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## Philippine macroeconomic issues and their causes

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# Philippine Macroeconomic Issues And Their Causes

by

**Gerardo P. Sicat\***

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## **I. Introduction: Macroeconomic and structural problems**

This paper reviews some macroeconomic issues relating to the current Philippine economy. To provide a proper understanding of these issues, their link will be associated with their structural underpinnings. Persistent macroeconomic problems often require a policy adjustment. Inevitably, the assessment of the problems boils down to an understanding of what gets done, what gets delayed or what is not possible to do under the circumstances. A further device in presenting the issues is through a comparison with the experience of other East Asian and high growth countries, which includes some ASEAN countries.

The review follows this sequence. First, the recent growth performance of the economy is discussed. Then, the compositions of aggregate demand and of aggregate supply are described, emphasizing the reasons for the observed changes and trends. Next, the economy's saving and investment issues are highlighted, paying notice to the large

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\* Professor Emeritus of Economics, University of the Philippines. This paper is a revised version of the author's presentation at a Conference on the Philippines with the theme "Whither the Philippines in the 21<sup>st</sup> Century," July 13-14, 2006, at the Institute of Southeast Asian Studies, Singapore. The statistics used throughout the study are derived from Philippine government sources. They may be reviewed from the Philippine Economic Indicators in the Bangko Sentral web page, [www.bsp.gov.ph](http://www.bsp.gov.ph). The international data comparison are taken and calculated from the Asian Development Bank's *Key Indicators*, an annual publication.

gap between saving and investment. After that, the spotlight moves to the fiscal front that is a major contributor to the country's low saving rate. The fiscal sector is discussed in terms of dealing with deficit reduction and managing the public debt. Finally, the review expounds on the economy's external trade and payments position. Current problems and new opportunities are discussed in the context of globalization and the country's open stance.

A major theme that arises from this discussion is that the potentials for development in the Philippines are not fully exploited at home. This underperformance contributes acutely to the slow conquest of poverty. A relative measure of this underperformance can be derived from the immense turnaround of economic prospects in 2006 just as soon as the government was able to deal with a reform of the fiscal front. A result of these measures led to higher tax revenues being earned, thereby saving a deteriorating fiscal problem. A lot of other benefits affecting macroeconomic fundamentals were likewise experienced, changing the dynamics of political and economic discourse.

## **II. The Rate of Economic Growth and Productivity**

Recent growth rates in the Philippine economy have ranged from 3 percent per year to 5.7 percent – the average growth rate of this from 1999 to 2005 is 4.6 percent. This is the growth of the GNP, a measure of total national income, not of GDP, or a measure of total output produced in the country. The annual GDP growth rate during the same period is lower, 4.2 percent. (The significance of this discrepancy is explained in detail later, below.)

Philippine economic growth has been on the modest side compared to that of high growth East Asian economies. During their rate of sustained growth in recent decades, these latter countries have achieved annual growth rates of real output ranging from 7 percent to 10 percent per annum of real output and income growth during their periods of sustained growth. The Philippines is literally surrounded by these countries – in the north, Japan (the earliest of the achievers during the 1950s to the 1970s), South Korea, Taiwan, Hong Kong, Singapore and Malaysia. Today, China is repeating the early “economic miracles” of these countries but on a larger scale. Indonesia had done very well four four decades but its performance was reversed by a lost momentum after recent political and economic crises.

Philippine economic performance has been characterized by recurrence of booms and busts that are sharp around average rate of economic growth. As soon as macroeconomic fundamentals had gathered momentum to reach a particular environment of encouraging growth, imbalances come back in the form of balance of payments and difficulties on the fiscal front. In part, this problem of recurring imbalances is due to lack of timely action related to the required economic remedies. Such policy actions are often painful and therefore difficult to push in the political front. The remedies are often in the form of adjusting macroeconomic policies such as dealing with tax reform and expenditure cuts. But often the problems that jolt the economic performance arises from some structural inflexibility that makes the economy very sensitive to political jolts of a

domestic origin or from external economic events. Such weakness in flexibility helps to disturb investment confidence.

There is another feature that characterizes the Philippine growth experience with that of the immediate neighbors. Population growth in the Philippines continues to be high at around 2 percent per year and has hardly changed much in rate of growth in recent years. This means that per capita growth of income and of output is lower because the high population growth absorbs much of the growth of the economy if only to maintain consumption per capita. In comparison, the East Asian high performers have experienced a halving of their rates of population growth from highs of close to 2 per cent per year during the 1960s toward 1 percent per year by this decade.

The rate of economic growth of output and of productivity in an economy depends on the technical relations with the rate of growth of the inputs of capital, labor, and other economic resources that enter the production process. A productive and efficient economy displays a high rate of economic growth that helps to eradicate a high level of unemployment. In these relations, the quality of the inputs (amount of knowledge, skills, and learning by experience of the labor force) builds up. It is not surprising that rising incomes and the savings derived from falling birth rates induce a higher investment in education, nutrition, and family welfare. They improve the efficiency of labor even as the economy and as the rise of inputs help to accelerate the growth of output.

Aggregative studies of growth and productivity have consistently explained that Philippine economic growth is due to the growth in the employment of capital and of labor inputs.<sup>1</sup> But total productivity growth has been inconsistent and in fact indicates that during some episodic periods, the growth of productivity had been nil or negative while the growth of capital inputs and of labor inputs have been positive. The rate of capital accumulation in the economy has been in general adequate during the years of development. However, even though at the same time such a growth of investment has led to the employment of labor, the total growth of output and productivity has not been adequate to generate a high level of employment and productivity growth.

These studies provide statistical evidence of what was happening in the aggregate. But to understand why this had taken place would require an analysis of the manner in which economic policy evolved in the goods and factor markets. In terms of the goods market, the industries that were promoted for a long time were mainly dependent on protection and high tariffs and government support, with many of them unable to become competitive as the economy was opened toward greater competition with international trade.

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<sup>1</sup> Studies of Philippine total factor productivity, pioneered by Richard Hooley and carried out by others, including Caesar Cororaton, have documented the poor record of total factor productivity. Although the findings about the low level of total productivity are consistent, the reasons for this occurrence have evaded consistent explanation. See Richard Hooley, "Productivity Growth in Philippine Manufacturing," Philippine Institute for Development Studies (PIDS); Cesar Cororaton, "Total Productivity in the Philippines," PIDS, Discussion Paper 2002.

On the goods side, the gradual evolution of the economy's trade and industrial policy forced a restructuring of the industrial sector. This liberalization of the economy was accompanied by the enlarging role of ASEAN economic cooperation through the preferential trade agreement that arose and, more importantly, the country's accession to the principles of world trading rules in the World Trade Organization. The protectionist policies on the goods side held back for decades the growth of competitive industries in international and domestic trade.

As important to the outcome of the process of economic growth in the Philippines are policies affecting the markets of the factors of production. This refers to the set of policies affecting the employment and attraction of the use of capital, labor, land, and natural resources. A major cause of the underperformance of the Philippine economy is related to the rigidities of the factor markets. As a result, labor and capital have not played as important a role in bringing the economy toward a higher level of growth as found among the East Asian neighbors.

On the labor side, the welfare-oriented approach toward labor introduced labor market rigidities that made it difficult for firms to hire labor. Legislated minimum wages were aggressively set higher than market realities, often guided by welfare considerations using urban-based living standards and often in response to populist tendencies to follow labor welfare standards of advanced industrial nations. This prematurely raised unit labor costs of labor and introduced antagonistic labor-management relations that were not present in other neighboring countries. This rendered employment creation more difficult for the government. Regional minimum wage setting was introduced during the 1990s that helped to factor in regional competition as a factor in setting minimum wages. Despite this effort, oft and on the new policy gets threatened with each new demand for wage revisions.

