

THE PHILIPPINES

Beyond
the
Crisis



DEPARTMENT OF FOREIGN AFFAIRS AND TRADE


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The National Library of Australia Cataloguing-in Publication data: 20 April 1998

The Philippines: Beyond the Crisis

Bibliography.

Includes index.

ISBN 0 642 30521-8

1. Philippines - Economic conditions -1986 - 2. Philippines - Economic policy. 3. Philippines - Foreign economic relations - Australia. I. Australia. East Asia Analytical Unit.

330.9599948

Design, typesetting and printing by Green Advertising #9300

ACKNOWLEDGMENTS


This report was directed by William Brummitt of the EAAU under the overall guidance of Dr Frances Perkins, head of the EAAU. Edward Sulikowski and Richard Begley of the EAAU assisted in the finalisation process, with Rosalind Callow providing administrative assistance.

The Australian Embassy in Manila provided invaluable assistance in producing this report. Particular thanks are due to H.E. Miles Kupa, Australian Ambassador to the Philippines; Nicholas Coppel, Counsellor and Deputy Chief of Mission; Julie Chater, John Feakes, Chris Cannan, Jane Carangal and Hazel Dazon. Michael Moignard (formerly Senior Trade Commissioner) and Natasha Winton from Austrade, Manila also provided valuable assistance as did Lynn Pieper of AusAID.

Within the Department of Foreign Affairs and Trade in Canberra, Dorothy Holt and Chris DeCure of the Philippines/Malaysia/Singapore/Brunei section were particularly helpful. Others who provided valuable assistance include Paul Gibbons, Richard DeFerranti, Andrea Spear, Vanessa Wood, Garth Parry, Susan Begley and Karen Medson. David Swan and Lindsay Chan from AusAID, Australia's official development assistance agency and Shaun Riley from Austrade, Australia's trade promotion agency, also provided valuable assistance.

The EAAU wishes to acknowledge information and material provided by the following consultants: Professor Michael Porter, Managing Director Tasman Asia Pacific; Peter Wallace, President EIU Philippines; Professor Ponciano Intal, President Philippine Institute for Development Studies; Dr Myrna Austria, Senior Research Fellow, Philippine Institute for Development Studies; Brendan Millane, Director, Key Economics; Professor Rolando T. Dy, Executive Director, the Centre for Food and Agribusiness, University of Asia and the Pacific; Dr Helen Cabalu, Research Fellow, Curtin Business School; Judith Bryant, Manila and Dr Ramon Clarete, Philippine Department of Agriculture.

Special thanks are also due to the following people in the Philippines who provided very useful information and comments: Dr Diwa C. Guinigundo, Director, Department of Economic Research, Bangko Sentral ng Pilipinas; Dr Johnny Noe Ravalo, Chief Economist, Bankers Association of the Philippines; Malcom Norris, Chairman International Mining and Exploration Committee; John Tivey, formerly Manager (Legal) WMC Philippines; Joven Balbosa, economist, W.I. Carr (Philippines) Securities; Michael La Brooy, General Manager, ANZ Philippines; Thomas K. Halim, Board of Investments; Jun Angeles, Manager Exploration, Newcrest Mining; Elbert Zosa, Vice President, Philippines Bankers Association; Professor Kondo, Asia Management Institute; Teofilo Pilando, Associate Executive Trustee, Asset Privatisation Trust; Professor de Dois, UPSE, University of the Philippines Economics School; Jose Yulo, President of Philippines Stock Exchange; V.F. Monte, Vice President, Citibank; Ricardo Romulo, President, Makati Business Group; Josefina Lichauco, Undersecretary for Communications, Department of Transportation and Communications; Dr Ramonette Serafica, Research Fellow, Philippine Institute for Development Studies; Dr Alan Ortiz, President of Dharamala Securities, Asian Capital Market Project; Horacio Ramos, Director, Mines and



Geoscience Bureau; Antonio La Vina, Undersecretary Legal and Legislative Affairs, Department of Environment and Natural Resources; Dr Bernard Funck, Senior Economist, World Bank; Aloysius Ordu, Acting World Bank Representative, Manila; Peng Reyes, World Bank consultant to Ministry of Finance; Professor Winnie Monsod, Economics Department, University of the Philippines; Professor Benjamin Diokno, Economics Department, University of the Philippines; Ferdinand Aristorenas, Chief Operating Officer, Subic Bay Metropolitan Authority; Ludwig Riedel, Manila representative Transfield Construction; Laza Lim, former Minister of Tourism; Raul Hernandez, President San Miguel Packaging and Vice President, Philippine-Australia Business Council; Rita Nangia, Senior Economist, Asian Development Bank; K.W. Lee and other members of the Private Sector Group at the Asian Development Bank; Dr Shrinivasa Madhur, Economist, Philippines desk, Asian Development Bank; Beth Hilton-Thorpe, International Development Program representative, Manila; Glen Turnbull, Marketing Manager, John Holland; Steven Shaw, President, AWA Plessey; Bing Ikamina, Chief Economist, EIU Philippines; Edgardo Abon and Anthony Abud, Commissioners, and Emmanuel Velasco, Chairman, Tariff Commission; Gil Beltram, Assistant Secretary, Department of Finance; Dante Canlas, Deputy Director General, National Economic Development Agency; Gerard Brimo, Philex Mining Corporation and Chairman, Chamber of Mines; Jose Almonte, National Security Adviser to President Ramos; Gabriel Singson, Governor of Bangko Sentral ng Pilipinas; Armando Titanko, Head of the Economics Department, Bangko Sentral ng Pilipinas; and Cayetano Paraganda, Member of the Monetary Board, Bangko Sentral ng Pilipinas.

Within Australia, the following people all provided useful advice and comments: Michael McDonald, President, Australia-Philippines Business Council; David Rosback, General Manager, Australia-Philippines Business Council; Ricardo Nubla, Managing Director Nubla and Company; Gavan Collery, Manager Corporate Affairs (projects), WMC; Ken Boundy, Executive General Manager (International), James Hardie; Clive Troy, Infratex (Australia); and Dr Ian Bevege, Australian Centre for International Agricultural Research.

AusAID provided substantial financial assistance for this report.

Editing was by Ann Duffy, typesetting by David and Lyn Lalor, and graphic design by Green Advertising.

The EAAU would also like to thank BHP, Pacific Power, National Mutual and Austrade for their corporate sponsorship.

EAST ASIA ANALYTICAL UNIT

The East Asia Analytical Unit was established in 1990 as the main agency within the Australian Government responsible for publishing analyses of major economic and political issues in Asia.

Located within the Department of Foreign Affairs and Trade, the Unit has to date undertaken and commissioned 15 studies on a range of topics related to Australia's trade policy interests in the region.

Staffed with five professionals, the EAAU also contracts a range of consultants with specific areas of expertise. It draws on a wide range of data and information sources, including reports from Australia's diplomatic and trade missions in Asia.

Reports and working papers produced by the Unit are intended to assist analysts and decision makers in business, the Australian Government and the academic community.

Full copies of previous reports and briefing papers and executive summaries of reports can now be downloaded from the Internet. See access details below.

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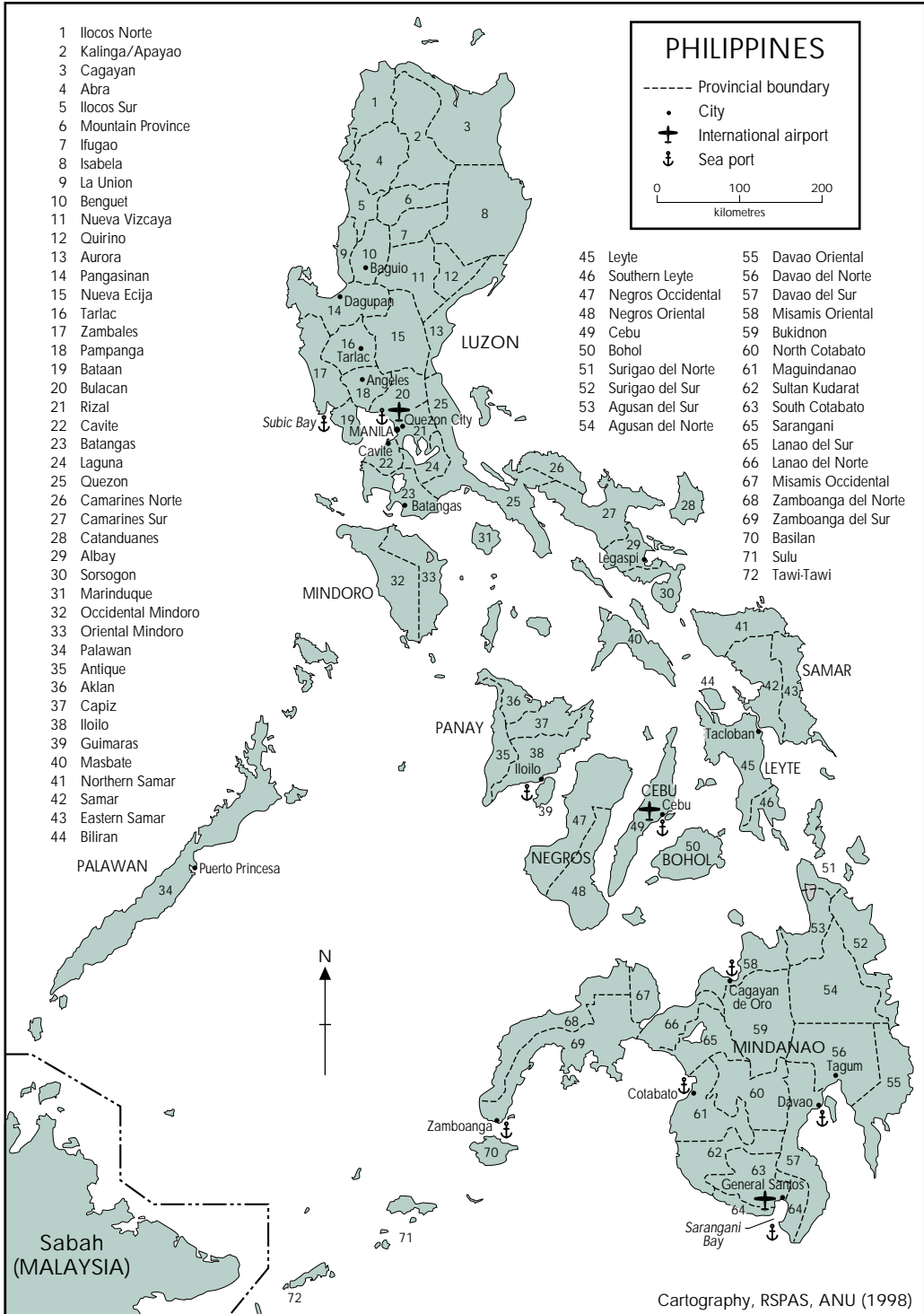
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EXECUTIVE SUMMARY

After decades of poor economic policies, political instability, stagnation and declining living standards, the Philippines now seems poised to raise and sustain its economic performance through its wide reaching economic reform agenda. Australian business, which in the past had relatively little trade or investment with the Philippines, now is re-evaluating business prospects with its APEC neighbour. For its part, Philippine business also is focusing on new markets, suppliers and investors in ASEAN and the Asia Pacific region, augmenting its traditional orientation to the USA and Europe. At the same time, ASEAN and APEC are strengthening for the Philippine's political links within the region. President Ramos' historic visit to Australia in 1995 was a watershed in Australian-Philippine relations. We therefore believe providing this overview of Philippine economic policies and prospects for Australian business and government is timely.

The report begins by surveying why post war policies failed and how the Aquino and particularly the Ramos administration reformed key sectors in an attempt to emulate more successful regional neighbours. The Philippine political situation and likely repercussions of the currency crisis on the regional and international environment are also assessed.

The report then analyses Philippine macroeconomic performance, particularly how the economy is weathering the currency crisis and its aftermath. The causes and effects of the peso's depreciation, the health of the financial sector and balance of payments, fiscal policy and savings performance also are examined. Recent and prospective trade liberalisation and its impact on Philippine trade structure and performance, including Australian-Philippine trade are then considered in depth. This is followed by chapters analysing recent foreign investment reform, the nature of the business environment and opportunities for investors and traders. Chapters on infrastructure and mining examine government policies, problems and opportunities in two sectors of significant interest to foreign investors. Constraints and prospects in agriculture, the weak link in Philippine development are discussed. Finally the report highlights implications for Australian business and government.

DEVELOPMENT POLICIES AND THE ASIAN CRISIS

The Philippines, in the centre of the dynamic East Asian region postwar enjoyed relatively high education levels and savings rates, export oriented agriculture and a developing industrial sector. However, poor economic policies and political instability meant growth stagnated and real incomes actually fell for most of the past three decades.

The Philippines failed to participate in East Asia's growth because it pursued inward looking protectionism, intrusive government driven industry policies and politically driven expansionist fiscal policies. It neglected infrastructure, over-taxed agriculture and mining and discouraged foreign investment. The peso was heavily overvalued, discouraging exports; potential employment growth from labour intensive manufacturing and agricultural and mineral commodity exports failed to eventuate.

Imports appeared cheap so were rationed by high trade barriers. As a result, the Philippines experienced almost continual balance of payments crises and income, employment, savings and investment growth stagnated. From being one of the highest income countries in East Asia after World War II, it became one of the poorest.

