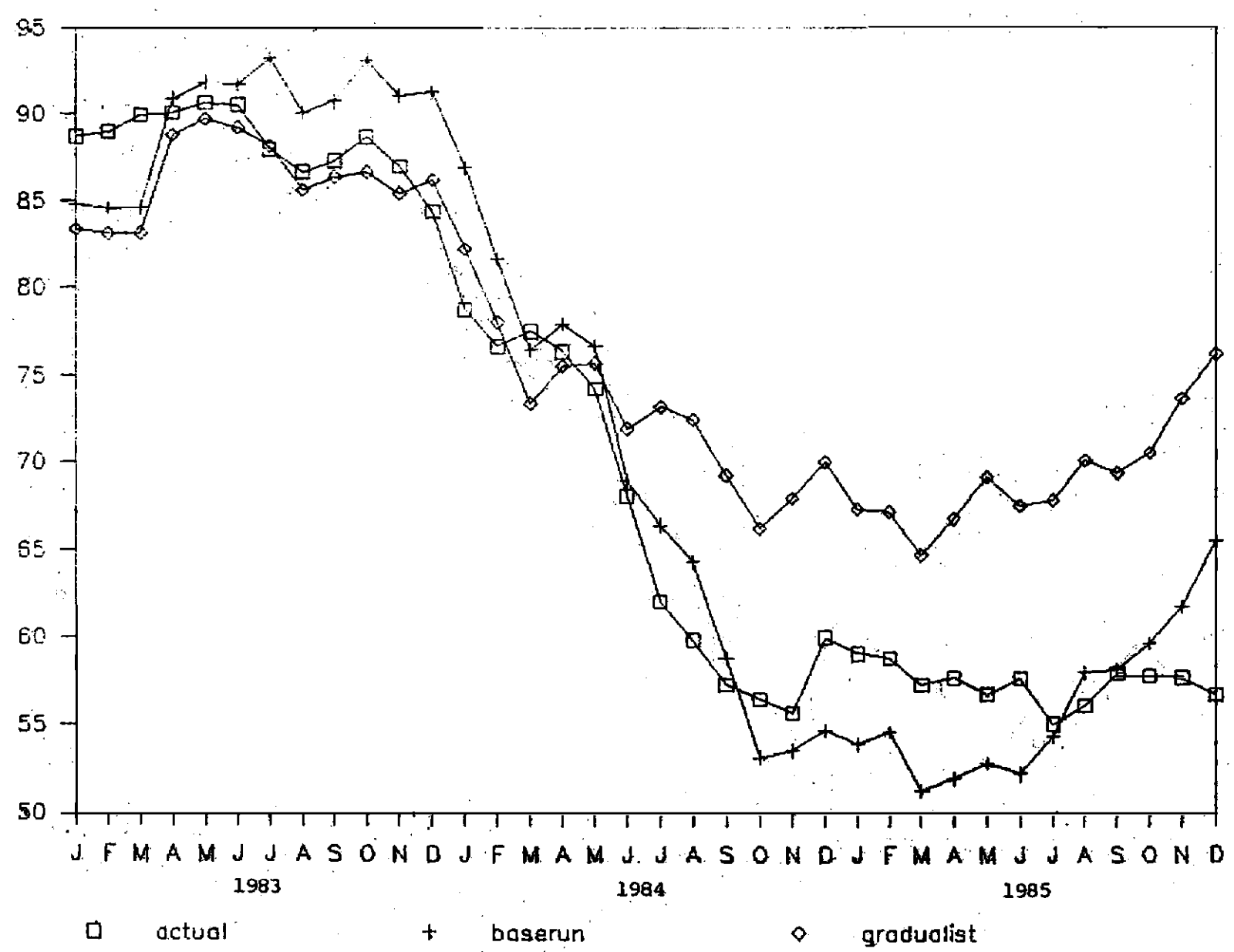

95
90
85
80
75
70
65
60
55
50
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
1983
1984
1985
actual
baserun
gradualist