Such an approach to labor policy would have had benign effects, or at worse, less harmful if the policy toward the attraction of foreign capital were more aggressive and had yielded more than just seemingly good results. On the capital side, however, the restrictions to foreign capital continued in critical sectors that were identified as far back in 1935 when the political constitution was framed.

Even as the country's investment policies flourished and became more open gradually as a result of the liberalization of many aspects of economic policy, the main restrictions of the constitutional provisions continue to remain in effect with respect to foreign capital in specific sectors including public utilities and natural resources. Foreign capital was essentially the "free" economic resource, for it is not hampered by the limitation of domestic capital faced in the midst of economic opportunities. Attracting capital to flow in more freely would have enhanced the rate of investment and the possibilities of technological growth. Incidentally, this was the pattern of policies in many of the high performing countries of East Asia, including even in countries where they tried to have capital controls for some other reasons.

Since 1935, the policy pertaining to the attraction of capital was undertaken with major exceptions to several sectors of the economy. These restrictions were specified in the Philippine constitution and they took on the nature of iron laws (of prohibitions or

exceptions to the role of) pertaining to foreign capital attraction. Foreigners are not allowed to buy land, and only companies that are substantially owned by Filipinos (at least 60 percent majority) are allowed to engage in the operation of public utilities and the exploitation of natural resources.

Over time, these provisions would create a structural problem for the evolution of public utilities and introduce higher costs on the provision of domestic infrastructure because capital – especially risk capital – in these sectors by virtue of restrictions around them would become even scarcer. They also affected the expansion of other sector activities, including agriculture, industry, mineral exploitation and the growth of services like tourism. The more obvious impact of these policies relate to the state of public utilities and the expansion of infrastructure. They suffered in quality as a result of the onslaught of capital inadequacy of local investors who were given the means and opportunity to pursue expansion, modernization, and even rehabilitation of existing facilities.

Under more open access to debt finance in the world's capital markets, these facilities became more dependent on borrowed capital for which there was a high element of risks associated with the interest rate and foreign exchange rate. The model under which they underwent expansion was mainly through borrowing but such borrowing was often limited by the amount of domestic equity capital that was put in the undertaking. Local savings and lack of access to foreign direct investments in these facilities because of constitutional regulations prevent rapid solution to a major problem that had worsened over decades of economic underperformance.

It is widely recognized in the Philippines today that foreign direct investment – its greater participation in the provision of public utilities – and in the exploitation of natural resources would greatly improve the economy's domestic infrastructure and export earning capacity. Some of the actions that permit the participation of foreign direct investment could therefore be undertaken through indirect mechanisms. This was achieved for instance through the layering of corporate structures that avoided direct conflict with the constitutional restrictions in these sectors. Others would be through service contract arrangements with state entities that therefore fulfill the equity requirements concerning citizenship without any doubt.

In a recent decision, the Supreme Court helped to make it constitutional to allow fully owned foreign owned companies to engage in mining exploitation under the framework of service contract arrangement with the government. The amendment of the basic document regarding these provisions would be needed to remove the threat of legal challenges that cause delays, discouragement and often uncertainty in the outcome.

The learning process in the Philippines toward promoting a liberal foreign investment policy climate was slow for decades because of the restrictions from the constitutional framework and the hang-ups that these restrictions have imparted on the policy milieu. The restrictive posture of investment policies from the constitutional framework had an overwhelming influence on the nation's attitude toward the role of foreign capital. Initially, the policies applied mainly in public utilities and natural resources exploitation. But these gradually expanded into many areas of industry and

commerce during the period of economic restrictions that permeated government policy for a long time. The infectious pattern of these policies enabled the growth of a highly protective industrial and trade regime that dominated economic policies for many decades.

### III. Widening disparity between GDP and GNP

Reference has already been made to the phenomenon of recent times that the rate of growth the GNP has been outstripping that of the GDP. As is well known, both concepts measure specific aspects of the output and income definition. The GDP measures output produced within the country's borders by all residents while the GNP measures the output or equivalently income earned by all the country's nationals. When a country's nationals earn a substantial amount of their income outside the nation's boundaries, then these represent incomes derived from work abroad. Hence output produced at home (GDP) has to be corrected by the *net* contribution of all national labor and capital working abroad (derived from the measure of GNP). In a sense, therefore, the GNP measures the incomes earned by all nationals whether working at home or abroad.

In recent years the GNP has consistently been growing at a faster rate of growth than the GDP. Real GNP grew by 3.7 percent in 1999 compared to 3.4 percent for GDP. In 2005, real GNP grew by 5.7 percent and GDP by 5.2 percent. The discrepancy in growth rates has been consistent throughout the period in between and even before. Before 1990, GDP and GNP were roughly equal. The phenomenon of the GNP being consistently higher than that of the GDP says that a large component of Philippine income and output is being accounted for by Philippine factors working in other countries, not at home. The source of output is mainly the out-migration of labor resources to countries of high wages for Philippine labor. In mature economies that export capital to other countries, it is capital that makes up the difference in their GNP and GDP. From 1991, the GNP began to get larger by virtue of the flow of net labor incomes arising from overseas Filipino workers (OFWs) sending remittances from abroad.

The discrepancy is seen from the ratio of GNP to GDP. This has been consistently higher than 1 by the 1990s. In 1999, the deviation of GNP was by a factor of 5.6 percent. By 2005, this deviation was by 8.3 per cent. Thus, GNP has outstripped GDP by as much as those levels, assuming the absence of statistical discrepancies. The differences in the total level of output are systematic in their tendency. Suppose, for convenience of illustration alone, that in a given year the initial value of the GDP and the GNP were equal. In 2004, the GDP was 4 trillion pesos in current terms. If GNP grew more by 0.5 percent of the growth rate of the GDP, the resulting difference in net output is 20 billion pesos. Cumulate this growth on a year-to-year basis, it is quite a large amount in five years in terms of level of output being discussed.

Thus, Philippine labor works abroad in combination with productive foreign capital located in those countries. Viewed from the Philippine side, the phenomenon manifests the relative inadequacy and inefficiency of the domestic capital at home. Philippine government policy is in control of providing better conditions for domestic capital formation and providing the proper regulation and protection of Filipino labor.

Yet, the paradox of the problem is that the promotion of foreign employment by Filipinos is almost a state frenzy. But the promotion of inward foreign capital is full still of inconsistent fears and laws that restrict it in important sectors. There is no state frenzy (in spite of the often announced promotion of foreign investments) in removing the real bottlenecks that prevent foreign capital from coming in and participating more fully in the growth of the domestic economy.

#### **IV. Composition of aggregate output and demand**

A brief overview of aggregate demand and aggregate supply below discusses the pattern of output demand and supply.

##### ***Aggregate demand***

Aggregate expenditure on output consists of private consumption, domestic investment (both public and private), government expenditure, and net foreign demand (demand for exports minus imports). Ignoring net foreign demand for the moment, we now examine these components of aggregate demand.