However, its economic devastation in the mid 1980s and the realisation that it lagged far behind its East Asian neighbours convinced the Government and business elite to undertake major reforms. Now, like the rest of the region, the Philippines has embraced policies of export-led growth and private sector development. Macroeconomic fundamentals have improved significantly with reducing debt service ratios, longer term debt structure, improved tax effort and a more robust financial system. The relatively favourable performance of the Philippine economy to date (April 1998) despite the regional currency crisis, suggests that structural reforms over the past decade, particularly improved financial market control, have reduced the country's vulnerability to external shocks. The depreciation of the peso, a result of the currency crisis, also should stimulate the beleaguered labour intensive manufacturing sector and encourage agricultural and mineral exports.

MACROECONOMIC PERFORMANCE

Since 1994, Philippine growth performance has improved dramatically relative to the early 1990s. The Philippines now looks likely to emerge from the Asian financial market turbulence of the second half of 1997 and early 1998 well placed relative to many of its Asian neighbours, although short term political developments will be crucial in this context. A key short term economic challenge is to control inflationary pressures resulting from the peso's depreciation, so that a real depreciation is maintained and Philippine competitiveness is enhanced.

Another challenge is to reduce interest rates towards levels prevailing before the depreciation, allowing normal growth to resume and investors to respond to opportunities presented by the peso's depreciation. Further rationalising small and medium sized banks and liberalising foreign bank restrictions would help reduce bank interest rate spreads by stimulating bank competition. An additional short term challenge is to ensure that the problems of individual borrowers in servicing US dollar loans are isolated and prevented from generating a system wide impact. This will require speedy liquidation of bankrupt firms so their assets can be returned to productive activity and creditors can receive some compensation. Further tightening loan loss provisions and improving the means of detecting and dealing with corporate and banking weakness at an early stage may also help.

In addition to these short term challenges, authorities must address some long term issues if the Philippines is to sustain growth. The Philippines' poor savings performance, particularly the low rate of household savings needs improving. Combined with a more competitively priced peso, improved Philippine savings performance will help reduce the current account deficit. The authorities also need to adjust the composition of public expenditure by raising the share of infrastructure spending and reducing spending on personnel.

TRADE POLICIES

The Philippines has increasingly opened to international trade over the last decade. Commitments to the WTO, the ASEAN Free Trade Area and APEC should help control the influence of vested interest groups trying to halt the ongoing process of trade liberalisation. Peso depreciation should also help maintain support for liberalisation.

In recent years, semiconductors and microcircuits have driven export growth. Finished electrical machinery exports including computers and office equipment are becoming increasingly important.

The peso's large depreciation will significantly affect both exports and imports. In the medium term, if the real depreciation of the peso is maintained, exporters will have an incentive to increase local content and value added, deepening the integration of export oriented industries into the local economy. Demand for imports destined for final use in the domestic economy, particularly luxury goods, will decline due to higher prices and, in the short term, weaker income growth. By contrast, imports of intermediate inputs for export oriented industries are likely to grow in the short to medium term.

Australia's bilateral trade with the Philippines is small compared to trade with Indonesia, Malaysia and Thailand, but is growing rapidly. Australian exports to the Philippines are dominated by food, particularly dairy products and live animals and copper, coal, zinc and aluminium. Exports of telecommunications equipment have grown strongly throughout the last decade. In the short term, as agricultural imports are largely for domestic consumption, Australia's agricultural exports are likely to be hit hard by the peso's depreciation and the prospective slowing in economic activity over the next year or two.

In the medium term, new and expanded opportunities are likely to arise as a result of the lifting of many trade restrictions on agricultural products. In the long term, if industrialisation really takes off, exports of industrial and construction raw materials and intermediate goods should grow. Exports of mining industry services also could become significant if mining reform finally proceeds.

FOREIGN INVESTMENT

Foreign direct investment, FDI in the Philippines has increased rapidly since 1993, due to major liberalisation of the investment regime but still remains low by ASEAN standards. The most important sectors for FDI are manufacturing, banking, infrastructure and public utilities, where reform has been most rapid. In sectors such as mining and agriculture, where trade and legal reform and implementation are lagging, FDI flows have been weak.

Dominant sources of Philippine FDI are Japan, followed by the USA. Australia's FDI flows to the Philippines are small and volatile, with strongest growth occurring in the late 1980s and 1994 and 1995. In spite of the Asian financial market turmoil, 1997 was also a strong year for Australian FDI. The biggest FDI destination is manufacturing, but FDI in public utilities, infrastructure and industrial services also has grown rapidly in recent years.

The major factors inhibiting further FDI in the Philippines include the relatively high cost of unskilled labour (less serious after the recent depreciation), lack of infrastructure, lack of support industries and concern about commitment to the reform process. Given the relative strength of Australia's mining companies and their interest in investing in the Philippines, slow government decision making and review processes are a particularly important constraint to Australian FDI in the Philippines.

Special economic zones increasingly are attracting investment to the Philippines and driving economic and particularly export growth. While comprehensive incentives packages contribute to the growth of zone investment, these incentives require rationalisation. Universal incentives applying inside and outside zones would be more efficient, causing firms to locate in zones only if proximity to suppliers, customers or infrastructure warranted this, rather than to obtain fiscal incentives.

BUSINESS ENVIRONMENT

Since coming to power in 1992, President Ramos has worked hard to reform the distorted and inefficient Philippine economy. Despite the challenges Asia's financial crisis pose, the Government has won the backing of the international business and financial community for its prudent economic restructuring and market liberalisation. While the economic architecture is incomplete, the Government's commitment to further economic reform, the country's strategic location, its large, educated and highly trainable English-speaking workforce and liberal business laws and incentives provide a strong stimulus for doing business with the Philippines.

President Ramos' visit to Australia in 1995 reinforced growing Australian business recognition of the positive changes occurring in the Philippines. Australian companies are boosting trade and investment links with the Philippines despite the recent turmoil in Asia. With expected real GDP growth of around 4 per cent in 1998, the Philippines will be one of the region's fastest growing economies. While a defensive strategy may be needed to survive short term economic fluctuations, particularly for exporters of luxury food and manufactures, Australian companies should prepare proactive, longer term strategies, including acquisition or merger, to be well placed for the return to stronger growth in 1999 to 2000.

INFRASTRUCTURE

After decades of neglect, infrastructure fell into disrepair and eventually crisis in the early 1990s. Now the Philippines is becoming an Asian market leader in developing innovative forms of appropriate private sector infrastructure participation. The recently refined Build Operate Transfer, BOT law enabled the Philippines to solve its crippling power shortages. Granting private sector concessions for Manila's water to two joint venture private suppliers has lowered tariffs, reduced the Government's fiscal burden and should improve water supply services significantly. While the road transport situation is near crisis with frequent traffic gridlocks in Manila, a number of toll road, light rail and other BOT initiatives are underway, which should bring real improvements over the next few years. The proposed restructuring of electricity embraced by the National Power Corporation, Napacor seems likely to break up generation into several generating companies which compete across an independent grid, very much like the Victorian model of the 1990s.

The Philippine experience confirms that clear regulatory structures protecting consumer interests are required for communities to accept private sector participation in owning and managing essential and often monopoly services. Several central government bodies, with multilateral and bilateral aid agency assistance, are acquiring the skills to create competitive markets for infrastructure services and develop efficient regulatory structures. However, the rapid increase in unsolicited private sector bids to supply infrastructure facilities in many sectors and provinces means that often officials, particularly in local government units are ill prepared for this complex task. It is essential that the government maintains control of this process and obtains the necessary technical assistance to avoid mistakes that could undermine public support for private sector infrastructure provision.

MINING

Despite surging international interest in Philippine mining in 1995 and 1996 in response to the 1995 Mining Act reforms, the sector still receives a lower share of foreign investment than its output share in the economy, and mining output and exports have stagnated. International exploration interest and expenditure in Philippine mining decreased significantly in 1997 and early 1998 as the mining reform process ground to a halt. Court cases and stricter environmental requirements after the Marcopper spillage, uncertainty created by the new indigenous peoples' legislation and unresolved taxation issues have all prevented the issue of new mining contracts. However, foreign investment is urgently needed to upgrade the skills and technological capacity of the local mining industry, to increase its competitiveness and reduce associated environmental problems. Increased capital for new foreign funded mining developments also will provide employment and development in isolated regions.

Rapidly restarting the mining sector reform process should be a priority for the new administration. If international mining investor confidence in this process is restored, Australian exploration expenditure in the Philippines should increase; some companies also may seek to reduce their exposure in Indonesia.

The next challenge will be to provide an environment where investors have the confidence to establish operational mines. This development will see a quantum increase in mining's contribution to Philippine employment, exports and government revenue. The demand for mining services, of which Australia is a competitive supplier, also will be strongly stimulated when mines move to this next stage of development.

AGRICULTURE

Previously efficient and profitable export oriented coconut and sugar sectors were seriously undermined by Marcos regime monopoly trading policies, price and export controls and excessive tax regimes. Throughout the Marcos era, the overvalued peso, chronically neglected rural infrastructure, and failing research and extension services further eroded agricultural profitability, investment and productivity growth. Heavy protection insulated traditional agriculture like rice and corn growing from competitive pressures. The result was slow output growth, falling exports, rising imports, low agricultural incomes and high domestic food prices. Given the pressure

on limited agricultural land from the large and rapidly growing population, the Philippines has no comparative advantage in broad acre crops like rice or corn, but efficiently produces more labour intensive products like tropical fruits and vegetables.

The Aquino administration's comprehensive agrarian reform program, CARP, aimed to redistribute large land holdings by selling small farms to tenant farmers over the period 1988-98. However, new farm sizes are too small (averaging 2 hectares) to achieve economies of scale; prohibition on consolidation is inefficient; implementation has been slow; and debt burdens on new owners are high. Protracted legal battles over land valuations contribute to uncertainty regarding CARP outcomes, slowing new agricultural investment.

Emphasising rice self-sufficiency focuses government agricultural support on a low return activity, slowing resource reallocation to more profitable, labour intensive crops and activities. Greatly increased public investment in rural infrastructure, particularly farm-to-market roads and improved extension and research services, credit access, market information and distribution and marketing infrastructure is needed to help farmers move out of low value, subsistence crops into more profitable activities.

Peso depreciation in 1997-98 has significantly improved prospects for agricultural exports like coconut products, fruit and vegetables, fish products and prawns. Import substitutes like rice, corn, pork, chicken and beef now require much less protection than they currently receive, despite useful reductions in agricultural trade barriers in February 1998. Analysis undertaken for this report shows that in most cases, quotas could be abandoned and tariffs reduced significantly, reducing the inflationary impact of depreciation. Depreciation therefore provides an opportunity for Philippine authorities to reassess agricultural protection policy and improve the profitability of existing exporters, hopefully encouraging a more efficient allocation of agricultural resources.

IMPLICATIONS

The report concludes by drawing implications from recent economic developments in the Philippines for Australian government and business. The Ramos administration achieved much in five years, notably in trade, foreign investment, infrastructure and financial market reform, setting the economy on the path to long term sustainable growth, on the East Asian model. However, the previous four decades of poor policy and neglect will take some time to redress. Some key problems confronting the incoming administration are falling educational standards, high social inequality, continuing bias against agriculture, stalled mining sector reform, an improved but still inflexible wage setting system, inadequate infrastructure, low savings rate, structural current account imbalance, the inefficient and unpredictable legal system, official corruption and poor quality government administration.

Implications for Government

Australia's bilateral relations with the Philippines are excellent, reflecting our shared democratic institutions and common outlook on key regional, economic and security issues. New initiatives like the Philippine-Australian dialogue will increase people to people links; in future, rapidly growing trade, investment and educational links can be expected to further strengthen these ties.

Australian-Philippine trade relations are growing strongly from a low base, due to the close complementarity of the two economies and falling trade barriers in the Philippines and Australia. This trend is set to continue in the medium to long term as past trade reform commitments are enacted over the next five years. Depreciation provides the Philippines with an historic opportunity to remove quotas and reduce tariffs, particularly on sensitive agricultural imports.

The Philippines is Australia's fourth largest recipient of official development assistance, after PNG, Indonesia and Vietnam. Australian expertise in many areas of governance is relevant to the Philippines which faces numerous institutional strengthening and governance challenges. These include regulating and deepening financial markets, administering tax, controlling government expenditure, encouraging private sector participation in infrastructure provision, providing agricultural extension services, and regulating and taxing the mining industry.

Implications for Business

Trade Opportunities

In the short term, the 1997-98 peso depreciation and economic contraction due to high interest rates will damage Australian exports of consumer goods like dairy products, live cattle and beef. Modest peso appreciation in April 1998 may reduce the severity of this demand downturn. Australian exports, like copper, used by export oriented Philippine industries, should benefit. In the medium to long term, ongoing trade reform should generate expanded trade opportunities for Australian agricultural and manufactured exports. With its large, rapidly growing population and limited arable land, the Philippines has no comparative advantage in relatively low value, land intensive broad acre crops like rice, corn or sugar, which Australia produces efficiently. However, the Philippines should become an increasingly important exporter of tropical fruits and vegetables and processed foods. With depreciation, Philippine labour intensive manufactured exports should become increasingly competitive, while imports of more capital and technology intensive imports should rise as trade reform continues and investment expands.