Chart 14

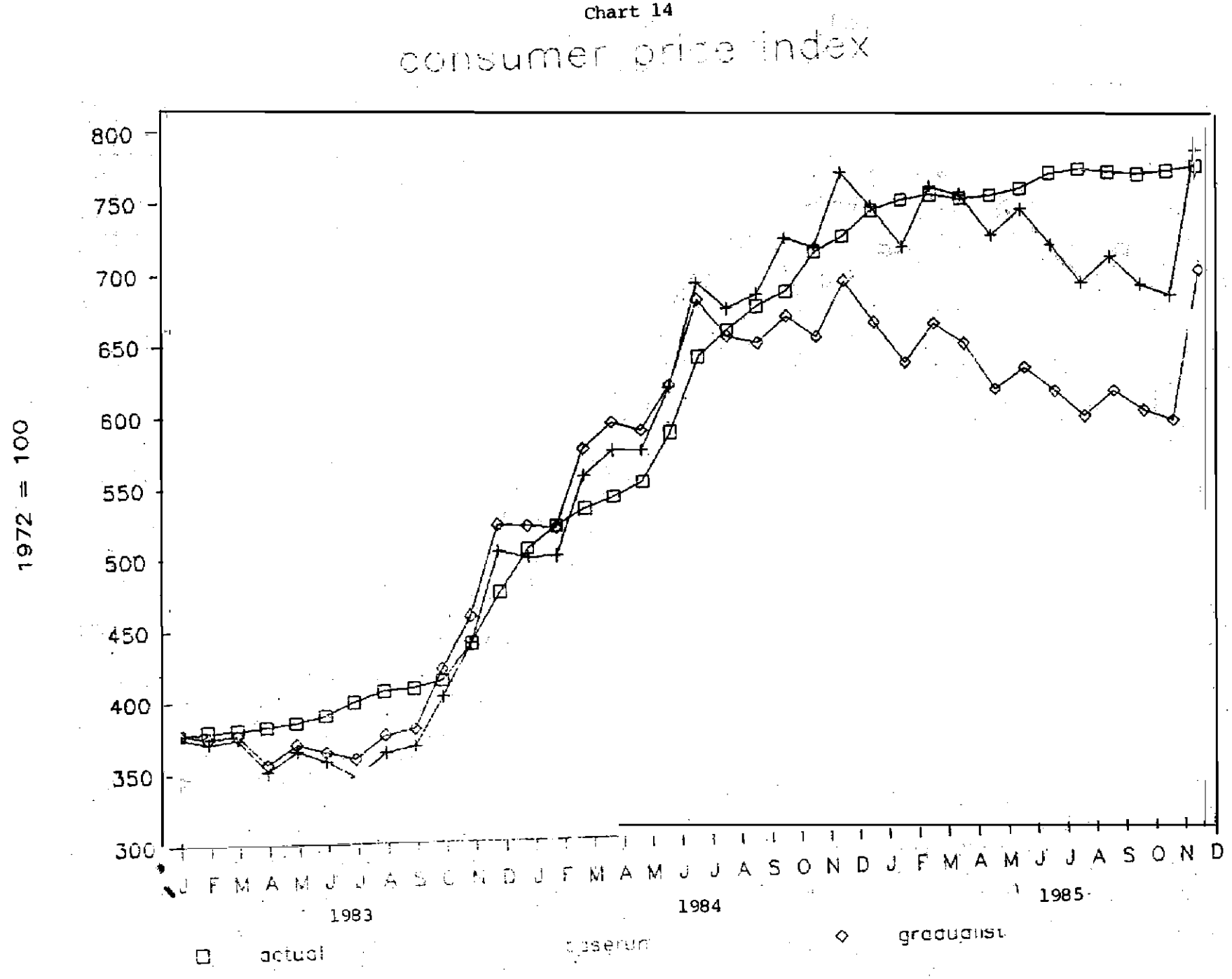

consumer price index
1972 = 100
800
750
700
650
600
550
500
450
400
350
300
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
1983
1984
1985
actual
gradualist

Chart 1.