Private consumption expenditure is the largest component of aggregate demand, ranging from 72 percent to 75 percent of total aggregate demand (GNP). In 2005, this was 72.6 percent of total demand. Government consumption expenditure has ranged from 5.9 percent to 7.7 percent of total demand. The lower demand depends on the level of fiscal operations to support government operations. The composition of aggregate demand is based on gross figures of income. Total consumption, combining that of private consumption and that of government spending, take up close to 80 percent of total final demand. In general, the remainder is relegated to the combined gross domestic capital formation of the economy.

Gross capital formation in the economy is around 20 percent of total demand. Part of total demand represents net foreign demand that in recent years has been in favor of relatively more importation of goods and services. As a result, gross capital formation has been a little less than the 20 percent level of total aggregate demand.

The Philippine economy is highly consumption driven. Poor economic performance at home is partly propped up by the influx of income transfers from OFW remittances, which in recent years have continued to grow. The vibrancy of the retail sector especially in the Metro Manila area and in other cities and towns where air-conditioned retail malls have been established indicates the strength of purchasing power that is powered from the incomes of workers abroad sending dependent families incomes for their consumption needs at home. The presence of a young dependent population arising from the country's high rate of population growth makes a contribution to this. The persistence of a highly young and dependent population creates a heavy pull of demand for consumption in the economy.

##### ***Aggregate supply of output***



The aggregate supply of output is what the economy produces in the economy. In 2005, agriculture supplied 17.8 percent of GNP; industry (which includes manufacturing) 30.7 percent of GNP; and services 44 percent of GNP. This composition is slightly different from that of 2000, at the turn of the millennium. Agriculture then was higher in relative composition, 18.5 percent of GNP; industry 33.2 percent of GNP; and services 42 percent of GNP. Such slow pattern of change in production has been happening over time.<sup>2</sup>

In the normal case, the structural change in output predicts a rising industrial sector in terms of total output until industrial growth has reached some kind of maturity. That is the pattern found in most developed countries today. But these advanced economies experienced in their economic history a process of growth in which industrial growth played a major role. The relative decline of their industry began when rising costs at home and the effectiveness of competition from other countries resulted in their loss of competitive advantage.

The composition of Philippine output however shows the relative decline of agriculture and industry to total output and the rise of the contribution of services. At the current stage of development, the pattern that is observed for the relative loss of importance of agriculture within a growing economy is not surprising. What is less expected is the relative decline of industry in relation to total output. With an economy that is still highly agricultural in terms of the dependence of the general population on rural and industrial employment, the Philippine economy is actually gradually moving away in relative terms both from agriculture and industry and towards a service oriented economy without having reached a high degree of industrialization. The expansion of industry and of agriculture does not catch up with the absorption of excess labor. The service sector is expanding more rapidly than the two other sectors.

Some of the promising efforts that were designed to raise the level of industrialization through the development of basic industries failed to grow out of the protective shell of the import substitution framework. When the design for export markets was the target, the heavy dose of government participation in the essentially private sector projects helped to doom the projects. The steel industry for instance was initially designed for a small market and the project was heavily borrowed at the start. Perhaps the more critical factor was in the poor choice of principal investor. Industrial cronyism was part of the Philippine political economy for large projects. Strong interests backed up highly protected industries. However, such a process was unsustainable over the long term.

Having thrived under heavy protection and governmental patronage before but still essentially undercapitalized even with access to government financial support, these early efforts in heavier industrial activity became victims of economic crises or financial collapse once they were exposed to international competition and market forces. These

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<sup>2</sup> The discussion of sector output aggregates is based on data calculated as a percent of contribution to GNP. As a result, the percentage output of all the sectors do not add together to 100 percent This is not a discrepancy but is due to the fact that the GNP includes estimates of output that are called net factor incomes of the nationals living outside the country.

enterprises suffered the pressure of limited markets, rising cost of credit due to interest rate and to foreign exchange depreciation. Their high level of foreign debts, lack of markets abroad, and high costs at home caused them to buckle under greater import competition. However, there are enterprises that were conceived under high levels of protection that had survived the shedding of protection and had become more versatile participants in the market place as a result. Through mergers and acquisitions and through privatization, some of the failed industrial enterprises have thrived under changes in ownership and economic rehabilitation.<sup>3</sup>

Despite these problems, new industries powered by a liberalization of foreign capital inflows thrived very well and strengthened the country's growth of new exports. These are the new industries that did not depend on tariff protection or market monopolies but which thrive in the open market. Around this framework of industrial growth has sprung the growth of new comparative advantage in international trade. The growth of electronics exports has been propelled by the influx of foreign direct investments in these areas. As a result, the industrial sector has become vibrant and new directions have opened under a more competitive industrial regime.

## **V. Saving-investment gap, or Why the low investment rate?**

Philippine capital formation rates during 1990 and 1995 were 22 percent and 24 percent of GDP, respectively. This fell to around 18 percent of GDP in 2000 (as an after effect of the Asian financial crisis and the political troubles of Joseph Estrada that brought in great uncertainty). In contrast, from 1974 to 1983, the country's capital formation rates ranged from 27 percent to 33 percent of GDP. Five of those years ten years involved capital accumulation rates in excess of 30 percent of GDP. The historic average of capital accumulation before 1974 was an average of 21 percent of GDP, still a high rate compared to the recent decline of investments. From 2000 to 2005, the rate of investments has fallen to around 20 percent of GDP. This rate of investment is even lower when measured in terms of percent of GNP (because GNP has exceeded consistently that of GDP).

The amount of domestic investment that is financed from national saving rate can be implied from the ratio of the domestic saving rate to total investment rate (as percent ratios of GDP), which is also a measure of the saving investment gap. The high saving economies finance most of their investment needs; in short, they have almost no saving investment gap. The gap that arises is essentially the result of short run imbalances including some structural problems arising from the immaturity of financial institutions. China, despite its huge inflows of foreign direct investments is essentially self-financing its domestic investments. South Korea is minimally dependent on foreign saving for its investment needs in recent years.

The Philippine saving rate is low and represents the bottleneck for attaining a higher rate of economic performance. It is deficient in relation to the country's

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<sup>3</sup> The restructuring of the cement industry was achieved essentially through their acquisition mainly by major international players in the cement industry. The steel industry has been resuscitated through privatization of the enterprise. The same is true with large scale copper smelter plant.

investment needs. It is low in relation to what other East Asian countries have accomplished and continue to achieve. It is low further in relation to what was possible in the country before – from 1974 to 1981, for instance, the investment rate ranged from 27 percent to 33 percent of GDP, made possible because the fiscal sector could produce peso funding counterpart for development projects. The national saving rate constrains the possibility of better and higher level of investments, for it reduces the capacity of the country to take in additional inflows of capital, both new debt and foreign direct investments.

In high growth countries in the East Asia region, the saving rates of the economy were consistently sustained at high levels. During 1985 to 2000, the rates of saving in these countries permitted high rates of domestic capital accumulation. In China, the rates of capital formation were in the order of 36 percent to 41 percent of GDP during this period. South Korea had rates ranging from 28 percent (during the crisis period of 2000 – after-effects of the Asian financial crisis) to highs of 37 percent of GDP during the 1990s.

Among the five original ASEAN countries during the 1990s, the Philippines had the lowest recorded rate of capital formation. Malaysia and Singapore have had outstanding rates of domestic investment ranging from 27 percent to 43 percent and Singapore ranging from 31 percent to 36 percent of GDP during the 1990s. Thailand's rate of investment of 42 percent of GDP during the 1990s was almost twice that of the Philippines during the same period. Indonesia consistently had a high rate of investment of around 30 percent of GDP during the growth years under Suharto. During the crisis years, in 2000, the rate fell to 15 percent of GDP.