Increased Philippine awareness of environmental issues should generate opportunities for Australian firms providing environmental management services for mining, forestry, agriculture, power generation, water supply and waste treatment. Ongoing reforms encouraging private sector infrastructure investment should provide opportunities for Australian construction firms and finance, management and regulatory system consultants with expertise in privatising infrastructure systems. Weak distribution and transport systems also provide opportunities for Australian firms with expertise in land and air transport, ports, distribution logistics and storage.

The opening of Philippine banking, insurance and other financial service sectors in recent years may accelerate as a result of the Asian currency crisis, providing more opportunities for Australian financial institutions. Australian educational institutions should be able to increase their modest exports of educational services, by establishing courses within the Philippines and providing more educational opportunities for Philippine students in Australia, particularly given the Australian dollar's depreciation against the US dollar.

Investment

Major factors attracting Australian investors to the Philippines include political stability, low labour costs, a relatively skilled English-speaking workforce, a large consumer market, reasonably high expected economic growth, government investment incentives and the relatively easy regulatory environment. Negative factors include slow government decision making, foreign exchange risk, restrictions on foreign ownership, infrastructure shortages, corruption, high company and personal taxes, concern about long term political stability, residual regulatory controls and slowing economic reform. Nevertheless, improvements over the past five years and reasonable expectations of further improvements make the Philippines an increasingly attractive investment destination.

Impact of the Peso's Depreciation on Potential Investors

The peso's depreciation should significantly improve the Philippines' competitiveness as a manufacturing base and reduce the cost of local equity and assets. To date, most Australian investment has serviced the Philippine domestic market. Peso depreciation will reduce the profitability of domestically oriented sectors like construction, infrastructure, building materials, distribution, retailing and other services but increase the profitability of export oriented sectors like garments, electronics, agriculture, mining and many sectors producing import substitutes. While stalled mining reforms reduce international and Australian exploration interest and expenditure, if the next administration can restore quickly foreign mining investor confidence, exploration expenditure could substantially increase.

With the peso's depreciation, Philippine imports into Australia will be more competitive, creating opportunities for Australian importers to distribute and add value to these products. Philippine direct investment to Australia is low, and probably will be flat after depreciation.

Continuing reform and market opening should ensure prospects for increased Philippine-Australian trade and investment remain strong, and provide numerous mutually beneficial business opportunities. The peso's recovery in early April 1998 appears to confirm the Philippines is weathering the currency crisis reasonably well and strengthens hopes of a full recovery in 1998-99. Strong bilateral relations and growing people-to-people contacts enhance the growing trade and investment relationship.

Chapter 1

DEVELOPMENT POLICIES AND GROWTH PROSPECTS BEYOND THE CRISIS

The Philippines, until as recently as 1993-94, stood out in the fast growing East Asian region as a poor performer, its growth undermined by a post war history of poor economic policies and political instability. However, in the early 1990s the Philippines embarked on a sweeping program of economic reform aimed at achieving rapid, East Asian style growth. This report examines the Philippines' economic reform achievements, contrasting these with its inward looking post war policies, and analyses the likely prospects of achieving rapid economic development, given the currency crisis.

In 1997 and 1998, only a few years into this reform program, the Asian currency crisis has hit the Philippines and the region. In the short term, this turmoil will slow growth and exacerbate economic management problems for the Philippine Government. However, in the medium to long term, if lessons learned from the crisis are acted on, they should make Philippine growth more durable.

This report is particularly relevant now, as Australian-Philippine economic and political relations are entering a period of enhanced mutual awareness. While Australia has had a long and strong relationship with the Philippines, President Ramos during his 1995 visit to Australia summed it up, saying the Philippines and Australia were 'looking past' each other.

President Ramos' visit marked a watershed in bilateral relations, highlighting to Australian business and government that the Philippines was shaking off decades of inward oriented stagnation and was preparing to join its East Asian neighbours in rapid economic growth. This report examines the many mutual business opportunities emerging for Australia and the Philippines, ranging from agricultural exports to infrastructure, mining, financial service and manufacturing investment. Separate chapters examine macroeconomic and financial, trade, investment, infrastructure, mining and agricultural developments. This chapter sets the new reforms in historical and regional perspective and examines the likely impact of the currency crisis on short to medium term prospects.

To date (March 1998), the Philippine economy has withstood the crisis reasonably well, mainly because its financial system is relatively well regulated and real estate is not considered overbuilt. However, the authorities recognise the urgency of pushing forward with reforms and institutional strengthening in many areas, including bank regulation, fiscal management and taxation enforcement, trade and investment liberalisation and agricultural modernisation. This will be essential to raise the economy's growth performance to the 7 to 8 per cent needed to progressively raise living standards for the mass of the population and to strengthen the economy's resilience to major external shocks.

Nevertheless, the increased globalisation of the Philippine economy already is raising growth and incomes, and expanding trade and investment opportunities for Philippine and foreign businesses. Australian business, which largely had ignored the Philippines, increasingly is exploring new opportunities in agricultural commodity and manufacturing trade, construction, infrastructure and industrial and service sector investment. Regional economic and financial uncertainty due to the currency crisis are unlikely to weaken growing business interest in the Philippines. Indeed between early 1997 and March 1998, the Australia-Philippines Business Council grew from 50 to 160 members. Furthermore, the peso's sharp depreciation since June 1997 should make investment opportunities more attractive. However, Australian exporters, particularly of luxury food items and finished manufactures could expect their trade prospects to deteriorate at least in the short to medium term.

Three major factors will determine the Philippines' ability to emulate and improve on the performance of the successful economies in East Asia: the international environment, particularly the repercussions from the 1997-98 Asian currency crisis; domestic policy reforms; and domestic political developments. This chapter examines these major factors in turn, the last two from an historical perspective. It concludes that the international environment, including the currency crisis, will not adversely affect Philippine medium to long term growth prospects.

While significant economic reform has been achieved in many vital areas, given the backlog of economic policy failure inherited from the Marcos regime, much more needs to be done, allowing no room for complacency. Political developments are largely benign for economic growth, despite the short term uncertainty of the 11 May 1998 presidential election. However, questions remain regarding the potential coherence and speed of economic reform while the courts play such a pervasive role in interpreting economic legislation, and constitutional checks and balances between the President and Congress can result in legislative stalemate.

THE POST CURRENCY CRISIS INTERNATIONAL ENVIRONMENT

For the Philippines, the international and regional economic environment involves constraints, risks and challenges as well as opportunities. The recent currency turmoil in East Asia highlights the risks of economies pursuing greater economic integration and in particular, open capital accounts, before implementing appropriate financial market prudential controls and competition and macroeconomic policies.

In the 1980s and 1990s, many regional economies, including the Philippines, opened capital accounts to essentially free international capital movements, embracing foreign direct and portfolio investment and foreign borrowing to finance large current account deficits. Stable nominal exchange rates against the US dollar throughout the 1990s, the large real gap between domestic and foreign interest rates and abundant capital from developed markets seeking high returns in emerging Asian markets, encouraged the private sector to undertake massive foreign borrowing, much of it short term in the worst affected countries.

This foreign borrowing, both direct and through domestic financial institutions, went to industrial plant, in some cases producing excess capacity and real estate which became overbuilt (Nidhiprabha, 1997; Perkins, 1997). Excessive lending to

real estate has been less of a problem in the Philippines except for luxury condominiums. (See Chapter 2 - *Macroeconomic Environment*.)

Another cause of the ongoing financial market turmoil in Asia is that domestic currencies became overvalued because the yen depreciated sharply against the US dollar in late 1995.¹ (See Chapter 2 - *Macroeconomic Environment*.) Authorities in affected countries gave too little weight to the Japanese yen in the basket of currencies used to measure currency movements, so failed to recognise the impact of the yen's depreciation on real exchange rates and take corrective action. Appreciation caused many East Asian economies including the Philippines to lose export competitiveness in 1996, slowing growth and precipitating widening current account deficits, exacerbating falling asset and stock prices, and exposing financial sectors to bad loan problems. Confidence in the region's fundamentals eventually eroded, sparking capital outflow and sharp currency depreciations in mid to late 1997 and early 1998, generating a steep rise in liabilities from unhedged foreign borrowing, markedly reducing growth and creating financial market crises in Thailand, Indonesia and the Republic of Korea.

Due to superior financial controls and the more efficient functioning of the Philippine central bank after years of IMF programs and recent reforms, the Philippine financial sector appears to be more resilient to the current crisis than many economies in the region. However, small and medium sized firms are reportedly heavily exposed to foreign currency denominated borrowing. Moreover, several smaller banks are vulnerable and likely to merge in future years; recently tightened prudential controls will strengthen the system further but domestic banks remain inefficient due to insufficient international competition, government regulations and taxation. (See Chapter 2 - *Macroeconomic Environment*.)

The recent East Asian experience suggests that large capital inflows pose macroeconomic risks where financial institutions are weakly monitored and regulated, and the capital market is too shallow to accommodate such flows without resorting to higher domestic interest rates to temper their inflationary impact (thereby increasing local investors' incentive to borrow abroad). The large volume of available capital also resulted in funds going to low quality and excessively speculative investments.

The recent crisis shows the need for stricter monitoring of financial institutions, in particular, tighter disclosure requirements regarding foreign borrowing especially short term borrowing, and lending to nontraded sectors like real estate. Finally, the crisis indicates the importance of liberalising the financial sector to strengthen local institutions by giving them access to the management skills, control systems and technology of foreign financial institutions. While the Philippines has granted several licences to foreign banks, their operations are too constrained by discriminatory regulations for them to compete significantly with major domestic banks and spur their efficiency. (See Chapter 2 - *Macroeconomic Environment*.)

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¹ Some analysts believe the depreciation of the Chinese yuan in January 1994 also precipitated the crisis. However, Jardine Fleming estimates that only 7 per cent of China's exports compete with products from South East Asia, and no discernible appreciation in the these countries' trade-weighted exchange rates occurred after January 1994, while a major appreciation is evident after the end of 1995 when the yen depreciated over 20 per cent (Figure 2.2).

DEEPENING OF THE ASIAN CURRENCY CRISIS

In December 1997, the crisis entered a new and more serious phase. Falls in regional currencies and stock markets accelerated due to severe and continuing deterioration in foreign investor confidence regarding:

- the poor transparency of the region's corporate accounting systems
- corporate exposure to short term foreign debt and high debt leveraging
- the crisis' negative effects on financial sector viability
- weak prudential controls over the financial system and credit allocation on a non-commercial basis
- weak, non-transparent government administration and vacillating commitment to economic reform.

When currencies experience depreciations as large as those in Asia in recent months, panic can set in and drive currencies much below their expected long term levels, seriously raising the repayment burden on companies with unhedged foreign borrowing. If currencies stay long at existing (April 1998) low levels, many companies holding foreign denominated debt could fail, taking with them weaker financial institutions that have lent to them. As a result, some regional banks are attempting to strengthen their balance sheets by refusing to extend new credit or provide letters of credit. Interest rates are generally very high throughout the region in response to reduced liquidity and to defend fragile currencies. If they continue to stay at these levels for more than two or three months, they could force even viable companies into default. This would further worsen the position of financial institutions exposed to such firms, increase unemployment and cut growth.

Solutions to the Crisis

A key circuit breaker to boost confidence in currencies and economies will be regional government action to undertake major structural reforms, especially addressing weaknesses in banking systems, ensure speedy corporate debt resolution and adopt most of the other macroeconomic and microeconomic reforms of the IMF regional rescue packages. Urgent short term measures include:

- liquidation or recapitalisation of insolvent financial institutions
- new legislation and transparent, possibly government coordinated, mechanisms to expedite bankruptcy and asset sales of unviable corporations and banks
- in the worst affected countries, measures to assure residents that international payments and financial systems will continue to function efficiently, if necessary with international or bilateral trade credit arrangements
- significantly improved prudential controls for financial sectors and rigorous implementation of these procedures.

Other measures necessary to restore investor confidence include:

- cancelling grandiose, low return public investments and winding back purchases of expensive military hardware
- curbing publicly granted monopolies and special access for insiders to government contracts
- terminating inefficient subsidies for commodities like oil and electricity, although in worst affected countries, this may have to be phased in more slowly to avoid social dislocation
- systemic upgrading and enforcement of corporate accounting standards
- greater transparency and efficiency in public administration, including credible commitment to ensuring fair and open bidding for contracts and access to licences
- commercial allocation of bank loans, through greater domestic and foreign competition
- guarantees of strong prudential control by increasing central bank competency and independence
- creation of fair and competent legal systems.

Apart from the present currency crisis challenges, a more open, integrated and competitive domestic economic environment poses other challenges for the Philippines. While peso depreciation should increase Philippine competitiveness, its industries must gear up to take advantage of international trade opportunities and meet foreign competition. Improving infrastructure, running a more efficient government administration, maintaining the real value of the peso depreciation and continuing the opening of trade and investment regimes will be fundamental to enhancing competition and efficiency growth.

Despite current problems, international and regional markets offer the Philippines many export and investment opportunities in the medium and long term.² International markets have opened and trade barriers wound back progressively in the past 40 years, with successive GATT rounds culminating in the Uruguay Round. There also has been unilateral liberalisation, and in the Asia Pacific, Asia Pacific Economic Cooperation, APEC, and ASEAN Free Trade Agreement, AFTA, commitments. World trade growth jumped from 4 to 5 per cent per year from the late 1970s to 1993 to about 9 per cent per year from 1994 to 1995. However, with the recent currency crisis, world trade growth is expected to decelerate and may average about 6 per cent per year during the next decade (World Bank, 1997a; IMF, 1998).

