Asian Studies Center

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THE ROOTS OF THE PHILIPPINES' ECONOMIC TROUBLES

INTRODUCTION

Economic and political indicators, like appearances, are often deceiving. In mid-1983, the Republic of the Philippines appeared to be on the road to economic recovery and political stability. After more than two years of deep depression, export prices had rebounded upward, industrial production had increased, inflation had fallen from double digits to 7 percent, and government spending had been slashed 30 percent below the 1982 level.

The political situation, which in the past always affected economic growth, also appeared stable. Martial law had been lifted in January 1981, presidential and barangay (city ward and rural village leaders) elections were held in April 1981 and June 1982 respectively, and the political opposition was in disarray. From all appearances, popular support for the government ran high, and the position of President Ferdinand E. Marcos was secure.

By fall 1983, however, a dramatically changed, somewhat negative picture of the Philippines emerged. In mid-October, the government requested a 90-day extension on a $500 million foreign debt repayment owed between October 17, 1983, and January 16, 1984. By year's end, the nation's external debt was said to be $30 billion instead of the projected $18 billion, and the balance-of-payments deficit had climbed above $2 billion. In September, industrial production fell for the first time in several years, and huge layoffs seemed imminent in the first quarter of 1984, given an extremely low inventory of materials in manufacturing firms. The rate of inflation doubled following two devaluations of the peso in June and October. Also, the country faced its worst liquidity crisis since 1945 due to an estimated $1 billion capital flight from late August to December.

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Along with these economic woes came serious political instability. The assassination of opposition leader Benigno "Ninoy" Aquino on August 21, 1983, incited massive demonstrations in the streets of Manila. And early in November, 700 of the country's top businessmen and industrialists confronted Marcos with their grievances about the country's mismanagement.

During early 1984 both the political situation and the economy continued to deteriorate. Some observers expressed serious pessimism about the future of the Philippines. There were suggestions that an economic collapse would lead to anarchy or a communist takeover.

The recent National Assembly elections have sounded a hopeful note. While the current crisis will probably extend through much of 1984, the long-term prospects for political stability and economic growth are not unfavorable. Since political stability depends on dealing with economic problems, the government must give a high priority to economic development. Thus it is essential to understand the roots of the Philippines' economic troubles.

THE ROCKY ROAD TO MODERNITY

Since gaining independence in 1946, the Philippines has been beset by two difficulties encountered by all developing countries. The first is how to plan and implement economic development, while maintaining political stability; the second is how to stay on course with a development strategy while fostering political modernization. Very few countries have successfully realized either, and both have proved troublesome for the Philippines.

Between 1946 and 1972, the Philippines (unlike Japan, South Korea, and Taiwan) failed to initiate land reform or develop an export-led strategy that gradually would industrialize the country and eliminate underemployment. The government lacked the political muscle to eliminate the powerful rural oligarchy and the mobilization capabilities to redirect more budget expenditure into expanding the infrastructure and promoting development in the countryside. At the same time, the government initiated policies counterproductive to economic development: overvaluing the peso, imposing high tariffs to protect urban manufacturing, and undertaxing the cities while making the farm population pay for development projects. And the strategy of import substitution[1] failed to stimulate economic growth so that the country's fledgling producers missed the opportunity to expand along with the rising world economy after World War II.

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[1] Import substitution is a commonly adopted measure whereby developing nations cope with the problem of excessive imports and conserver needed foreign exchange. It also facilitates the growth of local industries and relieves unemployment. It does, however, require tariffs or other barriers to protect domestic industry.

Political problems also contributed to this lackluster economic performance. Through the 1950s and 1960s, each succeeding President was faced with a recalcitrant legislature, which impeded such policies as land reform, agricultural innovations, and the development of a more competitive and efficient urban manufacturing sector. No President until Marcos was reelected to more than one term. Further complicating the situation was the violence of communist guerrilla activities which necessitated unplanned huge state expenditures.

Following the imposition of martial law in 1972, President Marcos was able to implement a multifaceted economic modernization program. On October 21, 1972, his government passed the Tenants' Emancipation Act, which transferred to rice and corn farming tenants the ownership of land they tilled if it exceeded 3 hectares (about 7.5 acres) of irrigated land or 5 hectares (about 12.5 acres) of dry land. Other legislation protected tenants of smaller plots. The government also expanded the activities of the Land Bank to provide loans for tenants to buy land. Loans were available to resettle farmers on other islands of the archipelago and provide them credit to buy newly available high-yield rice seeds, fertilizers, and insecticides. Village cooperatives were encouraged. As the rural economy improved and expanded, the country began to achieve self-sufficiency in rice production and even to export rice in the early 1980s.