Of the ASEAN countries, Singapore has become a saving surplus country, having essentially more saving than it can invest in the domestic economy. As a result, it has become a capital exporting country. Malaysia is close to achieving self-sufficiency. Of the three other original ASEAN five countries, the Philippines today is most dependent on foreign capital for its investment needs. In 1990 and 1995, only around three fourths of its investments were financed from domestic saving. The low level of investment partly arises from the limitations of saving. That limitation also contributes toward providing an upper limit on the inflow of foreign saving. As it is, the level of relatively high dependence on foreign saving makes the country more vulnerable to economic downturns arising from loss of business confidence and to external factors that affect the flows of capital from other countries and to the country specifically.

The capacity of private enterprises to save depends on their ability to earn profits. Profitability depends on the business environment in which they thrive. In general, that environment is made possible by the presence of competitive markets in the goods market. Producers have to face competitive market forces from imported substitutes and from other domestic producers. As a result, producers had to position themselves to produce at low costs in order to thrive. Trade and industrial reforms in the past improved the competitive framework of the goods market. The presence of fiscal and investment incentives further made it possible for some cost disadvantages to be overcome.

Factor markets that the enterprises face are very important too. The contradictory nature of the policies for labor and for capital (as expounded already) has limited the

opportunity to make major gains in inducing greater investments in the economy. Without the presence of profitable enterprises, the capacity to generate higher levels of saving in the private sector is also hampered.

Total saving to finance investment comes from three sources: domestic saving of households and enterprises; saving arising from the public sector, including those of government operations; and saving that comes from foreign sources, both foreign direct investment and foreign lending.

The capacity of enterprises and households to save is supplemented by forced saving schemes that are fostered by government programs. Of the latter, pension funds and retirement funds – the Social Security System, the GSIS, and medical and housing funds – are significant sources of institutional saving derived from households and enterprises. In Singapore and Malaysia, the central provident savings of households have brought in enormous resources to help finance investments in housing and other social amenities.

In the Philippines much needs to be done in mobilizing these financial resources to support private and public investment. These sources of saving have been used to help finance public investment requirements, including support of housing. In addition, they have been used to help in supporting particular private investments, sometimes in the rescue of ailing banking institutions that later were put into rehabilitation. The pension systems based on social security have become significant as generators of financial savings.

Economic policy liberalization has helped to expand the amount of foreign direct investment in the economy. The flow of foreign investments happened in the assembly and manufacture of parts of the electronics industry. Today, much activity is happening in the industries that take advantage of outsourcing of back office operations which is also powered by foreign investments. But in general, total foreign direct investments have not been as large as the flows that have gone into other regions of Southeast Asia and East Asia in general. In part, some restrictive provisions that discouraged substantial foreign capital in natural resource exploitation, investments in land (therefore in agriculture, commerce and property market), and most of all public utilities have played a role in this.

Philippine access to foreign direct investments has been *relatively* modest compared to the experience of neighboring East Asian countries. This was not always the case in recent times. In part, the political arena has contributed to the problem. Public debate on economic policies often have unfavorable political rhetoric unsettles established economic issues. In addition, political turbulence arising from perceived threat to social stability arising from attempted military coups has heightened tension. Other factors relate to the litigious nature of the business environment.

## **VI. Fiscal deficit: taxes, expenditure and public debt**

For years, government fiscal operations have resulted in deficit. Risk of larger shortfalls in resources when fiscal deficits occur in a persistent manner has larger costs. The

financing of the deficit has implications on credit policy, creating a potential trade off between private use of credit and the government's financing of its fiscal problems. Weak fiscal discipline could stir inflationary expectations and lead to a weakening of the exchange rate. The fiscal position of the government is sensitive to external circumstances because of the economy's openness.

From 2001 to 2004, the fiscal deficit peaked to 5.3 percent of GDP in 2003, remaining on average at around 4 percent of GDP. As stated in the previous section, improving the fiscal performance of the government is one way of improving the national saving rate. For the persistent fiscal deficit problem of the government contributes to the low saving rate of the economy. Since total saving is the sum of private saving and public saving, when government revenues are inadequate to cover public expenditure, the deficit contributes to a negative public saving. Therefore national saving is in part reduced.

Fiscal deficits weaken the national saving rate from the government side. This creates pressure for borrowing from the private sector or from external sources. In the latter case, the external public debt rises especially if private saving is inadequate. The financing of the fiscal deficit competes directly with the uses of private credit. The private sector requires its own use of credit for investment and for operations, its capacity as a generator of its own income surpluses, or savings, is also hampered. This restrains private saving rates. Monetary reform on the other hand has made it more difficult now to borrow from the central bank for purposes of the deficit.

The fiscal performance of the government can be improved via a number of routes: improved tax performance; increase of the government's non-tax revenue sources; greater efficiency of tax administration; reduced waste in public spending through the stream-lining, focus and reorganization of the government including greater vigilance in stopping corruption. But an indication of the need for tax revenues is that, in recent years, the government had to cancel quite a lot of projects that were borrowed from multilateral and bilateral lending institutions for lack of counterpart peso funding support.

### ***Tax revenues***

The ratio of total government revenues to GDP was 17.4 percent in 1999. This was the highest level during the next six years. The ratio fell by 3 percentage points to 14.5 percent in 2005. The tax effort (total taxes as percent of GDP) was of course even lower, because total government revenues are the sum of tax revenues and all forms of non-tax revenues – fees, profits of government entities, and revenues derived from the sale of services rendered and property owned by the government. Tax revenue effort in 1999 was 15.6 percent. Between 2000 and 2006, the tax revenue effort fell from 14.5 percent in the beginning year and fell even further to 12.4 percent by 2005.

Such numbers as found for revenue and tax efforts are comparable for similar fiscal efforts of governments in East Asia. The Philippine numbers are on the low side of the distribution among these observations. One big reason for the relatively low tax efforts in other countries, too, is the prevalence of investment and tax incentives that form a feature of the investment climates every where. Tax incentives competition especially

among ASEAN countries has led to some kind of race to the bottom among the countries. Of course, foreign investment attraction program is keyed along other criteria.

Reforming the investment incentives through a reduction of the excessive fiscal grants to private investors is a delicate issue. A streamlining of tax incentives by unifying them under a single system of fiscal incentives for the Board of Investments and the export processing zones investors would improve the setup, reduce some of the excessive incentives, and simplify further the promotion of investments. Such a program if planned should be undertaken with assurance to investors in the country so as not to create any uncertainty for investors. There is a great need to inject confidence in the business and investment climate through reassurance that reforms in this area will not affect currently enjoyed fiscal incentives.

The government's low attention to fiscal reform received a jolt from paper of a group of economics professors at the UP School of Economics that warned on the consequences of the large fiscal deficits. Up until that time, and during the all important occasion when the president made a post-election speech assessing the nation's future, the official rhetoric continued to be on expenditure program promises omitting a warning on the nature of the fiscal problem. The UP paper essentially emphasized that fiscal inaction put the country to the brink of a serious economic and financial crisis.<sup>4</sup> The leadership and Congress and the general public was jolted into action. Publicity of this analysis called for action or the nation would face an economic crisis similar to macroeconomic collapse of Argentina in 2003.