²
The unweighted average tariffs of Asia Pacific economies dropped 40 per cent from over 15 per cent in 1988 to 9 per cent in 1996 (Pangestu et al, 1996).

Similarly, output growth in East Asia will slow in 1998, 1999 and possibly 2000 due to the recent currency and financial market crises. While growth is expected to slow to an average of about 7 per cent per year during the next decade, East Asia is still expected to be the fastest growing region in the world (IMF, 1998). Annual growth in regional exports averaged about 11 per cent and imports 10 per cent during the 1980s and early 1990s (World Bank, 1996a). Foreign direct investment flows in the APEC region also increased dramatically in the early 1990s at four and a half times the rate of the mid 1980s (Pangestu et al, 1996). Despite the currency crisis and consequent short term reduction in portfolio and loan capital flows to East Asia, East Asia's prospects for continued high growth in the medium to long term remain sound, provided regional economies undertake the major necessary reforms in financial market and corporate management (World Bank, 1997a).

PHILIPPINE ECONOMIC REFORM IN HISTORICAL AND REGIONAL CONTEXTS

To determine the likely success of the Philippines' development strategy, this section briefly compares the recent economic reforms with domestic policies pursued over the previous four decades and those adopted by successful East Asian economies. Given the lessons being learned from the Asian currency crisis of 1997-98, it is also necessary to examine how well recent reforms are likely to equip the Philippines to address these policy challenges to achieve rapid, sustainable growth.

Reforms began in the late 1980s but accelerated during the Ramos administration, focusing on opening trade and investment regimes, creating macroeconomic stability, reforming the financial system, strengthening prudential controls and accelerating infrastructure provision. (These reforms are discussed in detail in Chapters 2 to 6.) Until reforms started, the Philippines compared very poorly with other East Asian economies on almost all development criteria, including economic growth; in many it still has much ground to recover (Table 1.1).

Compared with the other market oriented economies of East Asia, the Philippines is the major laggard in economic performance. Despite favourable natural and human endowments, which appeared likely to generate rapid economic growth in the early 1960s, the Philippines' subsequent economic history was one of unfulfilled promise (Cabalu, 1994a). In 1960, Philippine per capita income ranked sixth in East Asia after Japan, Hong Kong, Singapore, Taiwan and Malaysia (Table 1.1).³ The Philippines began to industrialise in the 1950s, twenty years before other South East Asian economies. However, it became the worst performer in the region from the 1970s to early 1990s (Table 1.1). While other East Asian countries rapidly industrialised, the Philippines achieved little structural transformation (Table 1.2).

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³ Using official exchange rates, the Philippines ranked second after Japan in per capita income during the 1950s. (See Ginsberg, 1961.) However, this exchange rate was heavily overvalued inflating the country's post war per capita income.

Table 1.1

Philippine Income Growth Lagged Badly
Real GNP per Capita for Selected East Asian Economies, 1960-96
(US\$, Constant 1987 Prices)

	1960	1970	1980	1990	1996	Average growth per year (1960-96)
Japan	4 702	11 868	16 378	23 084	25 039	4.8
Singapore	1 536	2 787	5 695	9 959	14 080	6.3
Hong Kong	2 247	3 128	5 939	9 897	12 256	4.8
Taiwan	759	1 401	3 256	8 307	11 128	7.7
Republic of Korea	324	974	1 894	4 098	5 942	8.4
Malaysia	675	967	1 628	2 199	3 021	4.3
Thailand	302	493	715	1 275	1 830	5.1
Indonesia	175	208	335	514	730	4.0
Average of above economies	1 340	2 728	4 480	7 417	9 253	5.7
Philippines	413	486	678	631	670	1.4

Source: World Bank, 1997c; data for Taiwan are from *Taiwan Statistical Data Book, 1997*, Taiwan; data for 1996 are estimates from International Economic Data Bank, Australian National University.

Table 1.2

Little Structural Change in the Philippines
Structural Change in Selected East Asian Economies, 1960 and 1996
(Percentage Share of Gross Domestic Product, GDP by Sector)

	Agriculture		Industry		Manufacturing		Services	
	1960	1996	1960	1996	1960	1996	1960	1996
Japan	13.0	2.0	45.0	36.3	34.0	27.8	42.0	61.1
Singapore	4.0	0.2	18.0	37.8	12.0	28.6	78.0	62.0
Hong Kong	4.0	0.2	34.0	14.9	25.0	7.3	62.0	84.9
Taiwan	28.0	3.3	29.0	35.7	22.0	28.1	43.0	61.1
Republic of Korea	40.0	6.3	19.0	42.8	12.0	30.7	41.0	50.9
Malaysia	37.0	12.7	18.0	48.5	9.0	34.5	45.0	38.8
Thailand	40.0	10.0	19.0	40.4	13.0	30.0	41.0	49.6
Indonesia	54.0	16.8	14.0	43.2	8.0	25.4	32.0	42.3
Philippines ^a	26.0	21.1	28.0	35.2	20.0	24.2	46.0	43.7

Note: ^a Data for the Philippines are as of August 1997.

Source: Calculated from data from World Bank, 1997c; data for 1960 are from World Bank, 1980; data for 1996 are estimates from International Economic Data Bank, Australian National University; data for the Philippines were calculated from data from Economic and Social Statistics Office, National Statistical Coordination Board, Philippines.

The Philippine population growth rate is the highest in East Asia except for Malaysia's and has fallen more slowly in the post war period than all others except Malaysia's (Table 1.3). Because of relatively slow output growth and rapid population growth, unemployment remains high. In 1995, unemployment at 8.4 per cent was nearly three times higher than in most successful East Asian economies. The Philippines' high population growth also exerts a negative influence on its savings performance.⁴

The Philippines experienced several acute balance of payments crises during the post war period; the most severe eventually led to a change in government in the late 1980s and the start of ongoing macroeconomic stabilisation and structural reform.

Table 1.3

Philippine Population Growth High, Income Growth Low
Basic Growth Economic Indicators for Selected East Asian Economies
1960-96 (Annual Average, Per cent)

	Real GDP	Population		Unemployment rate	
	1960-95	1960-69	1980-89	1971	1995
Japan	5.58	1.03	0.59	1.2	3.2
Singapore	8.26	2.47	1.67	4.8	2.7
Hong Kong	7.89	2.65	1.35	4.8	3.2
Taiwan	8.70	3.20	1.36	1.7	1.8
Republic of Korea	8.82	2.50	1.18	4.5	2.0
Malaysia	7.08	2.94	2.66	6.8	2.8
Thailand	7.71	3.07	1.92	0.5	1.5 ^a
Indonesia	6.02	2.25	1.86	na	1.6 ^b
Philippines	3.89	3.13	2.45	4.8	8.4

Note: a 1993 for Thailand; b 1994 for Indonesia; na means not available.

Source: Calculated on the basis of data from World Bank, 1997c; data for Taiwan are from *Taiwan Statistical Data Book, 1997*, Taiwan; unemployment data are from *UNDP Statistical Yearbook, UN Statistical Yearbook for Asia and the Pacific* and Asian Development Bank key indicators. All data are extracted from International Economic Data Bank, Australian National University.

The Philippines' Initial Conditions and Endowments

Philippine development prospects in the 1960s were high based on its comparatively favourable initial conditions. The country was better endowed with natural resources, particularly minerals, than North East Asian countries like the Republic of Korea and Japan. In 1960, of the population aged over 10 years, 72 per cent were literate, a similar level to Singapore, the Republic of Korea and Hong Kong, and superior to Malaysia and Indonesia (Table 1.4). The Philippines had a head start in

⁴ The linkages between savings rates and population growth are examined in more detail in the section in this chapter on savings and investment.

providing universal primary education, with the public system supplemented by a network of private educational institutions, particularly at secondary and tertiary levels. It already had a domestic savings rate of more than 25 per cent in the mid 1960s, a level comparable to that of the first generation 'miracle economies' (Figure 1.1). Various agreements between the Philippines and the USA gave the Philippines preferential access to US markets and created a level of political comfort that made the Philippines a favourite destination for US foreign investment. While the Philippines had a substantially less egalitarian income distribution than Taiwan, the Republic of Korea or Indonesia, it was more equitable than Malaysia in the early 1970s (Booth, 1997) or Japan in the 1920s and 1930s (Kawagoe, 1997).

Table 1.4

The Philippines Rates Well on Human Capital Literacy Rates and Average Years of Schooling in Selected East Asian Economies

	Literacy rate (per cent)		Average years of schooling	
	1960	1996	1980	1992
Philippines	72	95	6.6	7.6
Japan	98	98	10.4	10.8
Hong Kong	71	91	6.2	7.2
Singapore	72	91	9.5	12.0
Taiwan	54	93	na	na
Republic of Korea	71	85	6.6	7.6
Malaysia	23	89	4.0	5.6
Thailand	68	94	3.5	3.9
Indonesia	47	85	3.1	4.1

Source: Department of Commerce and Trade (Government of Western Australia), 1997; Leipziger and Thomas, 1997.

The Philippines' poor economic performance over the last three decades, despite favourable initial conditions, suggests failure was due to poor economic policies. The experience of successful economies, particularly those of East Asia in recent decades, indicates the importance of pursuing a range of core policies, including:

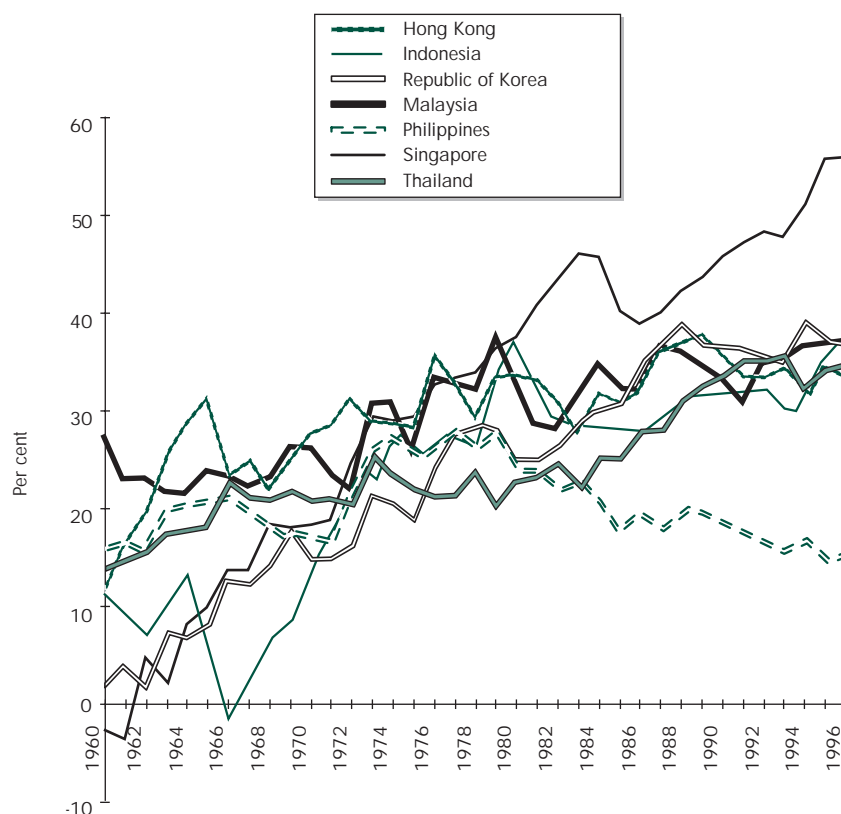
- developing outward looking, export oriented economies
- maintaining realistic exchange rates
- pursuing sound macroeconomic policies, fiscal discipline and lower inflation
- saving and investing more and encouraging foreign investment
- developing flexible labour markets and firms
- promoting social equity policies
- investing more in education and rapidly increasing human capital
- developing and maintaining more satisfactory infrastructure

- discriminating less against agriculture
- promoting effective bureaucracies to implement policies.

East Asian economies differ in their institutional approaches to attaining and maintaining this set of attributes. Some take a more market oriented approach (Hong Kong, Singapore and in recent years, Taiwan); others pursue more interventionist policies (Japan, the Republic of Korea and Indonesia). In the recent currency crisis, the former group of economies, with more transparent, rules based economic management has fared considerably better than others.

Figure 1.1

Philippine Savings Performance Poor since Mid 1970s
Gross Domestic Savings, Selected Asian Economies, 1960-94
(Per cent of GDP)



Source: Calculated on the basis of data from World Bank, 1997c.

Outward Orientation

The Philippines pursued inward oriented, protectionist, import substituting trade and industrial strategies longer and more indiscriminately than any successful East Asian economy (Table 1.5). Intimately intertwined with this protectionist trade regime was the overvalued currency maintained throughout the 1960s, and some argue up to the major depreciation post July 1997 (discussed in the following section). Peso overvaluation made exports and import substitutes uncompetitive, generating a balance of payments crisis in 1949-50, resulting in widespread import controls⁵ in the early 1950s and import substitution based industrial development. Protection and the overvalued exchange rate discouraged exports of both potential new labour intensive manufactures and traditional primary commodities.

Tariffs replaced generalised import controls in the early 1960s, and by the mid 1970s, the Philippines had the highest average tariff rates in ASEAN (Table 1.6). Typical of countries pursuing import substitution, the protection pattern was uneven, with high protection for finishing and assembly operations and low protection for raw materials, intermediate goods and capital goods production. The overvalued exchange rate made imports of unprotected items cheap, resulting in systemic discrimination against agricultural and intermediate and capital goods sectors, and favouring production of over-priced consumer goods (which only could be sold locally).