exchange rate

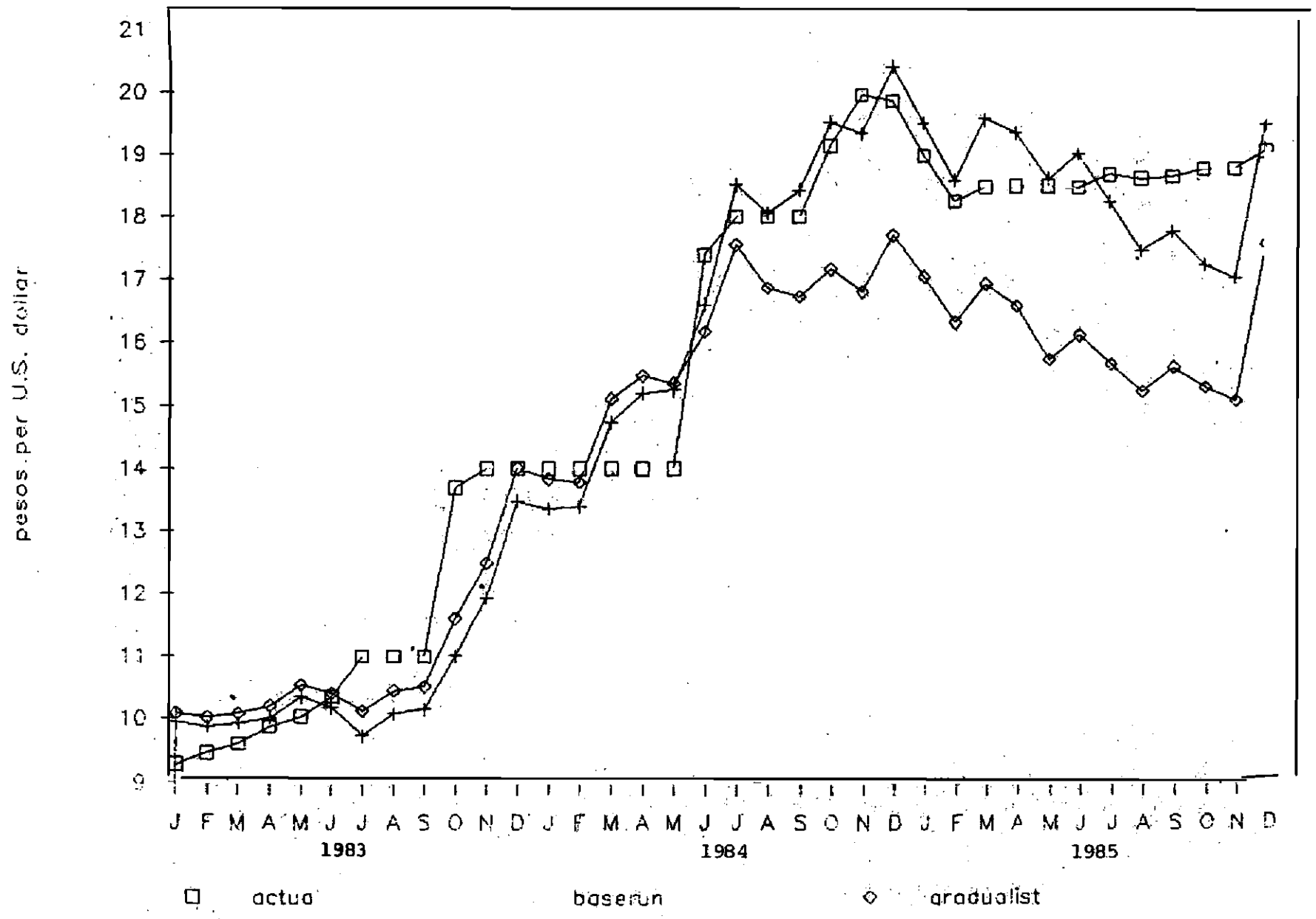


Table 4.2
Simulation Results

	Consumer Price Index		Exchange Rate		Multiplier		Imports		Gross Domestic Pr
year.month	baserun	gradualist	baserun	gradualist	baserun	gradualist	baserun	gradualist	baserun gradua
1983.01	374.5	377.7	9.9462	10.0930	4.0437	4.0078	4325	4323	25729
1983.02	371.1	374.2	9.8748	10.0213	4.0378	4.0019	4256	4254	25270
1983.03	373.0	376.1	9.9300	10.0769	4.0329	3.9969	4197	4195	25065
1983.04	350.6	355.7	10.0127	10.2061	4.0287	3.9927	5009	5007	25165
1983.05	364.2	369.4	10.3460	10.5434	4.0261	3.9892	4966	4963	25279
1983.06	357.3	363.2	10.1705	10.4001	4.0309	3.9862	4936	4933	25262
1983.07	345.9	358.5	9.7319	10.1291	4.0258	3.9469	4673	4581	25222
1983.08	362.9	375.0	10.0864	10.4580	4.0171	3.9447	4546	4453	25093
1983.09	366.6	378.7	10.1558	10.5198	4.0109	3.9429	4481	4389	25119
1983.10	401.1	420.5	11.0185	11.6110	4.0042	3.9046	4477	4373	25464
1983.11	438.2	456.4	11.9488	12.4993	3.9945	3.9033	4478	4375	25494
1983.12	501.2	519.6	13.4819	14.0070	3.9870	3.9022	4444	4320	25778
1984.01	496.3	518.4	13.3620	13.8334	3.9839	3.9380	4428	4209	25466
1984.02	497.1	516.3	13.3953	13.7835	3.9666	3.9373	4392	4200	25034
1984.03	552.3	571.1	14.7355	15.1176	3.9641	3.9366	4375	4194	24932
1984.04	569.3	588.8	15.2051	15.4851	3.9617	3.9728	4440	4199	25080
1984.05	568.8	582.6	15.2635	15.3661	3.9282	3.9723	4442	4240	24814
1984.06	612.3	613.5	16.6094	16.1803	3.7993	3.9719	4484	4321	23815
1984.07	684.0	672.1	18.5142	17.5557	3.6851	3.9899	4388	4294	23445
1984.08	665.2	645.7	18.0605	16.8751	3.6499	3.9896	4296	4240	23046
1984.09	674.7	640.3	18.4303	16.7376	3.5707	3.9894	4267	4228	22352
1984.10	712.7	658.6	19.5208	17.1713	3.4934	4.0259	4284	4310	21823
1984.11	705.6	643.6	19.3448	16.8086	3.4748	4.0257	4226	4312	21726
1984.12	757.2	681.8	20.4039	17.7082	3.4894	4.0256	3991	4269	22169
1985.01	732.8	652.2	19.5057	17.0463	3.6178	4.0254	3920	4349	22528
1985.02	703.7	623.2	18.5895	16.3289	3.6948	4.0253	3843	4333	22787
1985.03	745.4	649.8	19.5680	16.9374	3.6525	4.0252	3676	4278	22552