After 1972, the government became the driving force behind a new economic development strategy that stressed a free market and exports. The manufacturing sector generally benefited from this, though many other enterprises had operated inefficiently for too long to enable them to take a major role in bringing the economy into the modern era. Furthermore, the government failed to reduce tariffs and force urban manufacturers to become more efficient, as political conditions compelled the Marcos regime to go easy with the urban manufacturing elite. It was only in 1981 when the Philippines had slid into the worst recession since 1945, and leverage was exerted by the World Bank, that the government began to reduce tariffs and increase business taxes.

Even then, the government had not implemented its new development strategy. The sugar and coconut industries remained heavily overregulated: the processing mills were permitted to pay farmers far less than they might have, had competitive marketing conditions prevailed, so farmers did not benefit from increased world prices. The state discriminated against agriculture in other ways. Preferring to keep grain prices low for urban workers and consumers, the government purchased rice and corn which it resold at lower prices in urban markets. After 1972, rising oil costs pushed up the price of fertilizer and insecticides causing further problems for farmers. Hence real income for farmers barely remained constant or even declined during the 1970s.[2]

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[2] Philip Bowring and Guy Sacerdoti, "Time for a Real Debate," Far Eastern Economic Review, June 9, 1983, p. 54.

By 1979 a peculiar anomaly had taken place in Philippine agriculture. While land reform had improved producer and investment incentives in rice and corn production, reforms had not yet been extended into the sugar and coconut production areas. Enormous government expenditures had expanded rural infrastructures on Luzon and other major islands, but Manila had done little to encourage agricultural diversification or rural industrialization as measures for expanding employment opportunities. Consequently, grain output accelerated faster than population growth; by 1981-1982, the country was exporting grain--a first in the nation's history. But in terms of capital, labor, and land, or total factor productivity, agricultural productivity had not increased significantly.

Meanwhile, manufacturing development remained stalled. The World Bank reported in June 1983 that "the increase in GNP growth during the 1970s was achieved at a high investment cost."[3] The service sector had greatly increased because of the overextension of the state and the influx of workers seeking service related jobs. The country also still relied far too heavily upon its traditional export earnings from sugar, coconut, and copper.

Between 1972 and 1979, the Philippines enjoyed its best economic development since 1945. But the level of economic growth was not sustained, and by the end of 1979, export prices were falling and the Philippines was sliding slowly into a severe recession. For reasons that are still unclear, the government did not adopt strong anti-recessionist policies; it instead launched eleven costly new industrial projects.

ORIGINS OF THE CURRENT CRISIS

Experts are trying to determine the causes of the current economic catastrophe. Certainly they date from late 1979. What now seems clear, but was not so in 1980, is that excessive public and private borrowing during a period of depression pushed the country to the brink of economic disaster. Rather than blame Marcos as so many of his critics and opponents did last fall, responsibility must be shared by all Filipinos in government, the business community, and the professions.

A Scenario Doomed to Failure

During a recession, an economic system usually contracts and reorganizes to eliminate dead weight and inefficiency. Then business inventory stocks shrink and consumers begin to save

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3 See, in particular, the gloomy assessment of real wage rates for the early and mid-1970s in Dr. Richard Hooley, An Assessment of the Macroeconomic Policy Framework for Employment Generation in the Philippines, A report submitted to USAID/Philippines, April 1981, Tables A-2 and A-3.

enough to spend again. A combined spurt in business and consumer spending leads to expansion. This scenario was in play between 1980 and 1983 throughout the Pacific Basin--in South Korea, Taiwan, and Singapore--and their economies are now running strong.

Why was there not a similar chain of events in the Philippines? First, there was inordinate deficit spending in the public sector--unlike that in the countries mentioned above. One reason for soaring government expenditures was the decision to launch eleven major industrial projects in 1980--such risky and costly ventures as a $765 million integrated steel mill, a $484 million phosphate fertilizer plant, and a $93 million petro-chemical plant. Government experts argued that Philippine natural resources were abundant enough to supply the raw materials for these projects, and given low labor costs and their comparative cost advantages, these enterprises would quickly pay for themselves. The Philippines would thereby develop the means to satisfy more domestic demand and reduce import dependency. They would also be able to export to resource-poor countries in the Asian region.