Table 1.5

Philippine Outward Orientation Now Increasing Export-to-GDP and Manufactured Export-to-GDP Ratios for Selected East Asian Economies, 1970-95 (Per cent)

	Merchandise export to GDP ratio				Manufactured export to GDP ratio			
	1970	1980	1990	1995 ^a	1970	1980	1990	1995 ^a
Japan	9.5	12.2	9.7	8.7	8.8	11.7	9.4	8.4
Hong Kong ^b	53.6	48.0	38.8	20.8	51.4	46.3	37.1	19.9
Singapore ^c	81.9	165.3	144.1	141.1	25.0	89.2	104.9	121.5
Taiwan	25.2	47.9	41.9	45.8	19.2	42.1	38.8	42.6
Republic of Korea	9.2	27.4	25.6	26.9	7.0	24.6	23.9	25.1
Malaysia	40.1	52.8	68.8	86.4	3.0	10.1	37.3	65.7
Thailand	9.7	19.7	26.9	33.7	0.8	5.5	17.3	24.9
Indonesia	10.9	28.1	22.3	22.9	0.2	0.7	7.9	11.6
Philippines ^a	15.8	17.7	18.2	26.1	1.2	6.5	12.6	19.0

Note: a Data for the Philippines are as of August 1997; b excludes re-exports; c includes re-exports.

Source: Derived on the basis of data from UN Commodity Trade Data Base, and World Bank, 1997c; GDP Data for Taiwan are from *Taiwan Statistical Data Book 1997*, Taiwan. All data are extracted from International Economic Data Bank, Australian National University.

⁵ Under the import control regime, imports required approval from the central bank and foreign exchange was allocated according to 'necessity'.

Furthermore, the overvalued exchange rate, low levels of protection on capital goods and rationed foreign exchange allocated to imported inputs on the basis of the capital investment all created a bias towards capital intensive industry which generated little employment growth. Shielded by high rates of protection, production efficiency fell well below world best practice. As a result of the currency overvaluation, demand for imported capital equipment and intermediate goods was not matched by foreign exchange earnings from exports, causing severe and endemic balance of payments crises. Growth stagnated and the economy lagged behind neighbouring Asian countries.

Towards the end of the 1970s, the adverse effects of the country's anti-export and protectionist regime could no longer be ignored as social and economic unrest grew. The oil price shocks of the 1970s and recession in industrial countries in the early 1980s merely aggravated these underlying weaknesses, prompting major trade reforms in the 1980s.

The start of the tariff reform program in 1980 reduced the average tariff rate to below that of Indonesia and Thailand and lowered the incidence of nontariff barriers below those of Indonesia in the early 1980s (Naya et al, 1989). However, these tariff reductions were not accompanied by a real peso depreciation and were rendered ineffectual by foreign exchange restrictions imposed in response to the 1983-85 foreign exchange crisis.

Furthermore, the Philippines did not develop an effective duty drawback or bonded warehouse scheme or well located export processing zones with adequate infrastructure, transport and proximity to labour supply. Consequently, the Philippines failed to provide an effective offset to tariffs for exporters, especially given the overvalued peso (Cabalu, 1994b).

As the manufacturing sector's output share stagnated and the sector became increasingly capital intensive, its share of total employment actually fell between 1960 and 1980. This contrasted sharply with significantly rising manufacturing employment in Malaysia, Indonesia, the Republic of Korea, Taiwan and China (Table 1.7). With stagnant employment and continued labour force growth, real wages declined in the 1970s and early 1980s (Figure 1.2) and unemployment and underemployment grew. The strong anti-export bias of trade and industrial policies continued to contribute to the endemic balance of payments crises and recurring macroeconomic instability.

Table 1.6
Philippine High Tariffs Now Declining
ASEAN Simple Average Tariffs, 1978-96
(Per cent)

Country	1978	1983-84	1996
Indonesia	33	33	12
Malaysia	15	25	8
Singapore	5	6	0.04
Thailand	29	32	20
Philippines	44	29	13

Source: Azarcon, 1997.

Table 1.7

Philippine Manufacturing Employment Stagnates
Share of Manufacturing to Total Employment of Selected Asian Economies
(Per cent)

Country	1960	1965	1970	1975	1980	1985	1990	1994	1995
Philippines	12.1	11.2	11.9	10.9	10.8	9.5	9.7	10.3	10.0
China ^a	7.8	8.3	10.1	13.2	18.3	20.9	21.4	22.7	23.0
Hong Kong	na	na	79.6	50.7	42.1	36.1	27.7	19.6	18.4
Indonesia	na	na	na	6.7 ^c	9.1	9.3	10.1	na	na
Japan	21.3	24.4	27.0	25.8 ^b	24.7	25.0	24.1	23.2	22.5
Republic of Korea	na	9.4	13.3	18.6	21.6	23.4	27.2	23.7	23.4
Malaysia	na	na	9.0	11.1	16.1	15.0	19.9	24.9	23.3
Singapore	na	na	29.6	26.2	29.2	25.4	29.1	25.6	24.0
Taiwan	na	na	20.4	27.2	32.9	33.7	32.0	27.8	27.1

Note: a Share of industry employment; b 1972; c 1976.

Source: ILO Yearbook of Labour Statistics; UN Statistical Yearbook for Asia and the Pacific; Asian Development Bank Key Indicators, various years; Chinese Statistical Yearbook, 1996.

Trade Policy Reforms

The Government recognised that protectionist policies had severely hindered Philippine development, so during the past decade it has drastically liberalised the trade regime, cutting tariff and quantitative restrictions. From being one of the most protectionist economies in the region, it is becoming one of the more open. Under unilateral liberalisations and commitments made within APEC, most tariffs, except on a few sensitive imports like rice, will decline to 2 to 5 per cent by 2004. Recent trade reforms are discussed in detail in Chapter 3 - Trade. This policy already has generated a dramatic growth in non-traditional, manufactured exports; the 1997 peso depreciation should ensure renewed growth in labour intensive manufactures and help it reduce the country's current account deficit.

Realistic Exchange Rates

Central to outward orientation is maintaining a realistic exchange rate.⁶ The Philippine peso became overvalued after World War II when it was held constant at

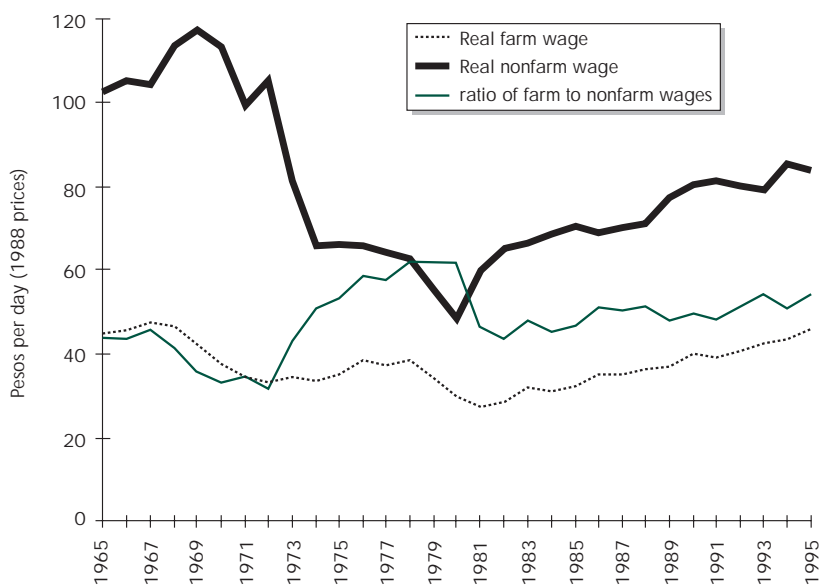
⁶ In most East Asian economies, real currency depreciation greatly facilitated sustained export growth. Real depreciation occurred in Taiwan and Korea during the 1960s and Thailand, Indonesia and Malaysia after the yen appreciation engineered by the Plaza Accord in the mid 1980s. Taiwan in the 1960s and virtually all of the 'Four Tigers' in the early 1980s kept their exchange rates at competitive levels to build export market shares (Petri, 1989; 1997). The dramatic success of Indonesia in non-oil exports since the latter 1980s arose from the successful real depreciation of the rupiah in the mid 1980s in tandem with a series of liberalisation efforts since then. The Thai baht depreciated in real effective terms by nearly 30 per cent during 1983-91 thereby improving its international competitiveness (Intal, 1992; Christensen et al, 1993). China's 1994 exchange rate reunification and 40 per cent depreciation contributed significantly to the surge in its exports in recent years.

the pre war level of 2 pesos to the US dollar, despite much higher inflation in the Philippines than the USA during and immediately after the war. (See Chapter 2 - *Macroeconomic Environment*.) Heavy overvaluation of the peso for much of the post war period combined with the protectionist regime that maintained this overvaluation was a central cause of the Philippines' failure to develop economically prior to the early 1990s (Intal, 1992; 1995). Peso overvaluation persisted throughout the 1960s and 1970s because of the strong ideological resistance to depreciation; agricultural landlords and foreign agricultural traders and processors would have benefited directly from it.

Figure 1.2

Real Wages Fall over Three Decades

Average Real Daily Wage Rates (1965-95) (Pesos at 1988 Prices)



Note: For farm wages, for 1965-77, nominal daily wage rates are based on the average wage rates for hired palay-farm labour engaged in all operations. For 1978 onwards, nominal data are based on the average wage rates in farm (palay-planting) households, deflated by CPI for areas outside metro Manila. Wage rates refer to payments in cash and in kind, excluding meals.

For non-farm wages, wage rates are based on the average wage rates for common labourers; wage rate is the basic pay including cost of living allowances. Nominal wages are deflated using the CPI for metro Manila areas.

Source: *Yearbook of Labor Statistics*, 1991 and 1995; *Philippine Statistical Yearbook*, 1990 and 1995.

The overvalued peso prevented the generation of employment opportunities in export oriented industries like garments, toys, footwear and light manufactures because it made Philippine labour too expensive in foreign currency to produce such goods competitively. In other East Asian economies, rapidly growing, labour intensive manufacturing for export markets drew surplus labour out of low productivity agricultural activities, relieving pressure on limited land and raising incomes throughout the economy. The Philippines missed this crucial development path.

Recent Peso Depreciation

The Asian currency crisis resulted in a 29 per cent real depreciation of the peso on a trade-weighted basis from January 1997 to the end of February 1998 (Table 2.2 and Figure 2.4). Assuming this depreciation can be sustained by containing inflationary pressures, it will contribute significantly to overcoming this structural problem in the Philippine economy. (See Chapter 2 - *Macroeconomic Environment*.) This will be crucial to Philippine development, giving the country a fresh opportunity to pursue broad based, labour intensive, manufactured export led growth as neighbouring economies have done in recent decades.

Macroeconomic Policies

Until 1994, Philippine governments ran expansionary fiscal and monetary policies throughout most of the post war period, with the largest fiscal deficits as a share of Gross Domestic Product, GDP, during the years of presidential elections. Lax fiscal policy exacerbated the weak balance of payments situation⁷ and generated major gyrations in demand and high inflation. This in turn slowed economic growth, discouraged savings and financial deepening, and reduced investment environment predictability and capital use efficiency. This contrasts with the generally disciplined macroeconomic policies successful East Asian economies pursued and with their superior inflation performance (Table 1.8).

The most serious balance of payments crisis was from 1983 to 1985. The country's external terms of trade deteriorated sharply during 1980 to 1983, externally financed investment funds were misallocated, and despite rising world interest rates, the government pursued expansionary 'countercyclical' macroeconomic policies financed largely by short term debt with variable interest rates. These policies were disastrous and required wrenching macroeconomic adjustment under IMF supervision in the late 1980s.

Recent Fiscal Policy Reforms

Since the early 1990s, the Ramos administration has strengthened the macroeconomic foundations for sustained robust growth, using privatisation, improved tax effort and greater fiscal discipline to achieve fiscal surpluses from 1994 to 1997, the first time for many years. As a result of improved macroeconomic management, inflation dropped rapidly and the country largely overcame its external debt service problem of the 1980s. (See Chapter 2 - *Macroeconomic Environment*.)

⁷ Since World War II, the Philippines has had balance of payments crises in 1949-50, 1960-61, 1969-70, 1983-85 and 1990-91.

Table 1.8

Philippine Inflation Performance Poor but Improving
Average Annual Inflation Rate in Selected East Asian Economies, 1960-96
(Per cent, Annual Average)

	1960s	1970s	1980s	1990-96
Japan	5.3	8.0	2.2	1.0
Singapore	1.1	5.9	3.4	3.8
Hong Kong	2.4	9.2	8.9	7.6
Taiwan	2.8	10.2	4.3	3.2
Republic of Korea	17.5	19.5	8.7	6.7
Malaysia	-0.3	7.3	2.5	3.8
Thailand	1.8	9.2	5.2	5.1
Indonesia	19.5	21.5	11.2	7.6
Philippines	5.8	13.3	14.9	9.9

Source: Calculated on the basis of data from World Bank, 1997c; data for Taiwan are from *Taiwan Statistical Data Book*, 1997, Taiwan; and data for 1996 are estimates from the International Economic Data Bank, Australian National University.