In early 2006, a substantial set of fiscal measures restored the country's fiscal fortunes. The government raised the 10 percent VAT to 12 percent and removed many exemptions and adjusted zero rates. Of the major fiscal measures taken, this one effectively stemmed the decline of the tax effort. At once a number of improvements in the country's macroeconomic outlook were reinforced. Fiscal fundamentals improved, with revenues rising significantly and the fiscal constraint being relaxed somewhat more. The economy's outlook in the short run turned positive. The decline of the peso exchange rate stabilized.

The reform of the VAT produced a change in expectations about tax revenue growth and the improvement of the fiscal position. With this, together with other favorable factors concerning payments inflows to the country, the impact on perceptions about the economy's position changed. The peso exchange rate, which had depreciated badly as a result of fiscal woes from 1997 to 2005, began to appreciably improve. This appreciation reached a point that the level of appreciation became a concern for exporters. From a low of 55 pesos to a US dollar, the rate today (October, 2006) has improved to 50 pesos to the US dollar. The assessment of sovereign credit rating agencies improved in tone: downgrades that were made because of the worsening fiscal position

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<sup>4</sup> The UP Eleven paper, so-nicknamed in public discussion, is Emmanuel de Dios, Benjamin E. Diokno, Emmanuel F. Esguerra, Raul V. Fabella, Ma. Socorro Gochoco-Bautista, Felipe M. Medalla, Solita C. Monsod, Ernesto M. Pernia, Renato E. Reside, Jr., Gerardo P. Sicat, and Edita A. Tan, "The Deepening Crisis: The real score on Deficits and the Public Debt," UP School of Economics, August 2004. The paper received major notice in the newspapers and suddenly became a focal point on the debate to deal with the fiscal deficit.

became less damaging in their later assessments and an improved assessment of future fiscal prospects became a more common theme of their analysis.<sup>5</sup>

In the case of excise taxes, Congress displaced an *ad valorem* tax base for so-called sin taxes – especially cigarettes and tobacco – in favor of specific taxes that were fixed to 1996 prices. Because of inflation and the lack of a flexible inflation re-basing mechanism, the tax take on these objects of taxation had fallen off the pace of economic growth – a desirable feature of tax buoyancy therefore had been lost. The tobacco companies have a strong lobby that successfully checks any attempts of Congress to raise taxes on the sin goods. Obviously, there is need to raise the buoyancy of taxes with respect to changing incomes. Since excise taxes are structured as per unit or specific taxes, they need to get re-based to a higher level of values with price inflation. The Philippines is one of the least taxed in the form of cigarettes, tobacco, and alcohol. It is amusing and somewhat ironic that the government was able to adjust tax rates on fuel, a very touchy and basic need, but it has failed to properly re-base those on tobacco!

### ***Tax administration***

Raising the tax effort is often mixed with the problem of the efficiency of tax administration. Both are needed to improve tax collections without changing tax rates and for fiscal stability. In fact, with increased efficiency, further tax rises can be postponed. But somehow, the two go together if the government has to raise its fiscal discipline to a higher level. For one thing, the peso funding for foreign financed public infrastructure projects would need to be made available.

Government efforts to deal with tax administration are focused on improving the administration of the tax collection agencies. Some are linked with administrative changes – personnel changes affecting the collecting agencies at the national and at regional administrative districts, with changes in management practices, including the building of special units of collection for big tax payers, computerization and so on. The most significant change recently is linked to the introduction of pay incentives and targets for personnel. Efforts to pin down widely publicized cases of tax evasion have had difficulty succeeding in the court system.

The last effort is still tied up with a more drastic reordering of incentives and pay of the bureau personnel. The last of these changes still needs to be fully implemented since it was passed only almost simultaneously with the VAT reform. Varying degrees of success have been met by the other reforms. In general, it is linked with the effectiveness of the national leadership in dealing with the tax administration issue. It is also tied up with the quality of the appointments at the top of the bureaus. Some of the best bureau directors have not lasted long in their jobs – an indicator of the difficulty of reform in this area.

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<sup>5</sup> Tracking down the press statements of the credit rating agencies – Fitch, S&P, Moody's, and other such credit rating companies – for instance, in recent months following the passage of the VAT law, would show positive evaluation from them although they still await more positive macroeconomic news.

### *Public expenditure efficiency*

Some government expenditure is dissipated through waste and corruption. Corruption in publicly executed projects is widely known to be a problem. It is apparently systemic: the process of bids and contracting is one issue. The other is in the execution of projects. Infrastructure projects that are fully funded by the government tend to be of poor quality. A high degree of accountability in the bidding, construction, and audit system needs to be put in place – an improved governance of the public administration. High profile cases have set back the country's international image and practically added higher costs in terms of actual delays and prolonged economic inconveniences for the general community. The landmark case that symbolizes this is the new international airport in Manila, which is now on its third year of non-start after almost having been finished. This case has been a black mark in the country's investment promotion program.

Projects funded from international development institutions tend to be of better quality and with reasonable construction periods than those directly funded from peso funds. Internationally funded projects have more steady sources of financing and are therefore likely to get finished on time. Their quality and durability in the end mean lower maintenance and repair costs. This is most evident in the case of road and port projects and irrigation projects. This says a lot about the quality of supervision and the nature of accountabilities that are observed during the process of construction, audit and post-construction. These examples indicate that governance is a major problem.

Projects undertaken with peso financing should be as good as those funded from loan programs if proper governance were in place. To strengthen the accountabilities of the present system that requires effective leadership from the government. (In contrast, changing the political system or the structure of certain institutions is just a palliative that forces diversionary issues into play.)

Endemic corruption in public works contracts and execution has been a concern for years. The bad reputation of locally constructed projects could be partly aggravated by the pork barrel system allocations for members of Congress, a practice that was reintroduced after martial law with a vengeance. Of course, the pork barrel refers to the budgetary allocation to members of Congress and the Senate some amount of money to help out in the financing of their favorite projects, often for their constituencies. The pork barrel is a concession to political expediency.

One example of how this has reduced public use of funds is that invariably the quality of works of roads produced through this method was generally poor. The mincing of public resources into different small parts contributed to the ill execution of projects even though these are often good rural projects. Alternative system for the allocation of public money for projects that involve the participation of the legislative branch needs to be instituted to replace the waste of the pork barrel system.



### ***Public enterprises and privatization***

Public corporations have added to the fiscal problem because of heavy losses incurred in their operations. The problems of the public financial enterprises were dealt with during the reforms of the 1990s.<sup>6</sup> This included their downsizing and recapitalization, their charter revisions, and some element of privatization. The current problems deal with those public corporations that deal with the delivery of infrastructure, delivery of public utility services, and those dealing with development as well as price stabilization.

There is no reason why government owned corporations delivering public utility services should be losing money. If allowed to maintain a fair rate of return on their operations, profitability of these public corporations could be sustained. The idea behind government ownership and control is that they require larger scale of investments and the dearth of private enterprise and capital to provide these major services. Part of the problem is tied up with the restrictions placed on the maximum equity that foreign capital can play in public utilities, a rule that is imposed in the constitution. Public utilities are often natural monopolies and those who obtained the appropriate franchises were often undercapitalized.

Political interference in the control and operations of these enterprises often led to erratic and ill-timed decisions on the pricing of their services. These interventions often ended in large consumer subsidies, hence losses in operations. Another aspect of this interference often caused management to become inefficient through over-employment and inability to move personnel. Sound corporate governance of public corporations is an issue that competes with privatization. Introducing sound corporate governance under the public sector is a delicate operation that needs continuous nurturing. Privatization however offers the alternative of closing down the public role, except by the route of regulation.