1985.04	738.4	634.8	19.3406	16.5811	3.6396	4.0252	3562	4290	22514
1985.05	709.4	602.5	18.6054	15.7424	3.6505	4.0618	3550	4317	22491
1985.06	726.9	616.9	18.9966	16.1224	3.7019	4.0618	3642	4358	22758
1985.07	701.6	599.6	18.2409	15.6695	3.8047	4.0617	3731	4313	23266
1985.08	674.8	581.4	17.4495	15.2194	3.9001	4.0617	3799	4302	23869
1985.09	691.6	598.5	17.7489	15.6155	3.9350	4.0617	3742	4277	24096
1985.10	671.4	583.8	17.2238	15.2763	3.9515	4.0616	3741	4301	24215
1985.11	663.1	576.2	17.0064	15.0651	3.9588	4.0983	3738	4364	24362
1985.12	763.9	679.7	19.4727	17.5498	3.9624	4.0983	3765	4315	24852

the proposed values of total liquidity implicit in the gradualist simulation.

The simulation results for the key variables are given in Table 4.2.

For inflation, the gradualist values are slightly higher than the base run values for 1983. Chart 14 depicts the actual, base run, and 'gradualist' levels of the consumer price index during the simulation period. December 1983 base run inflation rate is 33.7 percent while the gradualist value is 39 percent. This is due to the higher interest rates in the alternative approach for 1983. In the model, higher interest rates are felt as higher import financing costs, and translated into higher prices.

The proposed alternative path shows a slightly higher than base run inflation rate until June 1984, after which the base run price levels are significantly higher than the proposed path. (Both the base run and alternative paths show a deflationary price trend from January 1985 which does not appear in the actual data.)

From January 1983 through May 1984, the exchange rate depreciates faster in the gradualist compared to the base run path (Chart 15). Beyond this point, the exchange rate shows values lower than base run. December 1984 base run exchange rate is P19.5 (compared to P19.9 actual) which is higher than P17.7 in

the alternative approach. This P2 difference is maintained until the end of the simulation period in December 1985.