Financial reforms also have deepened the country's financial sector, allowing more competition from new domestic and foreign banks. The central bank was reorganised and strengthened, and granted greater independence in conducting monetary policy. These reforms placed the Philippines in a relatively strong position in the recent currency crisis. (See Chapter 2 - *Macroeconomic Environment*.)

Investment and Savings Performance

Philippine savings and investment performance is well below regional averages (Figures 1.1 and 1.3) reflecting its past erratic macroeconomic policy, low growth and uncertain investment environment. Philippine savings rates compared favourably to other East Asian economies until the late 1970s, then fell rapidly due in part to the economic crisis following the second oil price shock (Figure 1.1).

Savings in successful East Asian economies continued to rise strongly in the 1980s and 1990s when a virtuous circle of rising savings rates and capital formation developed as income growth accelerated (Collins, 1991). Equally important to high savings rates in other East Asian economies were policies encouraging small family size that, together with declining child mortality, urbanisation, higher educational attainment especially of women, and rising child rearing costs, helped quickly reduce fertility rates and population growth (Table 1.3) (Mason, 1997).

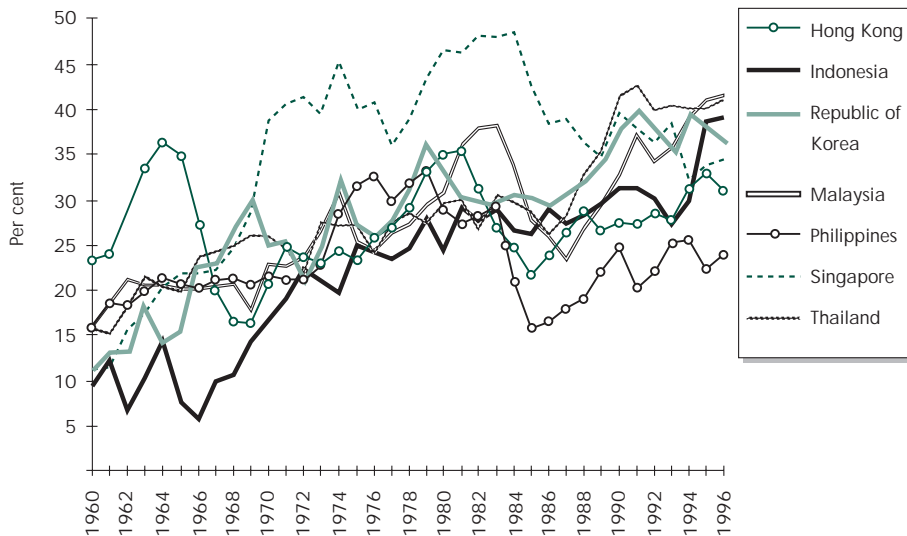
Philippine investment levels still are weak compared to East Asia (Figure 1.3). Lower domestic and foreign investment is a legacy of lower economic growth rates, past political instability, poor infrastructure, high protection and until the early 1990s, policies restricting foreign participation in many sectors. (See Chapter 2 - *Macroeconomic Environment* and Chapter 4 - *Investment*.) The investment rate declined dramatically in the first half of the 1980s because of the economic crisis and deteriorating infrastructure. (See Chapter 6 - *Infrastructure*.) Infrastructure problems, such as massive power blackouts also constrained growth in the early 1990s.

The investment shares in East Asian GDP have risen strongly over the past three decades primarily because of the investment-friendly environment: macroeconomic stability; low taxes; ample local savings; and high net returns on investments. These economies experienced technological catch-up in generally open markets which stimulated rapid growth. Foreign direct investment accelerated economic growth in Indonesia, Malaysia, Singapore, Taiwan, Hong Kong and Thailand from the early 1980s to mid 1997, particularly following yen appreciations in 1985 and again in 1994-95; this hastened technology acquisition (Petri, 1997).

Figure 1.3

Philippine Investment Levels Also Weak

Gross Domestic Investment, Selected Asian Economies, 1960-96 (Per cent of GDP)



Source: Calculated on the basis of data from World Bank, 1997c.

Recent Foreign Investment Reforms

Since 1991, the Ramos administration has opened most sectors of the economy to foreign direct investment, removing many previous biases against foreign investors and introducing investment incentives. It also has revitalised, improved and expanded the economic zones, helping to offset residual anti-export and anti-investment biases in the economy. The extensive foreign investment reforms are discussed in depth in Chapter 4 - *Investment*. Inflows of foreign direct investment help develop new export oriented industries and facilitate technology transfer and employment growth.

Labour Market and Firm Flexibility

In the Philippines, wages in formal sector enterprises are set by centralised wage fixing dictated by political rather than labour productivity factors. In the post war period, high levels of unionisation rapidly increased relative unit labour costs as productivity declined and compensation measured at the market exchange rate rose strongly (Table 1.9). However, the purchasing power of wages barely increased at all over the two decades to 1990, and real farm and non-farm wages actually fell until the early 1980s (Figure 1.2).

As unit labour costs rose in US dollars, footloose industries such as Korean footwear and overseas Chinese textiles and garment producers bypassed the Philippines to invest in countries like Indonesia and China. Consequently, the growth of labour intensive manufactured exports was sluggish compared to other South East Asian economies.

Table 1.9

Philippines Productivity Fell as US Dollar Wages Rose Growth in International and Philippine Labour Costs and Productivity, 1970-90

	Productivity	Compensation at PPP exchange rate	Compensation at market exchange rate
Philippines	-0.5	0.2	2.3
USA	3.0	1.7	1.7
Japan	5.2	5.4	8.4
Germany	2.2	2.8	6.5
Canada	2.1	1.4	3.1
Australia	2.6	1.1	3.2
Republic of Korea	6.5	7.0	8.2
Mexico	3.2	-0.5	0.4
Malaysia	2.0	1.8	4.0
Thailand	4.4	5.1	6.8
India	3.4	3.0	2.7

Note: PPP means purchasing power parity, reflecting the local purchasing power of wages.

Source: Golub, 1995; Intal, 1997.

Recent Productivity Rises

However, competitive pressures from trade reforms beginning in 1986 created a sustained rise in Philippine total factor productivity growth,⁸ or the efficiency with which labour, capital and other resources are used in the economy (Table 1.10). This increased productivity is even more striking if the period of weak growth during the 1990-92 energy crisis is excluded.

Social Equity Policies

Until the Aquino administration, few attempts were made to increase equality in the Philippines. Philippine income distribution, although less equal than in Taiwan, the Republic of Korea and Indonesia, now compares with Thailand and Malaysia. However, the low level of income and its unequal distribution combine so that the proportion of the population living in poverty is higher than in other ASEAN countries (Table 1.11). Neglect of agricultural development, rural employment and labour intensive manufacturing contributes significantly to poverty and inequality, concentrating the poor in rural areas.

Since the war, the most politically charged equity issue in the Philippines has been land tenure and reform. Unlike successful North East Asian land reform programs which were undertaken rapidly under extraordinary post war circumstances, powerful landed interests have opposed the Philippine process, making it highly divisive and tortuous. Although land reform has reduced share tenancy in rice and corn farms (Bravo and Pantoja, 1997), the purchase of land at near market rates, deteriorating government support services and insufficient productivity enhancing investments in agriculture during the 1980s and early 1990s, effectively constrained the productivity and welfare enhancing impact of the program. (See Chapter 8 - *Agriculture*.)

Table 1.10

Trade Liberalisation Spurs Productivity Growth

Total Factor Productivity (TFP) Growth Rates during Different Trade Regimes

Period	Industrial regime	TFP growth (per cent per year)
1960-65	Trade protection, initial phase	0.185
1965-70	Trade protection, rent seeking	-0.186
1970-80	Trade protection, export promotion, rent seeking	0.093
1980-86	Trade protection, macroeconomic and political crisis	-2.890
1986-96	Trade and foreign exchange liberalisation	0.930
1986-89, 1993-96	Trade and investment liberalisation ^a	2.120

Note: ^a Excluding energy crisis, 1990-92.

Source: Austria, 1997.

⁸ Total factor productivity growth is output growth not accounted for by input growth, that is the more efficient use of inputs.

Table 1.11

Poverty Much More Prevalent in the Philippines

Incidence of Poverty in the Philippines and other ASEANs, 1981-95

Percentage of population living on less than \$1 per day (PPP)	
Philippines	27.5
Indonesia	14.5
Malaysia	5.6
Thailand	0.1
Singapore	0.0

Source: World Bank, 1997b.

Other equity related programs like spending on public education, health and housing also have lagged in the Philippines. Failure to achieve a dynamic labour intensive manufactured export sector has prevented the rapid reduction of rural poverty that occurred in Thailand and Indonesia in recent years.

Current Poverty Situation

Although poverty has lessened in the last decade, over 35 per cent of families and 40 per cent of the population were considered poor in 1994 (Reyes and del Valle, 1997). People in rural areas still face disproportionately high levels of poverty. Inequality has remained static and high since the 1960s, but improved slightly after reforms began in the 1990s (Table 1.12).

Infrastructure Policy

The Philippines' neglect of public infrastructure development in the 1980s resulted in low growth of new transport, electricity, telecommunications and water services. By contrast, other East Asian countries directed a high proportion of their public investment to infrastructure, rapidly expanding rural roads, electricity coverage, telephones and irrigation (Table 1.13). Nevertheless, infrastructure shortages still severely constrain growth in several East Asian economies (East Asian Analytical Unit, forthcoming).

The crippling power crisis of 1992-93 precipitated bold policy reforms, privatisation, deregulation and innovation by the Ramos administration that enabled substantial private participation in infrastructure services. (See Chapter 6 - *Infrastructure*.) However, after years of neglect, the Philippines seriously lags behind many East Asian economies in the coverage and quality of infrastructure services; the Government also must resolve difficult regulatory and competition policy problems to optimise the use of private sector funds for infrastructure. (See Chapter 6 - *Infrastructure*.)

Table 1.12

Poverty Declining but Still High in Rural Areas
Poverty and Income Inequality Indicators 1961-94
(Per cent)

Year	Poor families (as per cent of total)			Contribution to total poverty		Gini coefficient
	Total	Urban	Rural	Urban	Rural	
1961	59	51	64	30	70	0.465
1965	52	43	55	26	74	0.465
1971	52	41	57	24	77	0.453
1985	44	37	49	32	68	0.446
1988	40	32	46	31	69	0.445
1991	39	31	47	39	61	0.468
1991 _{adj}	37	23	53	35	65	na
1994	36	24	47	na	na	0.451

Note: The Gini coefficient is a measure of income equality ranging from 0 to 1; the larger the coefficient, the greater the inequality; adj means adjustment made by Reyes and del Valle study.

Source: World Bank, 1996b; Reyes and del Valle, 1997.

Table 1.13

Philippine Infrastructure Lags Badly
Growth in Infrastructure Selected East Asian Countries, 1980-90
(Growth over Period, Per cent)

Country	Paved road	Electricity generating capacity	Electricity production	Telephone main lines	Railroad tracks	Access to safe water ^a
Republic of Korea	120	134	197	299	38	18
Malaysia	36	107	143	301	7	15
Thailand	69	142	206	262	6	14
Indonesia	106	312	534	184	5	11
Philippines	-20	48	46	45	-55	36

Note: ^a is percentage change in coverage.

Source: Kohli, 1994.

Bias against Agriculture

For the past two decades, Philippine agricultural performance has been poor. Government policy discriminated against traditional agricultural export sectors via export taxes and an overvalued peso, making exports like coconut and sugar lose international competitiveness. The economic crisis of the early to mid 1980s led to deteriorating support services to agriculture and farm infrastructure, especially irrigation (David et al, 1993). As a result, the Philippines was the worst agricultural performer in East Asia in the 1980s and early 1990s and became a marginal net agricultural importer in 1996. (See Chapter 8 - *Agriculture*.)

By contrast, many other East Asian economies did not neglect agriculture and governments invested significantly in rural infrastructure. In Taiwan, Thailand, Indonesia and Malaysia, agriculture played an important role at the start of industrialisation, with agricultural trade surpluses providing a major source of foreign exchange and investment for non-agricultural sectors, competitively priced agricultural inputs for industry and cheap food for urban workers.

Current Agricultural Policies

Agricultural reforms under the Aquino and Ramos administrations included dissolving many inefficient and rent seeking agricultural marketing monopolies controlled by Marcos cronies and giving higher priority to agricultural development. However, the rice self-sufficiency policy absorbs much of this assistance. Corn, sugar and other land intensive crops are also protected. Thus farmers are encouraged to grow low value added and low profit crops in which the Philippines has no long term comparative advantage.

The 1997-98 peso depreciation will improve the competitiveness and profitability of agriculture. However, longer term productivity rises require significant investments in rural infrastructure, particularly farm-to-market roads, research and extension, and assistance with marketing of higher value added, labour intensive crops like tropical fruit and vegetables and activities like fish and poultry rearing. Resolving the land reform impasse would encourage new agricultural investment.

Human Resource Development

While historically the Philippines had higher levels of schooling and adult literacy than many other East Asian countries (Table 1.4), its human capital has yielded low returns. Low capital intensive growth led to little demand for unskilled (or even skilled) labour. As a result, many educated Filipinos took their skills abroad, and low skilled workers stayed in agriculture.