Two factors undermined this argument. First, it still represented the import substitution strategy that had failed the country since the early 1950s. Second, the timing of these projects was terrible. For one thing, export earnings had fallen, yet huge expenditures required for these projects necessitated foreign bank loans. For another thing, these projects prompted imports as an income multiplier effect worked to spread income through the urban economy and to increase Philippine import propensity. Given the longstanding policy of pegging the peso to the U.S. dollar, the overvalued peso also stimulated a torrent of imports in 1980 and 1981 when imports should have been reduced.[4] Not surprisingly, in 1981 government spending skyrocketed to produce a deficit of 56 billion pesos (about $480 million), of which 51 percent was borrowed from domestic sources and 49 percent from foreign sources.[5]

At the same time, private short-term borrowing burgeoned from the domestic banking system (whose cash balances and lending capabilities had been enhanced by government deficit spending) and from foreign creditors eager to invest their petro-dollars and other cash balances. Domestic credit to the private sector jumped from 67,189 to 95,128 million pesos. In fact, between 1979 and 1982 domestic credit to the private sector expanded at an annual rate of 18 percent compared to an annual rate of 14 percent between 1976 to 1979 when the economy was expanding at a

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4 Central Bank of the Philippines, The Philippine Economy: Policies and Developments, 1975-1982 (Manila: Central Bank of the Philippines, 1983), p. 20. But in 1979-1980 the value of total Philippine imports in million of US$ rose from 6,142 to 7,727 (a 25.8 percent growth) and between 1980 and 1981 a 7,727 to 7,946 expansion (2.8 percent).

5 Ibid., p. 40.

very rapid clip.[6] A considerable amount of private borrowing was obtained from foreign sources as well. The upshot of these twin developments of government and private debt expansion was to increase Philippine external debt. Even more serious, a high percentage of that debt was short term.

By 1982 the state collected far less revenue (46,947 million pesos) than in 1981 (57,166 million pesos) because of the severe impact of the depression. Total government debt in that year reached the all-time high of 63,426 million pesos, 48 percent of which was borrowed from foreign sources. In other words, the 1980-1981 scenario was reenacted in 1982. The same was true for private borrowing, which rose from 97,463 million pesos in 1981 to 113,188 million pesos in 1982. There were few bankruptcies or business failures during these three years because the business sector was being held up by an expanding sea of debt, much of it on short term and to foreign creditors.

Misreading the Signals

Even the experts did not understand fully what had been happening during these years. World Bank officials voiced concern about the government's need to restructure the economy and promote more efficiency in manufacturing and agriculture. For example, in June 1983 the World Bank reported that "the current account deficits of 5-8 percent of GNP which the Philippines has experienced during the last five years cannot be sustained indefinitely. While there is no immediate liquidity problem, fundamental structural changes need to be made in the Philippine economy if future growth is not to be seriously limited by balance of payments constraints."[7] Six months later the Philippines was in the midst of a severe balance-of-payments crisis and in desperate need of dollars to pay for imports. Since World Bank officials had not pinpointed the impending disaster, it is little wonder that President Marcos and his advisers also misread the extent of economic damage that was in progress.

In mid-1983, then, public and private experts alike were commenting favorably on the economic upturn and predicting that the worst was over.[8] As late as September 9, 1983, the Manila press was reporting on the resiliency of the Philippine economy and the favorable economic and financial indicators of economic recovery.[9] By November, however, it had become clear that a disaster was in the making.

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6 Ibid., p. 25.

7 World Bank Report, June 1983, p. 6.

8 Rigorberto D. Tiglao, "Central Bank reports encouraging start for economy in 1st quarter," Business Day, April 15, 1983; "RP Economy off to a Good Start," The Manila Evening Post, April 29, 1983.

9 "RP Economy shows resiliency in first half of 1983," Business Day, September 9, 1983, pp. 15-21. This report gave an up-beat overview of the favorable economic and financial indicators for the Philippine economy in the first six months of 1983.