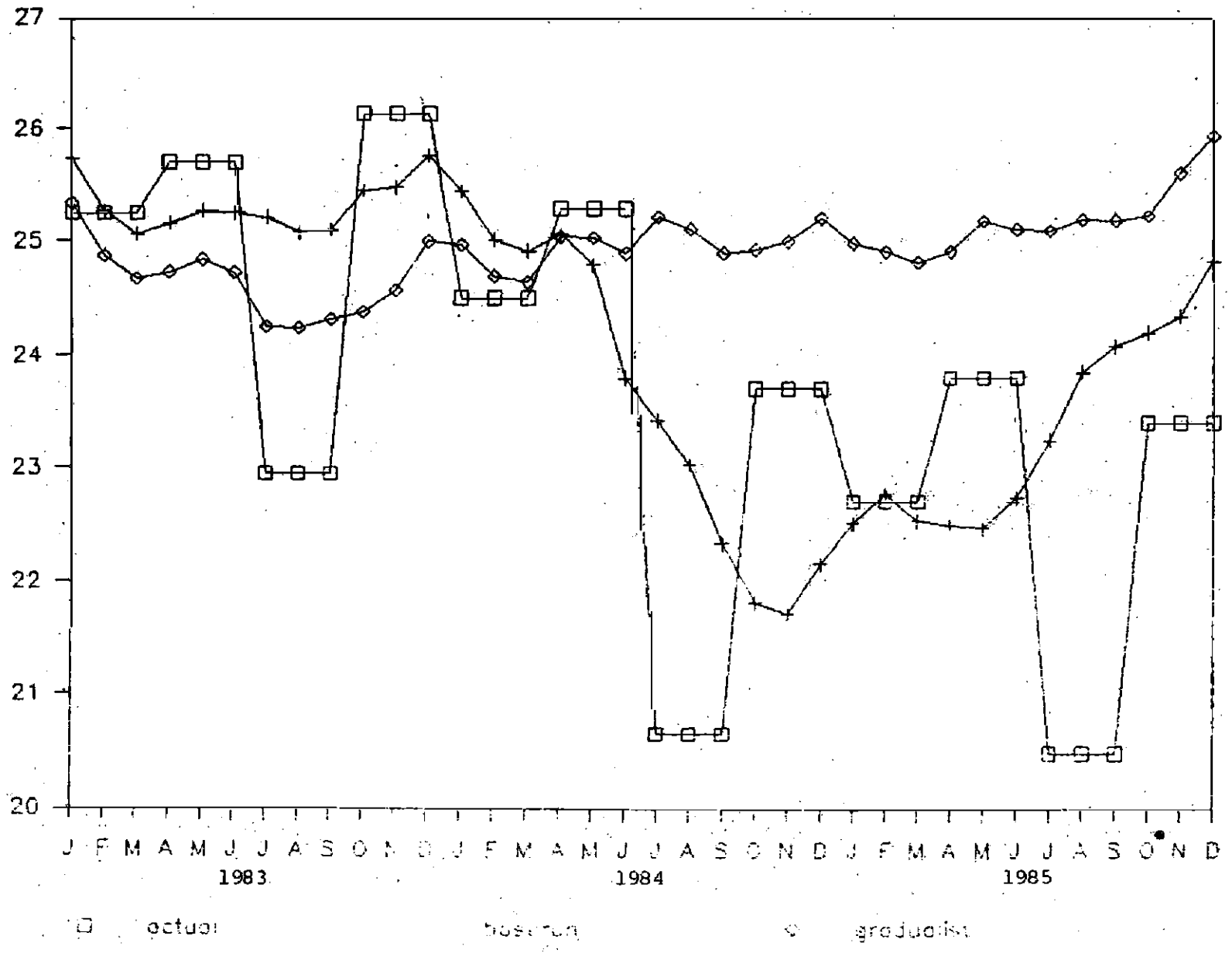
The more gradual stabilization policy has its most beneficial effect on the real variables. Gross domestic product for 1983, under early but more gradual adjustment, is lower by 2.6 percent than the corresponding base run level. GDP grows by 1.8 percent in 1984 as opposed a decline of 6.6 percent in the base run and 6.8 percent in the actual. In 1985 there is another positive growth of 1.8 percent as opposed to a fall of 1.2 percent in the base run and 3.8 percent in the actual. In Chart 16 the level of quarterly real gross domestic product under more gradual adjustment is practically constant through the period while the actual and the base run values exhibit large drops.

The same flat pattern is shown for imports, except for the year 1983 (Chart 17). For 1983, both the base run and the alternative path show an earlier fall in imports than the actual. The alternative path is however lower than the base run, by 2.8 percent in December 1983, as a reflection of the earlier start of the adjustment for the gradual strategy. Beyond November 1984, alternative path imports are higher than both base run and actual values.

Imports for the whole year of 1983 are 1.1 percent lower under the alternative path compared to the base run path. For 1984, imports are a full 7 percent higher for the alternative path; for 1985, imports are 15.8 percent higher compared to the corresponding base run values.