In the past decade and a half, the quality of education across all levels appears to have deteriorated; the percentage of examinees who passed the national college entrance examination dropped from 60 per cent in 1981-82 to 53 per cent in 1991-92. Also the rate of secondary school graduates able to enter university fell from 75 per cent in 1983 to 69 per cent in 1996 (Herrin, 1997).

By contrast, other regional governments promoted broad based education by focusing on primary education.⁹ Spending at the post secondary level was more limited and focused on strengthening technical skills. The development of universities and other tertiary institutions was often left largely to the private sector. Consequently, the Republic of Korea, Taiwan and Singapore produced spectacular gains in tertiary education in one generation (Birdsall and Sabot, 1993).

The key to providing resources for public education is upgrading the taxation compliance system. Essential social services like health and education receive insufficient quality human resources and facilities because fiscal allocations to these sectors are inadequate, due to low taxation compliance and collection. (See Chapter 2 - *Macroeconomic Environment*.) While the Ramos administration gives high priority to improving tax collection, and shares of GDP collected as tax are now approaching East Asian levels, Congress's recent dilution of the comprehensive tax reform package, slow progress in reforming the Internal Revenue Bureau and the sudden increase in the cost of servicing foreign public debt with the recent peso depreciation all undermine significantly improved tax outcomes.

Bureaucratic Effectiveness

Performance of the Philippine bureaucracy is patchy. During the 1970s, government economic technocrats became increasingly marginalised by vested interests and politically connected individuals seeking profit opportunities from the industrial protection system, monopoly control of industries and expanded public investment. Political considerations, especially national election cycles strongly influenced government spending during the 1960s to the early 1980s (de Dios, 1984). In the late 1980s, broad public participation in government, the urgency of many reforms and numerous personnel changes in the bureaucracy contributed to policy uncertainty and weak program implementation.

The politicised nature of Philippine economic policy making is reflected in weak public institutions. Often, even when good policies are articulated, institutional weaknesses hinder implementation. Promotion on merit is not yet fully established. Political appointments go down to much lower levels of the bureaucracy, introducing some excellent people into government, but also reducing incentives for career public servants. Pay levels are significantly lower than in many other East Asian economies. These policies reduce morale and create opportunities and incentives for public service corruption (World Bank, 1997b).

Other East Asian economies generally created institutional mechanisms that allowed and encouraged government bureaucrats to pursue policies favouring macroeconomic stability, business investment, social equity and rapid economic growth. The more advanced East Asian economies of Japan, Hong Kong, Singapore and Taiwan reduced corruption and increased the professionalism of their government administrations.

⁹ For example in the mid 1980s, Indonesia, the Republic of Korea and Thailand devoted more than 80 per cent of their education budget to basic education (Page, 1994).

Major Policy Challenges for the Next Decade

While the Philippines has progressed significantly in several key policy areas, many major issues still must be addressed. These include:

- raising the relatively low savings rate
- reorienting government expenditure from salaries towards education, health and infrastructure investment
- furthering taxation reform and its administration
- increasing the flexibility of labour markets and wage determination mechanisms
- raising education and human resource development standards
- reducing high levels of social inequality
- addressing poor agricultural sector performance and resolving the land reform impasse
- eradicating official corruption and improving the quality of government administration (particularly at junior and middle levels)
- meeting shortages of critical infrastructure.

Government initiatives to address many of these issues are addressed in the remainder of the report; the final chapter draws conclusions for Australian government and business. (See Chapter 9 - *Implications*.) Overall, the Aquino and particularly Ramos administrations made significant gains in many crucial areas in the past decade, most notably in trade, investment, financial market and infrastructure reforms. However, the Philippines has effectively lost four decades in its quest for economic development and higher living standards, and is still well behind most of its successful East Asian neighbours. The new administration cannot slow the pace of reform, but must consolidate the considerable gains of the past five years and redouble reform momentum if the Philippines is to achieve the high levels of sustainable growth its people deserve.

POLITICAL STRUCTURES AND DEVELOPMENTS

Political developments will be a major factor determining whether the Philippines can sustain high growth into the next century. Restoring political stability after the peaceful people's revolution ousted the corrupt Marcos regime and after the numerous coup attempts during the Aquino administration is one of the foremost achievements of the Ramos administration. This stability has underpinned the progress on economic reforms discussed above and provided domestic and foreign investors with confidence in the Philippines' future.

The Presidency and Legislature

The 1987 Constitution restored a presidential-style republican government with an extensive system of checks and balances. The president, who heads the executive branch, serves for a single six year term, as does the vice president. President and vice

president are elected by separate ballots. As with the US system, the vice president has no defined role or responsibilities other than ones dictated by protocol.

The bicameral congress consists of a senate and a house of representatives. The Senate has 24 members each elected in a nationwide ballot; regions are not represented, although several presidential candidates for the May 1998 national elections pledged to review this situation. The House of Representatives has 235 members largely elected through single member constituencies; some sectoral or minority groups are also represented.

While the presidency commands great prestige and moral authority, constitutional safeguards constrain executive powers. Thus to perform executive functions, the president must rely on the Congress and judiciary. Congress must approve the legislation that underpins any administration's policies and programs. These checks and balances are designed to avoid the excesses of the Marcos era.

Senators, elected nationally, tend to view themselves as mini-presidents, operating as a countervailing force to the administration. Administration bills, even non-controversial ones, can languish in Congress, hostage to the political whims of members and an overloaded legislative agenda. The business community and the Ramos administration, notably the President's national security adviser, Jose Almonte, have criticised these delays, and suggested the political system the Philippines adopted in 1987 has outlived its usefulness. The need to constrain the exercise of executive power, so the argument runs, is no longer there. Filipino democracy is entrenched and the present system merely acts as a brake on the country's economic and social development.

This criticism also has been directed at the Supreme Court, which has used its current constitutional powers to overturn several important pieces of legislation in the Ramos administration's deregulation and liberalisation program. (See Chapter 5 - *Business Environment*.)

In addition to structural or constitutional hurdles, poorly developed party discipline and machinery constrain presidential executive power. Congress members often belong to several parties during the course of their careers. Generally, Philippine political activity lacks the ideological or policy differentiation common in much of the western world. Political support is based on personality rather than ideology or policy. For instance, despite the proliferation of non-government organisations and 'cause oriented groups', there are no mainstream left or green groups in Congress.

Also, the sources of political power are somewhat diffused. Traditionally, average voters are influenced by local issues and primary loyalty is not necessarily to a political party, but to a local political identity, whose claim to voter support may be based on non-political factors, such as family or kinship connections. However, as the Filipino middle class expands and increases its political influence, a more centralised, national political perspective is emerging, rejecting traditional political practices for a more issue oriented approach.

As the middle class exerts itself, the profile of those elected to Congress is changing. While many members of the House of Representatives come from large, land owning families and rely on the traditional politics of patronage, a growing number of politicians, usually representing urban electorates, come from professional or

business backgrounds. Their entry into politics has stimulated debate about issues of policy and administrative competence rather than patronage and power.

Despite these modernising and centralising forces, ethnic and provincial factors remain the crux of modern Philippine politics, particularly in the Visayas and Mindanao. The results of the last presidential election reflect this.

The Ramos Administration

After the authoritarian Marcos era, democratic rule was restored in the Philippines in 1986 following the 'people's power revolution' and the election of President Corazon Aquino. Ramos as Armed Forces Chief then Defence Secretary provided critical support to President Aquino in 1986 and in subsequent coup attempts. President Aquino, who belonged to the Laban Party endorsed Ramos as the preferred candidate to replace her at the 1992 presidential elections. This endorsement came despite Ramos forming the breakaway Lakas Party after he failed to secure Laban's presidential nomination. In a many sided contest, Ramos secured a narrow victory in the election with only 23.5 per cent of the vote.

Ramos' presidential term ends on 30 June 1998 and his achievements in a range of fundamental areas have been substantial. He has achieved these through astute alliance building and by projecting the image of a responsible, consensus oriented, hands-on leader. He pursued major programs of national political reconciliation with the three main threats to the country's internal stability, bringing into the political fold the military rebels and signing in early September 1996 a peace accord with the main Muslim rebel group, the Moro National Liberation Front, thus ending 24 years of insurgency.

Perhaps President Ramos' greatest strength is his consistent pursuit of the economic reforms begun, but not consolidated, by President Aquino. Under Ramos' presidency, the economy is beginning to approach the strong growth rates of its East Asian neighbours. Reducing tariffs, deregulating the domestic economy and pursuing a vigorous privatisation program were crucial reforms.

Due to the nature of the 1987 Constitution, during his presidency Ramos has been forced to work hard at cultivating Congress. His record in securing the passage of much needed legislation has been mostly good. Major legislative achievements of the Ramos administration include:

- accession to the World Trade Organisation, WTO agreement in December 1994 and passing the implementing legislation
- implementing a new mining code
- implementing a defence modernisation bill providing authority for forward commitments for defence purchases
- reforming the central bank
- liberalising the financial sector
- making build operate transfer (BOT) projects more attractive
- liberalising the foreign investment regime
- assisting the peace process with new amnesty provisions

- passing the Comprehensive Tax Reform and Oil Industry Deregulation Acts
- seriously attempting, after years of neglect by previous administrations, to tackle the Philippines' crippling infrastructure bottlenecks, including securing special powers for the executive to deal with the country's serious energy and water problems.

The President's broad message on the need for national economic renewal also addressed deep seated frustrations felt by many Filipinos that their country was lagging behind its neighbours and needed to recover economically to regain national self respect. President Ramos' initial success in tackling the nation's crippling electricity supply problems and returning the economy to solid growth rates boosted his credibility enormously. Importantly, the country's faster economic growth, the withdrawal of the US bases and the Philippines' more active role in APEC (hosting the 1996 APEC Leaders' Meeting) and ASEAN (acting as Chair for 1998), have restored the self-esteem and self-confidence of the Filipino people.

Despite these achievements, on the political front, the last six months of 1997 were problematic. As the end of his presidential term approached, he faced a challenge in maintaining his authority, especially as the constitution prohibits him from seeking another term. The risk was that he would be regarded as a lame duck. Accordingly, throughout 1997 various figures close to the administration began promoting constitutional change.

This campaign left open the possibility of a second Ramos administration. Some critics assumed the President was behind the campaign. The martial law experience under Marcos has made Filipinos suspicious of political leaders seeking to prolong their term in office. These fears were harnessed by the political opposition, elements of the business community concerned about the economic impact of political upheaval, the Catholic Church and former President Aquino.

Political uncertainty over constitutional change coincided with the Asian currency crisis. Some critics claimed the administration focused on the constitutional debate rather than effectively managing the impact on the national economy of the peso's depreciation.

A nationwide campaign against constitutional change and highly critical of the President ensued; President Ramos' political stocks, in the short term at least, were damaged. His legacy will nonetheless be impressive but it will be further enhanced if he can recoup some of this lost political ground before the May 1998 elections. Early 1998 completion of oil industry deregulation and continuing banking system reforms indicate he has recaptured the political initiative.

The Peace Process

Critical to the Ramos administration's policy platform is the comprehensive peace process to provide political stability. The peace process involves detailed and continuing discussions between the Government and leaders of the Philippines' four most significant armed insurgent groups.

Talks with the military rebels responsible for a series of destabilising coups in the late 1980s resulted in a preliminary peace agreement settled in 1992. This agreement brought the leaders out of hiding, effectively defusing this threat to the Government.

Rebel leader Gregorio 'Gringo' Honasan (instigator of several coup attempts), was elected to the Senate in 1995, effectively signalling the integration of military rebels into mainstream politics.

In September 1996, the Government and the largest Muslim separatist organisation, the Moro National Liberation Front, MNLF, signed a comprehensive peace settlement to end the long running Muslim separatist rebellion in Mindanao. A new administrative council, the Southern Philippines Council for Peace and Development, chaired by MNLF Chairman Nur Misuari was central to the peace settlement. The victory of a joint ticket between the MNLF and Lakas party, in elections in October 1996 for the Autonomous Region of Muslim Mindanao brought the MNLF further into the political mainstream. Relations, however, between Chairman Misuari, the MNLF, and the administration have deteriorated over funding for the Southern Philippines Council for Peace and Development.

Preliminary talks between the Government and the more radical Moro Islamic Liberation Front began in September 1996, but stopped following a heavy government offensive against front strongholds in central Mindanao in mid 1997. 'Talks about talks' between the Government and the Moro Islamic Liberation Front are now underway.

Peace talks with communist groups have been less successful, but the communist insurgency has waned and is no longer a major government priority. Small scale, isolated clashes sometimes occur with government forces. However, over the past few months, the various communist splinter movements have started to regroup. This could be because the Government is focusing its military efforts on Mindanao, allowing the communist groups to operate more freely. Also with the military focusing on Mindanao, the Philippine National Police are now responsible for the campaign against communist insurgents.

Talks between the administration and the communist umbrella group, the National Democratic Front, continue in fits and starts in Holland, where the movement's senior leaders are in self-imposed exile.

1998 and Beyond

In the 1998 national elections, the list of would-be presidents is long, although probably only a few have any chance of winning on 11 May. Many believe the two main contenders are from the administration Lakas party and the main opposition LAMMP party, which is a coalition between three parties, Laban, the Nationalist People's Coalition and Vice President Estrada's Partido ng Masang Pilipino.