On November 7th, the Central Bank of the Philippines recorded its interpretation of what had derailed the Philippine economy. Its argument was that (1) far too much public and private borrowing had occurred after 1979 (particularly from foreign sources); (2) a substantial amount of this debt was in short-term obligations and not reported to the Central Bank; (3) the peso had been overvalued so that imports were constantly favored. As a result:

> The net outcome of international and domestic developments was a weakening of foreign exchange receipts as a result of the world recession and an overvalued peso, at the same time that foreign exchange payments were mounting with the debt service arising from the investment program of the past decade, and with an international capital market that was less ready to finance the inevitable balance of payments deficit, let alone new investment projects.[10]

Still another factor severely aggravated the foreign exchange shortfall: an incredible flight of capital occurred in the months following President Marcos's illness and the street demonstrations in Manila after Aquino's murder. In particular, large amounts of dollar earnings from Philippine exports such as sugar and coconut were placed in foreign banks rather than remitted to the Philippines. Therefore, the capability of paying for imports still exists, provided business confidence and will are forthcoming.

Coping with the Crisis

Although the government learned too late the facts of its economic disaster, the Marcos administration has taken correct steps to deal with the emergency. As early as July 25, 1983, the President reported to the Parliament that the government would adopt a "more austere financial program with the objective of keeping the budgetary deficit to 9.4 billion pesos (or 2.5 percent of projected GNP), limiting approvals of new foreign loans to $2 billion, and keeping liquidity expansion to 14.7 percent."[11] On October 5th, a second devaluation of the peso occurred, making imports 25 percent more expensive. During late November and throughout December, anti-profiteering task forces cracked down on the hoarding of consumer goods by merchants. On December 7th, President Marcos authorized foreign businesses to invest up to 100 percent in Philippine enterprises. Two days later the President opened yet another door to the import of raw materials by authorizing manufacturers to use their dollar earnings which had not yet been remitted home from banks abroad. On December 11,

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10 "The Philippine economy: what did actually happen?" Bulletin Today, November 12, 1983, p. 7C1.

11 President Fernand E. Marcos, "Report to the Nation: Agenda for Growth," Bulletin Today, August 4, 1983.

the World Bank approved the additional release of $83 million to help the country weather the dollar difficulty.

Delays in negotiating debt rescheduling with the International Monetary Fund in the first quarter of 1984, however, forced Manila to ask for another repayment moritorium from its creditors. A new 90-day debt postponement was approved in April, but an agreement on rescheduling was not reached.[12] In early April an additional 3 percent import tax was levied. The policy of promoting exports and limiting (and in many cases restricting) imports had produced a $106 million surplus in the balance of payments ledger during the first quarter of 1984. But this was still not enough given the size of the nation's debt. The government's goal was to reduce the deficit to 5 percent of the gross national product in 1984 and 3 percent in 1985.[13]

Devaluating the peso to dampen imports, reducing government spending, trying to halt the flight of capital, rescheduling the external debt, and obtaining new loans were suitable remedies for the Marcos government, which it proceeded to implement.

ECONOMIC PROSPECTS

The first half of this year will be an extremely difficult period for the Philippines. Inflation is currently running at 35 percent and unemployment is about 23 percent throughout the Philippines.[14] Economic growth may fall by as much as 7 percent this year, which means that the standard of living for most people will decline markedly. These developments, of necessity, must cause a reduction of imports. Increases in exports should then result in the accumulation of enough foreign exchange to begin repaying a substantial part of the foreign debt.

Are the sources of economic growth strong enough to revive the Philippines's economic engine so that long-term prospects are favorable? Several factors favor an eventual economic recovery and sustained growth:

1) The strong economic upswing taking place in Japan and the United States (Manila's major trading partners) should spur exports for at least the next two years.

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12 "Manila Gets 4th Moratorium on Its Foreign Debt," Asian Wall Street Journal, April 16, 1984, p. 12.

13 "Manila Plans to Cut Current-Account Gap to 5 Percent of GNP," Asian Wall Street Journal, April 30, 1984, p. 5.

14 Guy Sacerdoti, "Tougher this time," Far Eastern Economic Review, April 26, 1984, p. 144; "Many in Philippines Lament Decline in the Quality of Life," Asian Wall Street Journal, May 14, 1984, p. 3.

2) The recent recession and current crisis has weeded out many inefficient manufacturing companies, thereby strengthening the urban industrial sector, and giving a further boost to productivity. The quality of industrial exports, as a consequence, will improve. Exports also will increase in quantity due to two sharp devaluations of the peso in 1983 and this should help to strengthen Philippine competitive footing in the world market.