Chart 16

gross domestic product



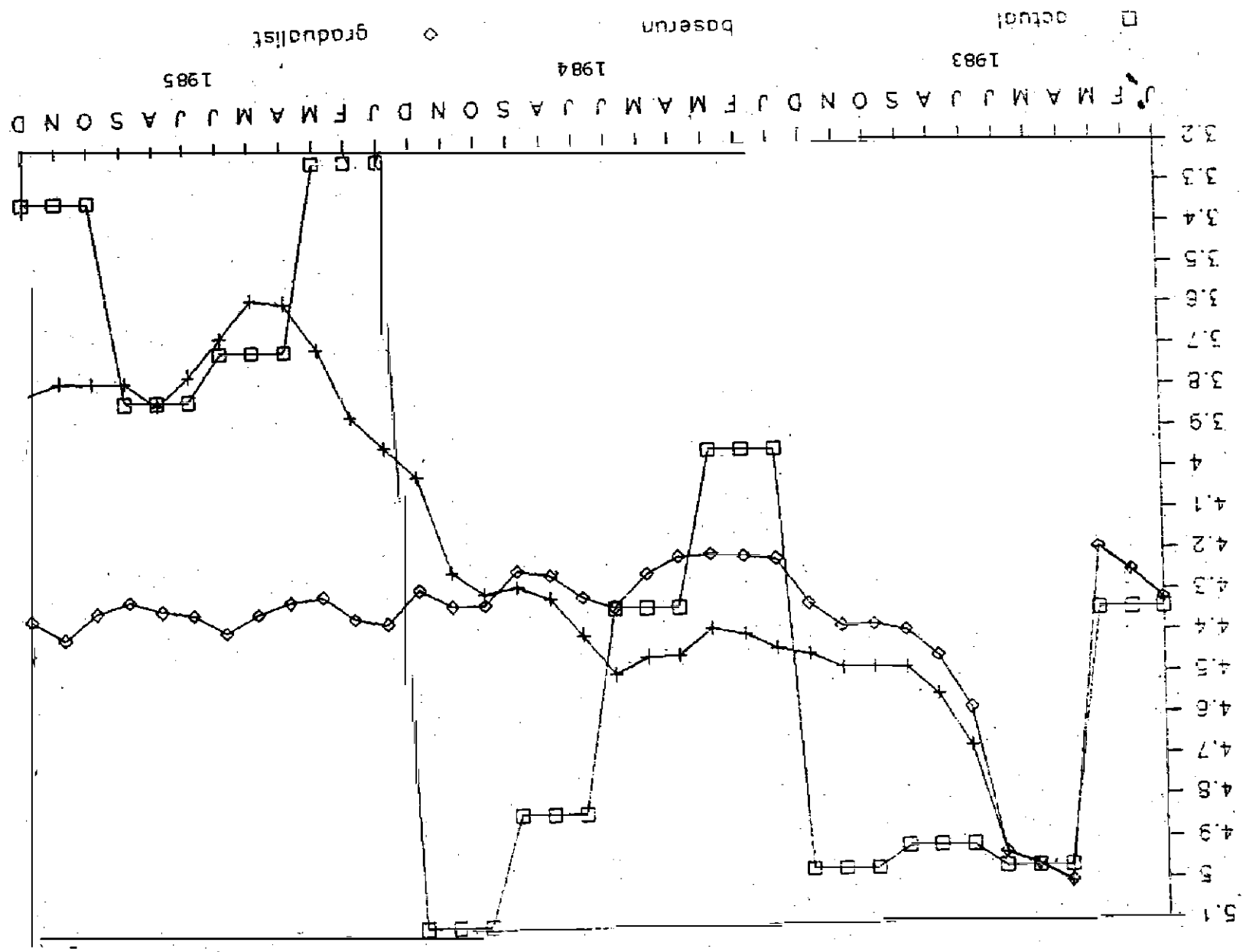

actual
baserun
gradualist
1983
1984
1985
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
3.2
3.3
3.4
3.5
3.6
3.7
3.8
3.9
4
4.1
4.2
4.3
4.4
4.5
4.6
4.7
4.8
4.9
5
5.1

Chart 17

Table 4.3

ADDITIONAL FINANCING CALCULATIONS
(In Million $)

	1983	1984	1985
Actual:			
Merchandise exports	5,005	5,391	4,629
Merchandise imports	7,487	6,070	5,111
Merchandise trade balance	-2,482	-679	-482
Current Account Balance	-2,750	-1,268	8
Memo: Target Current Account Balance	-2,800	-1,500	-1,300
Alternative:			
Merchandise imports	6,533	6,413	6,614
Merchandise trade balance	-1,528	-1,082	-1,985
Current Account Balance	-1,796	-1,671	-1,491
Additional Financing:			
Against actual trade deficit	-954	403	1,499
Against target current account balance	n.a.	171	191

Let us now compute the additional financing that might have been necessary for the alternative path. Let us assume the level exports to be what they actually were during the period 1983-85. This is a conservative assumption since exports themselves were constrained by financing cost during the period. Under this assumption, using the inflation and exchange rate results from the alternative path, the merchandise trade deficits in 1983, 1984 and 1985 would have been $1528, $1082, and $1985 billion respectively.

Compared to the actual merchandise trade deficit these alternative import values would have meant financing requirements of $954 million less for 1983, $403 million more in 1984 and $1499 million more in 1985 (Table 4.3).