The reforms undertaken in the public corporate sector are hard to take root unless the issue of public control of their services is severed from politics. Without the development of strong public institutions of governance, the same problems of financial indiscipline would keep coming back. Political interference often dissipates the ability of well meaning management to function effectively. The cycles of political change in an electoral democracy contribute to such disruptions.

Public corporations are likely to be more subject to political interference in pricing decisions. The concept of fair rate of return could become a victim of political expediency and populist action.<sup>7</sup> Management that is interfered with often becomes

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<sup>6</sup> These were discussed in GP Sicat and R. Abdullah, "Public finance," in A. B. Balisacan and Hal Hill, eds., *The Philippines: Development, Policies, and Challenges*, Oxford University Press, 2003, pp. 106-135. This volume of Balisacan and Hill provides a comprehensive discussion of various sectors of the economy, including recent developments and policy issues. The introductory essay of the two presents a thoughtful discussion of the key issues affecting development.

<sup>7</sup> The National Power Corporation, instead of being allowed a return on its costs (in 2003), the public electricity generating supplier was made to bear additional losses amidst the public criticism against the rate increase of Meralco electric tariffs. The effect of the decision was to raise the losses borne by the National Power Corporation.

hostage to the decline of sound practices. Rent seeking if not corruption could permeate their operations, either through the supply contracting or through the provision of their service.<sup>8</sup>

Privatization therefore appears to be the better alternative. Privatization is permanent in that most if not all the problems would be removed from the public domain. Private sector management is more likely to be stable and efficient than public sector management, especially if public salaries are kept at the low rates that these public enterprises often suffer from.

These considerations had caused the move toward privatization of major public corporations as a desirable reform direction. In the early 1990s, the government took advantage of privatization. It proved more difficult to sell large government-owned public utilities than to sell the land assets of the government. The privatization of the waterworks system has generally led toward a better management of the system than under the old regime of a completely public setup.<sup>9</sup>

Privatization of enterprises that sell their services to the general public will become successful if the buyers of privatized assets are well capitalized, have a reputable track record in their running of similar enterprises, and are dedicated to the task of improving the service. Such buyers have access to expertise in the industry in addition to access to the international capital market to augment their capital contribution. Privatization, if the government makes it into a credible exercise, could lead to a successful turnover of viable public enterprises into private entities that are better managed and capitalized. By moving these enterprises to the private domain through the privatization, their fiscal burden is removed.

### ***Financing the public debt***

In recent years, total public sector debt as a result of the fiscal deficits has risen. By 2000, total public debt has reached parity with the level of the GDP, even though about 75 percent of that is directly due to the national government. From 2001 to 2005 the ratio of public debt to GDP soared to 1.18 (or 118 percent of GDP). The rise of the public debt is still essentially within reasonable limits taking into account other countries.

The debt service has two faces. The internal debt service burden is linked with the capacity of the government to raise tax money to service the public debt. Of course, the other option is to refinance the debt with debt, a highly popular method of just continually raising the fiscal deficit. When taxes become inadequate, the proportion of the budget that is devoted toward debt service naturally rises. An obvious impact of this

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<sup>8</sup> In general, corruption is not an issue as much as political interference. Many government corporations are professionally run. The public employees here are often checked by the presence of auditing and other public institutions that are designed to deal with corrupt practices. Often, the issue of public performance is related toward protecting the integrity of the professional service against the incursions of political interference.

<sup>9</sup> This privatization has done very well in the improvement of the management of the water utility compared to the previous public sector run utility. However, one of the major privatizing companies has encountered problems of insolvency mainly through problems of its own related to its own poor financial structure.

is to restrain the amount of public resources devoted to the programs of government that are designed to provide public services, including raising the capacity to raise public capital formation. The complaint that the budget for debt service is the highest expenditure of the government is related to the fact that fiscal deficits had been high and that public tax resources had failed to catch up with wiping out the government's (primary) fiscal deficit.

The second face of the debt service burden refers to the external debt burden. Here, the problem is one of maintaining a high enough level of export and foreign exchange earnings capacity so as to pay for the required debt service. If export earnings and inflows of foreign exchange suffer a downturn, the debt service burden rises (assuming the same level of external debt).

The diversification of the sources of foreign exchange earnings is important for the stabilization of the debt service burden. Those debts that need to be rolled over face interest rate and foreign exchange risks as new terms are sought. Debt consolidations and improvement of long term debt position is one method of doing this. This requires accessing the capital markets – both local and international – in order to float bonds of long term duration to finance the public debt. In recent years, the government's access to the capital market has improved.

However, access to international credit depends on the perception of the country's fiscal operations. If the fiscal sector suffers from heavy deficits, the country is penalized by higher costs of financing. Pricing is based on LIBOR (London inter-bank rate), and the poorer is the assessment of the credit rating of the country, the higher is the interest rate penalty. Of course, the other problem that would bite in that circumstance is whether the exchange rate depreciates as a result of the deficits. In that case, a kind of double whammy results as penalty in the matter of foreign borrowing.

The servicing of interest payments from the debt was 4.2 percent of GDP in 2000. This rose to 5.6 percent of GDP in 2005. The magnitude of the debt service on long term resources would be large until the government is able to improve its fiscal position. Reduction of the fiscal deficit can be undertaken a combination of tax increases, expenditure moderation, privatization of non-essential demands on the government and prudent management of the overall fiscal resources.

The high cost of the interest service of the public debt in the budgetary allocations of the government is troublesome. The risk of exposure to a rise in interest rates has the potential of tilting the economy toward crisis if the rise were sudden and steep. This is because the debt service represents one-fourth of the total resources devoted to the government's public expenditure program. The politics of the debt then becomes a problem for managing the public debate on how little is the remaining total of resources left to finance other government programs and priorities. This is where the efforts to raise the level of taxation has paid off because higher revenues raise the budgetary levels and reduce the relative burden of interest cost as a percent of the budget.

More important also is the effect of relying on extraordinary revenues that can be collected as a result of the program of privatization if it is done correctly and it is

undertaken with greater speed so that the nation realizes the fiscal benefits sooner. Privatization revenues almost reached 2 percent of GDP in the early 1990s for two years when the government sold many government entities. The revenues from privatization are not permanent but their effects on the fiscal budget could be long lasting.

The scale of the next round of privatization around the energy sector could bring in more resources to the government. This could provide the opportunity to reduce the principal debt and thereby help to extinguish interest cost. But so long as development projects yield productive output and are not overpriced, the interest cost of servicing the public debt would yield positive benefits for the economy.

## **VII. Trade, balance of payments, and external debt**

The Philippine economy has been an open economy for years, even during the years of foreign and exchange controls in the distant past. Today the economy is more open than at any time during the republic's history. Through the policy of economic liberalization of the trade and industrial front, the exchange rate has become flexible. Public consciousness already accepts exchange rate variability as a fact of life.

In general, the movement of the exchange rate has caused the path of the economy to take on a more realistic and pragmatic course in providing some kind of balance between internal and external prices. The level of the peso exchange rate no longer causes public acrimonious debate. Instead, the peso exchange rate is now taken for granted as changing on a daily basis as a result of the pushes and pulls of the marketplace – domestic and international happenings – that are an integral aspect of the country's daily life.

The liberalization of the economy has helped to strengthen the country's external payments position. The exchange rate of the peso has become a price stimulus for creating export industries and as a brake against imports. The country is geared as never before toward balancing export growth with import restraint. Some structural distortions in industry and agriculture remain, arising from tariff protection despite reforms that have brought down high nominal tariff levels. The major distortions arise from policies regarding resource use. Policies related to factors of production – whether labor or capital – continue to provide a drag on economic performance.