3) The agricultural sector is currently strong, thanks to government assistance to the rural infrastructure during the past ten years. New projects now under way to develop diversification in the rice and corn growing regions as well as to provide for more rural industry will help productivity. (Examples are pig and poultry production, improvement of root crops, and a variety of labor intensive industries such as furniture, textile, and food processing.)

All of these developments represent positive aspects that many critics have overlooked. Even so, more must be done by both government and the private sector to expand employment and to provide for the more than half a million people entering the workforce each year. Rural industrialization is one of several answers. The government's Technology Resource Center (TRC) is one of the innovative agencies already addressing this problem. In the past few years, the TRC has been providing credits and on-site training for goat breeding, feedmill production, agro-forestry products, pepper and rubber tree production, and a variety of other agro-industrial activities. Developing labor intensive export industries is also high on the TRC's agenda. Funds have been dispersed to wood processing, light metal producing, and food processing firms, leading to the construction of more than 25 new factories in 1982-1983 alone.

If more small and medium-sized firms based upon labor intensive technologies could be created in the immediate future, the Philippines should be able to minimize the underemployment that has steadily worsened during the recent past. Much will depend, however, upon the government's ability to avoid any further large-scale capital intensive projects like those launched in 1980, further retrenching, and sticking firmly to a holding operation in terms of public spending. Bold steps taken by the public sector would then free more resources for the private sector to utilize in the expansion of small and medium-sized entrepreneurial firms. This prescription for economic survival, of course, depends entirely upon political stability.

CONCLUSION

At the present time, the Philippine government is doing all that is possible to resolve its foreign exchange crisis and external debt problem. Assuming that the debt can be rescheduled and new loans obtained to tide the country over, the next huge bulge in debt repayment will not come for four or five years.

There will have to be sufficient foreign exchange on hand to meet that demand. The state also is trying to retrench its activities, foster more competition in urban manufacturing (protected for far too long), promote rural development (especially diversification of agriculture and rural industry), and tax the urban middle class more heavily to force them to pay for a larger share of the development costs. This is as it should be, and all signs indicate that the Marcos administration has put in place the correct economic development strategy. It must now hold its course and limit changes to fine tuning of those policies.

Although confronted by a serious liquidity crisis, the Philippines can be expected to reschedule its external debt repayments, obtain new loans, and limp through the rest of this year and into 1985. Central Bank controls over credit and restriction of imports as well as government efforts to economize should shrink an overinflated public sector and weed out the inefficient and wasteful private business firms. Unemployment and inflation have risen in the first part of this year. Vocal interest groups in Metro Manila will continue to oppose the lowering of tariffs and new taxes. But now the state must persevere against both the entrenched bureaucrats and the long protected businessmen.

The rural sector, which has benefited this past decade from government help, will have to bear much of the cost for cushioning the flow of unemployed that can be expected to leave Metro Manila and return to the small towns and barrios. And, as it began almost too belatedly in early 1977, the government must continue to transfer credit and technical know-how to agro-business and export manufacturing firms. The Philippine economy is needful, as never before, of an upsurge in such small and medium-sized businesses eager to employ more labor. If new entrepreneurs come forward in the coming year during the restructuring process, a more robust Philippine economy with a greater export earning capacity will eventually emerge.

In retrospect, the economy performed better after the Marcos administration declared martial law than at any previous time since independence. Bad luck in 1979 in the form of world recession snuffed out the miniboom under way. A number of government agencies are now trying to industrialize the countryside and diversify agriculture--developments that offer the only hope for the economy to catch up with other newly industrializing countries of East Asia.

The recent National Assembly elections in the Philippines suggest that economic policies have generally been worked out. The links between economic and political policies remain to be ironed out and the future leadership of the Marcos government remains to some degree in limbo. On the other hand, if the debate of economic issues during the campaign is any measure, the nation is on the right track. Keeping it there is now the major problem.

Election results thus far indicate that Marcos's power will not be immediately threatened, though he must now deal with a substantial, though fragmented, opposition. But progress in political reform will depend on a continued economic stability. This should signal the Reagan Administration and Congress to provide only the economic assistance that will enable the Marcos administration to continue its efforts to industrialize the countryside and deregulate much of the export manufacturing sector. This might afford the Philippines enough time and assistance to turn the corner from its present difficulties and break into the stage of sustained economic growth and stable political leadership.

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