Thus an additional net financing requirment of $948 million ovr three years would have been required by the alternative path for merchandise trade alone. Given that by end 1985, $1.74 billion of the trade facility had remain unused, there seemed to have been sufficient resources for the alternative strategy. In fact, the economy was so extremely depressed that by 30 September 1986 $1.66 billion of the trade facility remained as deposits with the Central Bank. Between 1984 and 1985 alone, the additional financing required would have been $1802 million. Even assuming that the reduced financing requirement for 1983 had not materialized, this would only have meant an additional financing requirement of $100 million for the years 1984 and 1985.

The suggested approach is still monetarist, since it relies on credit control. However, the model that is used embodies the cost push elements that had a strong impact in the period of the 1983-85 adjustment. These results suggest that an abrupt monetary correction should be avoided in such an economy.

The suggested approach would only have been feasible in conjunction with the other elements that we suggested above. In particular, significant progress in solving the government budget deficit-government corporate contributions problem would have to be made. In this problem, strong legal actions and negotiating stances usually associated with unorthodox adjustment policies, would have to have been undertaken.

5.0 Some Lessons from the Experience

Let us sum up here some of the elements that were part of the 1983-85 adjustment experience in the Philippines.

1. The first lesson is that for an economy such as that of the Philippines where labor and other human costs of operating the economy's production processes do not adjust to (or through) inflation,<23> a monetarist program which depends on the constriction of credit to solve the external imbalance (stabilization) is effective.

2. When such a monetarist program does work in an economy such as the Philippines, it works with a vengeance because of features that are present in the economy. Since working capital is the first to be constrained and since such capital tends to be almost wholly raised from the financial system, a monetarist program will immediately shut down the manufacturing sector and reduce imports.

However, the raising of working capital finance cost and the increase in its local currency cost induce inflation even as real liquidity is declining drastically. General inflation unmatched by income increases leads to reduced real incomes and reduced domestic demand.

3. A monetarist program that works through the constriction of credit has very poor chance of inducing a real adjustment because of the very fact that it kills off investment. In an economy such as the Philippines, where as much as 70 percent of

GDP can be classified as nontradeables, an enormous amount of investment is required to increase the domestic production of tradeables. But tight financial credit will not permit this to occur.

4. The cost on the human population of such a program is enormous. Table 5.1 reports on the weight for height status of preschoolers in the Philippines in 1984 and 1985. In one year, there was an increase from 13.3 to 14.3 percent in preschoolers who fell less than 85 percent of the weight-height standard. As would be expected for a country with a large nontradeable sector located in cities, the same statistic shows an increase from 8.8 percent to 14.4 percent in the national capital region (NCR) of Manila. The human tradeoff against a program that did not put in place a real adjustment is deeply negative.

5. The IMF must work with the government currently in power. Even though the IMF has an overall framework which, at least hypothetically, 'will work' in some fashion such a framework is often not completely implemented. This was especially evident in the 1984 portion of the adjustment program even though it was not officially under the IMF; but it was also true in 1985. Parts of the agenda that are in the interest of the government in power will be implemented; parts that are not will be amended or not implemented at all. The actual resulting program will be in the interest of the government, which is not necessarily consistent with any real success in adjustment.

Table 5.1

DISTRIBUTION OF PRESCHOOLERS BY WEIGHT-FOR-HEIGHT STATUS (WH)
BY REGION, 1984 AND 1985

Region	Less than 85% of WH Standard				Greater than 85% of WH Standard			
	1984		1985		1984		1985	
	No.	%	No.	%	No.	%	No.	%
Ilocos	54	17.2	63	20.6	260	82.8	243	79.4
Cagayan Valley	41	12.1	31	8.6	298	87.9	330	91.4
C. Luzon	67	16.8	82	24.2	332	83.2	257	75.8
S. Tagalog	71	19.6	52	15.3	292	80.4	288	84.7
Bicol	50	18.7	21	10.6	218	81.3	177	89.4
W. Visayas	38	13.8	44	20.1	237	86.2	175	79.9
C. Visayas	18	6.1	14	5.6	277	93.9	23	94.4
E. Visayas	29	11.5	26	15.5	223	88.5	142	84.5
W. Mindanao	8	5.3	12	9.2	144	94.7	119	90.8
N. Mindanao	16	10.7	14	10.3	134	89.3	122	89.7
S. Mindanao	14	12.2	18	14.8	101	87.8	104	85.2
C. Mindanao	16	9.3	20	9.8	156	90.7	185	90.2
NCR (Metro Manila)	19	8.8	43	14.4	198	91.2	256	85.6
NATIONAL	441	13.3	440	14.3	2,870	86.7	2,634	85.7

Source: National Nutrition Council Survey, 1984 and 1985.