The exchange rate is highly sensitive to short run changes in expectations. The source of instability is the movement of short run capital flows often in relation to the volatility of the domestic capital stock exchange. For instance, when the fiscal difficulties during the early part of the decade were pronounced, the peso exchange rate depreciated sharply as a result of withdrawals of funds in the country. This heightens the nature of the domestic shocks. In the beginning of 2006, however, as a result of the anticipated improvement of the fiscal position of the government due to the passage of major fiscal reforms, the peso exchange rate has appreciated. (The peso exchange rate appreciated to the level of 50 pesos to the dollar when only a few months before it was 55 pesos to the dollar.) The volatility of the short run exchange rate fluctuations has implications on many aspects of the economy, not the least of which are export industries that require a more stable exchange rate framework in order to thrive.

### *Exports and industrial performance*

Exports during the early 1990s had spectacular growth, brought in by the foreign direct capital inflows related to the manufacture of semiconductors. This experience had a gestation that began in the late 1970s, something that was postponed in acceleration because of the economic and political volatility of the 1980s. The export boom in this industry established the Philippines as a component of the production base for the revolution in technology and telecommunications that found itself based in the dynamic economies of East Asia. The great industrial boom in this technological revolution in the production place has found a niche in comparative advantage for Philippine labor skills.

The export sector is gradually changing in character. Even though electronics and semiconductors dominate manufactured exports are dominant now, there is a potential for a deeper expansion of the industry as suppliers and manufacturers agglomerate to form a network of producers. A potential for deeper expansion of the industry could take place if complementary factors and infrastructure continue to improve within the country. Exports of new and traditional products (including garments) are strengthening on wide range. Car manufacturing parts exports contribute to the growing sophistication of the ASEAN complementation in this industry. The car manufacturing industry is linked primarily within the ASEAN market but a growing positioning of the region within the Asian production network for the vehicle is happening. It is most fully integrated in Thailand with other countries having become satellites of that network.

Foreign direct investments in shipbuilding represent a new phase in the country's export industrialization. Since the mid-90s, a Japanese shipbuilding company has been expanding its operations in Cebu, and current commitment has led to a future entry of a major Korean shipbuilding enterprise in the Subic area. The future of a number of new export industries brought in by world quality export players guarantees that some growth in this area will be expected.

The country missed the great export boom in labor-intensive skills for industrialization based on garments, textiles and other labor intensive skills decades before. That was the pattern of industrial growth that propelled the early industrialization of virtually every other East Asian developing country. In the case of the semiconductor industry, the wage rate for the types of high skills of the labor force required for assembly of semiconductors and computers was competitive. And the first flush of industrial manufacturing success for the Philippines helped to win over the substantial side the domestic debate about economic liberalization in the country.

Export performance just before the Asian financial crisis of 1998-2000, had been at spectacular rates averaging just short of 20 percent per year. By 1998, export levels had peaked to almost US \$40 billion. Seen in relative terms with respect to East Asian counterparts, this expansion of exports is quite modest. By 2000, the level of exports of Malaysia was US \$98 billion (more than double the Philippine export level); that of Thailand US \$69 billion (more than one and a half times that of the Philippines).

In 1985, the Philippines was in severe economic crisis (that was brought about by internal political events and the third world debt crisis that engulfed it) while the rest of

Malaysia, Thailand, and Indonesia received massive flows of capital from the Northeast Asian industrial countries that were transferring industries to other countries, mainly to neighboring Southeast Asia. By 1990, Thailand, Malaysia, Singapore at least doubled the level of their exports of goods and services. The Philippine case showed the same doubling but 1985 was the worst year of the economy when the country was in severe crisis. In fact, there was hardly much growth if for instance 1980 was used as the base rather than 1985. But the scale of growth of exports between 2000 and 1990 was extraordinary, and the Philippine case showed very good improvement in scale. From the still low level of exports of 1990 at the time and compared with other East Asian countries, the Philippines had the highest multiple growth in export growth.

The financial crisis toward the close of the 1990s created a downturn in the exports sector affecting a wide range of export products, otherwise the Philippine export growth of the period would have been even much more impressive. By then, semiconductor parts accounted for almost 70 percent of total export revenues. The effect of the crisis was in part to make the export sector grow somewhat modestly from that point on throughout the first half of 2005. Developments during this period intensified some of the trade competition with East Asian neighbors.

Within ASEAN and as a result of the projected ASEAN Free Trade Agreement that was by then an agreed program of future cooperation, the reorganization of industries and exports began to take on a region wide realignment among the member countries, with foreign direct investors especially directing mainstream industries (in the consumption based industries especially) reorganizing and rationalizing their market positions. Some trade diversion took place with some Philippine industries moving to other production sites in ASEAN and other countries where overall unit costs were lower. Many formerly import substituting industries shifted production sites from the Philippines to other ASEAN competitors, including China. Some of the operations also in the semiconductor industrial revolution transferred their production sites to China and some to Vietnam. But the complementary production of semiconductors in other fields had created new levels of trade. The restructuring of industry has been going on, and part of the transitional move is the relocation of production centers where the least cost of production and comparative advantage in all aspects of the productive trade contributes to the outcome.

In this industrial development, Philippine success has so far been modest. In part, the reason is two-fold. Political uncertainty at home worsened because of the leadership changes at home that were outside of the ordinary constitutional process.<sup>10</sup> The stormy politics of the last six years was therefore not of much help in stabilizing the economy's forward course. The lag in infrastructure services that has accumulated after decades of persistent fiscal deficit problems and poor domestic investment levels in that sector has aggravated competitiveness on an international level. The scale of needs has gotten bigger of a larger economy and a higher level of population.

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<sup>10</sup> Reference here is being made to the people power revolt (EDSA II) which unseated Estrada as president and replaced by Mrs. Macapagal Arroyo. Current political problems in the country are focused on the question of legitimacy that arose out of the outcome of the presidential election in 2004.

### *Trade and payments balance*

The growth of trade – of exports and imports – mirrors the open economy. In 2005 export revenues topped the US \$40 billion level again, with exports rising modestly from year to year during 2000-2005. Imports have become higher because of the growth of energy imports and of raw materials needs of the active semi-conductors assembly sector. The balance of payments of the country has improved over the years. In 2006, despite the pressure of high prices of petroleum imports and their uncertainty in supply because of the volatile situation in the Middle East, the balance of payments improved. The trade balance has been negative but the current accounts balance has been kept solvent. The capital accounts balance has improved somewhat because the country has much more access to international credit. This has permitted an improvement of the country's overall payments position, making international reserves rise toward comfortable directions.

Several factors account for this improvement of the balance of payments. For one thing, the open economy stance of economic policy has allowed movements of capital and permitted a wider movement of goods and factors so that while exports could be developed, raw materials for exports and capital goods could be made available at home more easily.

The industrial sector, especially the newly rising competitive sector including the burgeoning export sector, has access to international credit. This growing sector is more cost effective and efficient than the highly import dependent import substituting sector which was high cost to the economy and highly inefficient then. The current import substituting sector that was forced by the restructuring of recent years can avail of raw materials from abroad on their own credit. Moreover, the manufacturing sector based on export markets have access to their own finance from the world capital market through their parent company or through the financial sector in the Philippines which is also geared internationally. The banking and financial reforms of the 1970s and the 1990s have helped to strengthen domestic banking and internationalized its outlook.