The element that would have been a key ingredient in an IMF program which the Marcos government found ways to suppress is the private sector response. In fact, the program in the Philippines channeled private sector resources away from investment that might have increased the production of tradeables and directly into the financing of government requirements and debt service.

Even assuming for the sake of argument that the IMF economic model is correct, it is highly unlikely that any government in the Philippines will accept the IMF monetary model as being completely applicable to the Philippines. As shown in the recent experience, in a very authoritarian government, it will be very possible to religiously fulfill program targets while killing off the very private sector which the IMF approach places so much reliance on. As an organization whose terms of reference are to deal with governments, it can be futile for the IMF to attempt to suggest that the government implement its competitive model.

The end result of such cross purposes in the case of the recent Philippine experience is that the IMF targets were achieved, stabilization was attained, and, but for the fact that the government was eventually overthrown, the members of the government succeeded in protecting their economic interests. Thus, the two active parties in the program - the IMF and the government - manage to protect their own interest while the nonparticipants bear the cost.

The prospects for the Philippine economy for the rest of the decade of the 1980s are not bright. The recent adjustment program left many of the old industries at 40 percent capacity utilization and induced ICORs hovering around -4 for 1984 and 1985 and over 40 in 1986 when the first nonzero GNP growth rate was attained. The destruction of many of the old industrial operations that occurred during the adjustment program suggests that ICORs in the near future will be high.

It is unlikely that the country will recover the investment ratios approaching 0.3 that it achieved in the 1970s. Even if an investment ratio of 0.2 were achieved, an ICOR of 8 would only permit an income growth rate of 2.5 percent, which is only slightly below the 2.6 population growth rate. An ICOR of 4, the historical ICOR from 1960 to 1980, will permit 5 percent annual growth.<24> If such a growth rate can be sustained until 1990 then percapita income in 1990 would be 13.7 percent lower than it was in 1980.

The key factor behind increasing the investment ratio is the debt service. With an average growth rate of around 5 percent per year, interest service will average 8 to 10 percent of GNP for the rest of the decade. By basing its negotiating stance on the standard 18-month IMF standby, the new Aquino administration has chosen the orthodox strategy to deal with this problem. To reduce its net debt service burden to around 4 or 5 percent of GNP, it is negotiating for a growth facility with the commercial banks and the multilateral finance agencies.

Footnotes

<1>See also Bello and Others [1982].

<2>There is some evidence that the country's oil purchasing operation was a channel through which the capital flight of the Marcos family had been carried out.

<3>San Miguel Corporation, a beverage and processed food conglomerate.

<4>The coconut industry program had managed to replant 55,000 hectares.

<5>See also Table 1.2.

<6>Lamberte, Montes and Others [1985].

<7>The IMF program targets were updated during the program reviews in the period. The value of the original table is that the Philippine government attempted to religiously fulfill the monetary targets in the November 1984 table even when the targets for the endogenous variables in that table were being seriously missed or overachieved.

<8>Quote from the telex from the Prime Minister and Minister of Finance and the Central Bank governor to the IMF, multilateral finance agencies, and the commercial banks dated 2 November 1984.

<9>The latter election was actually first announced in the U.S. -

in a television interview Marcos had with David Brinkley.

<10>The week after the 7 February 1986 election the Central Bank implemented the same strategy, mopping P15 billion in one week, which is about 40.5 percent of the outstanding reserve money at that time. The purpose was to meet the 1986 first quarter monetary targets of the IMF program. But at this point the regime had only two weeks of life.

<11>He eventually resigned his post in the financial institution.

<12>The nature of this long standing problem is discussed in Bello and Others [1982].

<13>After the nickname of the Central Bank governor.

<14>See Lamberte, Montes, and Others [1985], pp. 15-16.

<15>In fact, military officers, acting in their private capacity with the clearance of their superiors, accompanied the shipments.

<16>See Lamberte, Montes, and Others [1985].

<17>If Mr. Marcos had managed to stay in power after that period, a general crackdown on the 'legal opposition' was widely expected.

<18> Of course, it should have commenced in 1979, after the second oil shock or in 1974, after the first oil shock.

<19>Such an analysis has now become fashionable in the academic community, but unfortunately not so in the Bretton Woods

agencies.

<20>Even with the new Aquino government, the taking of a more aggressive negotiating stance continues to be an issue.

<21>In fact the Development Bank of the Philippines lent more for real estate development projects than to agriculture.

<22>The IMF program which began in January 1983 was also intended to help ward off the speculation against the currency.

<23>Such as in Taylor [1983], Chapter 5.

<24>Some more detailed calculations are reported in Montes [1986].

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