Capital flows continue to be free following capital deregulation and liberalization in the previous decades. The current policy rules and regulations have hardened through monitoring across countries as a result of international efforts linked with money laundering arising from hot money movements. But the regulations are formed within the liberal framework.

The market based peso exchange rate policy allowed the peso to float relatively freely thereby making it possible for international payments to proceed quite freely and for values on goods and services to seek their proper levels. The economy was made freer from price controls on consumer essentials. Price controls on fuel and other essentials have been removed as a result of the reform of the energy sector that was put in place during the early 2000s. As a result, energy prices are flexible and are relatively free of public acrimony and protests (compared to the time before the energy reform act was passed). These prices have become like the price of the peso in the foreign exchange market. Price flexibility in the exchange rate, fuel and other prices has permitted

domestic prices to remain relatively stable under the guidance of monetary policy that has guided inflation in the range of 7 percent per year.

Foreign direct investment flows have improved. The record is modest by comparison with the other countries during critical periods of their development. Foreign direct investments have come in substantially during the 1980s to 2000. Net foreign direct investments in 1999 was US \$1,114 million and US \$1,477 million in 2002, although in 2001 direct capital inflows fell to US \$ 335 million. The average direct investments inflow for 2003 to 2004 fell to lows of US \$ 188 million and US \$ 109 million. In 2005, the level has risen again but was just short of US \$ 970 million. The fall in direct investment flows were due to political volatility and bad publicity due to peace and order conditions during the period.

The drop in foreign direct investments during the early 2000s is partly an indication of the poor record of the privatization program. Any success there would have meant new inflows of foreign direct investment as asset ownership changes took place. Recent adjustments arising from the financial crisis in East Asia at the close of the 1990s was facilitated by the influx of foreign direct investments in South Korea and in Thailand. In the Philippine case, the early episodes of foreign direct investment inflows were linked with major liberalization activities and the effort to bring in new strategic foreign investors in the banking system. Various infrastructure projects were undertaken on the basis of BOT (buy-operate-transfer) investment arrangements related to the investments in the electricity generation field when the energy crisis dominated the problems of investments during the early 1990s.

The volumes of foreign direct investments registered during this period are quite modest compared to those that went to ASEAN partners like Indonesia, Malaysia, Singapore and Thailand. They were certainly much lower than the heavy flows that have entered China during this period.

### ***OFW remittances***

A new major factor in the balance of payments is the inflow of remittances from OFW workers. In 1999, remittances were US\$6,022 million. From 2000 to 2005, remittances rose from US \$6,050 million to US \$10,689 million in 2005. OFW remittances are likely to reach more than US 12 billion by the end of 2006. The OFW remittances represent a major boon to the country's balance of payments position. The growth in OFW remittances has provided greater international liquidity in spite of the rise in energy imports. The remittances have helped to reduce the burden on the nation of the external debt service. OFW remittances in recent periods have constituted around 25 percent of the overall receipts from exports and other payments inflows to the country.

External debt service constitutes 13.3 percent of export receipts in 2005. This is an improvement over the same ratio of 17.1 percent of exports in 2003. Such volatility in debt service burden emphasizes the importance of rising export revenues as the base for shouldering the external debt burden. Translated into debt service as a percent of total current accounts inflows (which now includes OFW remittances), the debt service burden in 2005 was 12.5 percent and 15.8 percent in 2003. In short, the effect of OFW



remittances on easing the debt service burden is being felt. Quantitatively, it helps to ease about 7 percent<sup>11</sup> of the total debt burden based on the capacity to pay through export earnings.

Other new sources of foreign exchange are shaping up and in the near future, there are likely to be large jumps in new export activities. Call centers and other back office operations have become a new industry with still rising potential. Outsourcing through these new firms has produced a new boom in the employment of young professionals and college graduates with strong qualifications in the English language. The labor market for this group of workers is relatively thin, but the average salary is a large multiple of the minimum wage income for salaried workers. So the net income generation is relatively good. However, the supply of qualified workers is being gobbled up through the high demand for outsourcing of back office operations coming from developed countries. The migration of workers exerts a competitive pull with the problem of retaining workers at home to work in home industries.

Remittances from OFWs have helped to ease the pressure on the balance of payments and consequently that on servicing of the external debt. There is less external indebtedness being incurred, except that maturing obligations are still of course refinanced. External debt finance is constrained by lack of counterpart financing which is one way of saying that domestic saving is inadequate. The remittances have improved the payments inflows to create greater solvency for the balance of payments. This has obviously given the country more room to service the external debt. It is possible to buy back expensive short term debts and help to foster a sound debt profile that is affordable which makes it possible to make room for more investments.

### **VIII. Concluding remarks: direction without drift?**

A forward view of the Philippine economy leaves one with qualified but hopeful possibilities. The macroeconomic fundamentals could be immensely strengthened through the pursuit of economic reforms that have eluded change in the past. From the government sector, fiscal sector reforms are basic to the improvement of the national saving rate. This means, essentially, trying to achieve a fiscal surplus on the operational side in order to provide strong support and finance to the public capital formation. Such an effort includes the need to speed up the stalemated privatization of state assets that have awaited such a program.

The macroeconomic performance of the economy could be improved significantly through structural policy reforms affecting public utilities and infrastructure as well as land and natural resources. These will have immense impact on investment performance in the economy. The clearest case of need is to generate a greater flow of capital to the hitherto restricted sectors where there is a great deal of inefficiency and where the need to improve is critical for raising overall economic performance. This reform needs to address the liberalization of foreign capital participation in the country's public utilities

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<sup>11</sup> The rule of thumb I use for calculating this is by taking the fall of the debt service burden (based on current account receipts) to the debt-service burden as a ratio of export receipts (=0.8 divided by 13.3).

and infrastructure. This calls for a move to lift the restrictive provisions of the constitution on foreign capital participation in restricted sectors of the economy. What is needed primarily on the capital side is to remove the highly restrictive policies that prevent foreign capital to participate more fully in the economy. *The changes in these directions constitute the difference between the present unimpressive economic growth rates that are experienced in the domestic economy and what could be possible – the performance that is characteristic of East Asian rapid growth.*

Such measures will make it possible to reform internal cost reductions due to the poor state of inadequacy of public utility services in some regions of the country and of infrastructure services. By making possible the enlargement of capacity and quality of service of Philippine public utilities and infrastructure facilities, domestic costs of production can be reduced. This is accomplished through the economy's increased efficiency resulting from these investments. This will help to make the economy more competitive arising from the reduction of internal costs of production to all investors. The country's export industries will be induced to become even more competitive as a result. In this manner, the main beneficiaries will be domestic factors of production because higher incomes and employment will result.

Getting the required economic reforms to work is not an easy job to do. If the economy is to catch up with the rest of high growth East Asia, the hard economic reform issues have to be faced squarely. Reforms of the critical issues have to be pushed forward.

The scenario described above is hopeful and idealized. Under normal circumstances, governments do not fulfill ideal scenarios. But if leaders in the government stay close to certain ideas of honest economic reforms, the proper forward direction of the economy could be set in motion. The danger is that hesitation in the adoption of the required remedies is always tempting as an alternative. And often, these alternatives produce outcomes that are basis of political advantage among contestants. Failing to get the reforms done properly contributes to the resistance to the economy's smooth forward direction.

## Statistical Appendixes

Room for Table A

Room for Table B

Room for Table C

Room for Table D

Room for Table E