The Lakas presidential candidate is the Speaker of the House of Representatives, Jose de Venecia. In the late 1950s he served as adviser to the then House Speaker, Cornelio Villareal. From 1970 until the overthrow of the Marcos regime, De Venecia worked in private enterprise. In 1987 he was elected to Congress. De Venecia was elected to the influential position of Speaker of the House of Representatives in 1992 and re-elected in 1995. In 1992 along with President (then candidate) Ramos, De Venecia founded the Lakas party. He put together the 'rainbow coalition' between Lakas, Laban and several smaller parties, which was central to the Ramos administration's ability to pass its legislation. De Venecia also occupied a fairly central position in negotiations with rebel Muslim groups.

De Venecia is an old style politician, deriving power and influence from his ability to dispense political patronage. If elected, he plans to continue the policy directions of the Ramos administration.

His vice presidential running mate is the popular Senator, Gloria Macapagal-Arroyo, who abandoned her own presidential ambitions to join the Lakas ticket. The De Venecia-Macapagal-Arroyo team is presented as a partnership between traditional political skill and policy continuity (De Venecia) and popularity, charisma and economic credibility (Macapagal-Arroyo).

LAMMP, after much internal debate, selected Vice President Joseph 'Erap' Estrada as its presidential candidate. For almost three decades, Estrada captured hearts through the Filipino film industry. Ordinary people recognise a fellow traveller in Estrada, and he has deliberately blurred the distinction between his acting and political careers.

Estrada also has built a reputation as an effective and shrewd politician. Nonetheless, Estrada's film career still largely shapes his public image. He appears as a non-intellectual, someone who stands up for the 'little guy' against the corrupt authorities. Both the content and style of his campaign reflect this populist bent.

Estrada's running mate is Senator Edgardo Angara. Angara is a serious intellectual, with excellent policy skills. The LAMMP machine is presenting the Estrada-Angara partnership as a shrewd political marriage, bringing together Estrada's man-in-the-street popularity and Angara's high minded, policy credibility.

The other major candidates are the Mayor of Manila, Alfredo Lim; former Secretary of National Defence, Renato de Villa; and the former Governor of Cebu (and President Ramos' 1992 vice presidential running-mate), Lito Osmena. Each is running small, tightly focused campaigns.

Lim has fashioned his entire message to the electorate around a tough law and order message, drawing heavily on his own background as a policeman with a reputation for a no-nonsense approach to managing crime. He is the candidate of the once dominant Liberal Party and officially endorsed by former President Aquino.

De Villa, who has a reputation for honesty and personal probity, has gone to the electorate offering 'a genuine alternative' to the existing major parties and candidates. The focus of his campaign is very much anti-traditional politics. He has sought to portray himself as a non-politician (he was a career soldier) who if elected would sweep away the entrenched privilege and practices of the current system.

Osmena's strong showing in the Visayas (he comes from Cebu) and in Mindanao were responsible for his good position in early polls. His campaign has tapped into popular feelings outside Luzon about the priority Manila receives. His popularity in the south reflects very much the anti-Manila, pro-regional nature of his campaign, and recognition of his contribution to the recent economic success of Cebu.

The candidate who wins is unlikely to change radically the direction of government policy because all major candidates plan to maintain the general thrust of current economic policy. Most observers consider the current administration's economic reforms irreversible. To undo them would require legislative action and this is not likely. Still, a lot more needs to be done. As discussed previously, serious structural weaknesses remain, including a low savings rate, high unskilled labour costs due to minimum wage fixing, poor infrastructure, a stalled and flawed land reform program

and inappropriate food self-sufficiency policies. The question is whether the next president will enthusiastically tackle these issues and rapidly progress the Ramos reform program.

PHILIPPINE-AUSTRALIA BILATERAL RELATIONS

The Philippines, as a democratic, Christian country with a long exposure to western culture and a relatively well-educated, English-speaking population, has much in common with Australia. They also share common positions on key regional, economic and security issues.

In recent years, both partners have given the bilateral relationship higher priority. Australia provides the second largest grant aid program to the Philippines and leads in Defence Cooperation assistance. Foreign Minister Downer made his first official bilateral visit to the Philippines in October 1997, where he opened the first Philippine-Australia Dialogue which brought together politicians, business people, academics and journalists from both countries to consider the bilateral relationship and develop strategies to expand it.¹⁰ The relationship also has advanced recently with bilateral regional security talks in November 1997 and senior officials' talks on the bilateral relationship and trade. The strengthening bilateral relationship is underpinned by a growing Filipino community in Australia of over 140 000 in 1997.

Australia and the Philippines share a common outlook on issues like Burma, Cambodia, Cairns Group and APEC and a desire to maintain a stable political and strategic environment in the Asia Pacific.

The 'All the Best - From Australia' promotion in Manila in November 1998 should boost the relationship further. This promotion will showcase Australian business, science, technology, culture and sport, including sectoral business missions from agribusiness and defence, a business forum, a best practice mining techniques workshop, a food and wine festival and a varied cultural and sporting program.

Development Cooperation Program

Australia's development assistance program to the Philippines also enhances the bilateral relationship. The Philippines is the fourth largest recipient of Australian aid after Papua New Guinea, Indonesia and Vietnam. Australia is the second largest grant aid donor to the Philippines after Japan. Overall, Australian aid makes up 4 per cent of total official aid to the Philippines.

Australian assistance to the Philippines is expected to total \$57.0 million in 1997-98. Some 90 per cent (\$51.2 million) is provided bilaterally under the Development Cooperation Program; the balance is provided under programs delivered through non-government aid agencies and regional programs.

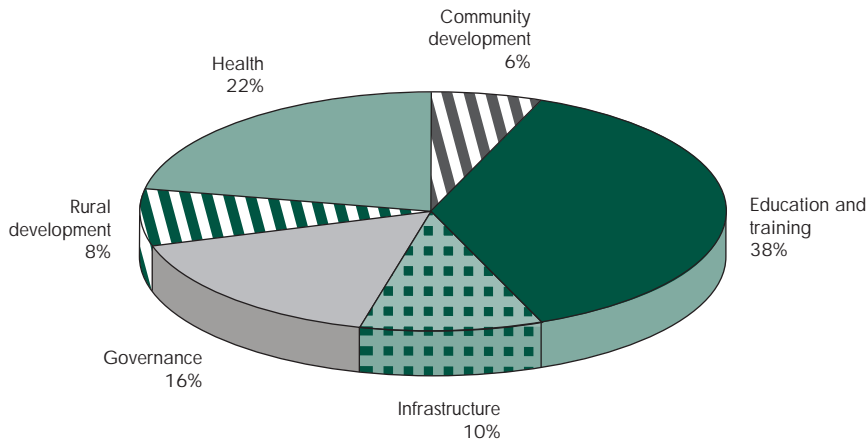
Training, education, health, governance, infrastructure, and regional and community development are the main priorities of the assistance program (Figure 1.4).

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¹⁰ Also signed by Mr Downer in Manila in October 1997 was the Memorandum of Understanding for Joint Action to Combat Child Sexual Abuse and Other Serious Crime, between Australia and the Philippines. It proposes cooperation between the relevant authorities in exchanging intelligence and information, and consulting and cooperating in international forums on child sexual abuse and other serious crime.

Figure 1.4

Education and Training Dominate Aid Flows

Australian Development Cooperation Flows to the Philippines by Sector 1997-98



Source: AusAID, 1998.

Australia's assistance increasingly focuses on Mindanao in the southern Philippines. Insurgencies now being resolved have left Mindanao a long neglected region, with about 20 per cent of the Philippine population but about 30 per cent of the country's poor. This aid focus is in line with the Australian Government's decision to concentrate Australian development cooperation on the poorest regions of aid partners such as the Philippines.

As peace is a pre-requisite to developing Mindanao, Australia is assisting the peace process initiated between the Philippine Government and the Moro National Liberation Front. Australia's assistance includes \$2.0 million to help some 45 000 people through an emergency program for former combatants and their families.

CONCLUSION

The Philippines has not participated in East Asia's growth over the past three to four decades because it failed in several key policy areas, particularly export orientation and macroeconomic stability. In addition, the Philippines neglected infrastructure and agriculture. However, its economic devastation in the mid 1980s and realisation that it lagged far behind East Asian neighbours convinced the Government and business elite that major reforms were urgently needed.

Since the late 1980s, the Philippines has made great strides in shedding its unenviable reputation as the sick man of East Asia. Like the rest of the region, it has embraced policies of export led growth, private sector development and a supportive rather than intrusive role for the state. Macroeconomic fundamentals have improved significantly in terms of debt service and debt structure, tax effort and a more robust financial system. The Philippine economy's relatively favourable performance to

date in the regional currency crisis suggests that structural reforms over the past decade, particularly financial market control, have reduced the country's vulnerability to external shocks. The peso's depreciation of 1997-98 should provide a reprieve for beleaguered labour intensive manufacturing and agriculture.

Nevertheless, the country's savings rate is still very low; the agriculture sector urgently requires investment and policy priority; the industrial sector has failed to generate rapid employment growth; wages, while now lower in foreign currency, are high in relation to unskilled labour productivity; education standards are falling; and the poverty situation remains serious. As debate on the comprehensive tax reform program in late 1997 indicated, the tug-of-war between '... populism and the hard reality of governance'¹¹ is likely to continue, and pose a continuing challenge to President Ramos' successor.

The increasingly open and competitive international and domestic economic environments will provide both opportunities and challenges for the Philippine Government. However, all major sections of the policy or decision making elite are now committed to economic reform, assisting the Philippines to address these policy challenges. If it does so successfully, the country should be able to sustain high economic growth well into the next century, achieving its full potential.

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¹¹ Attributed to Senator Juan Ponce Enrile, head of the Senate Ways and Means Committee, Republic of the Philippines, on his thoughts on the Comprehensive Tax Reform Program, signed into law on 11 December 1997.

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Chapter 2

MACROECONOMIC PERFORMANCE, POLICIES AND CHALLENGES

The Philippines' current economic recovery, which began in earnest in 1994 is now well into its fifth year. However, financial market turbulence in the Philippines and elsewhere in Asia has clouded the outlook. Against this background, this chapter analyses Philippine macroeconomic performance, the causes and effects of peso depreciation, the health of the financial sector, the balance of payments, fiscal policy and savings performance.

The peso's depreciation presents both challenges and opportunities. A major challenge is to control wage and price inflation to maintain the peso's real depreciation. It also is critical that individual borrowers' problems in servicing US dollar debts do not threaten the financial sector as a whole. Opportunities from depreciation include the prospect of increased foreign direct investment inflows and the potential boost to Philippine competitiveness.

To improve growth performance, the Government also needs to increase public spending on infrastructure, education and health while maintaining the fiscal discipline necessary to raise national savings. This will require significantly increased tax effort and reduced expenditure on administrative personnel.

RECENT MACROECONOMIC PERFORMANCE

After weak or negative growth between 1991 and 1993, solid gross domestic product, GDP growth really began in 1994 (Figure 2.1). In the first half of 1997, before the regional economic crisis, growth already had begun to slow largely because the peso's real appreciation in 1995 and 1996 undermined manufacturing competitiveness.¹ This slowdown continued into the second half of 1997 when the currency crisis increased the indebtedness of many companies that borrowed in US dollars and raised interest rates.

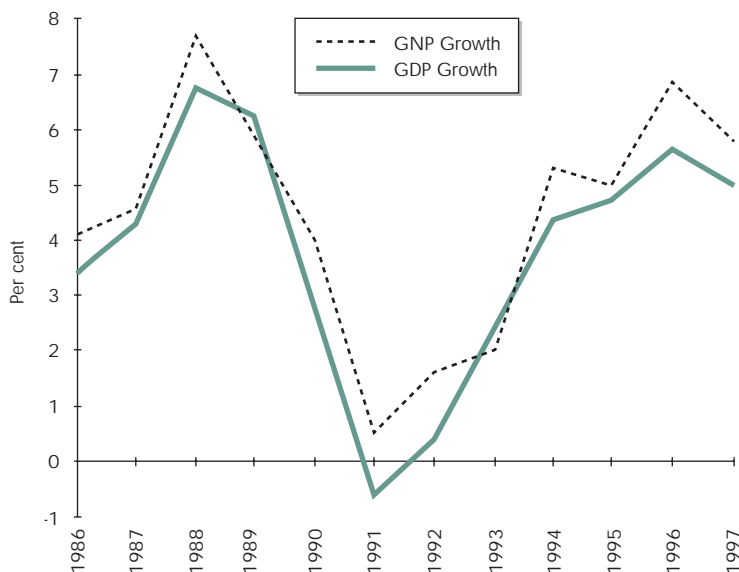
Philippine gross national product, GNP is usually above GDP because significant remittances from overseas Filipinos workers are included in GNP. Since 1994, the gap has widened because of increased remittances due to growing confidence in Philippine economic and political stability (Figure 2.1).

¹ In the first half of 1997, annual real GDP growth was 5.3 per cent compared to 5.8 per cent in the second half of 1996 (IMF, 1998).

Figure 2.1

Surging Remittances Boost GNP Growth

GNP and GDP Growth



Source: Bangko Sentral ng Pilipinas, 1998a.

On the expenditure side, the fastest growing components of GDP in the current expansion are exports, imports and fixed capital investment (Figure 2.2). Export growth is concentrated in semiconductors, electronic microcircuits and electrical machinery. (See Chapter 3 - Trade.) However, due to rapidly growing imports net exports do not contribute to growth.²

Because private consumption represents around 73 per cent of GDP, private consumption growth also has driven GDP growth in the 1990s.

Inflation

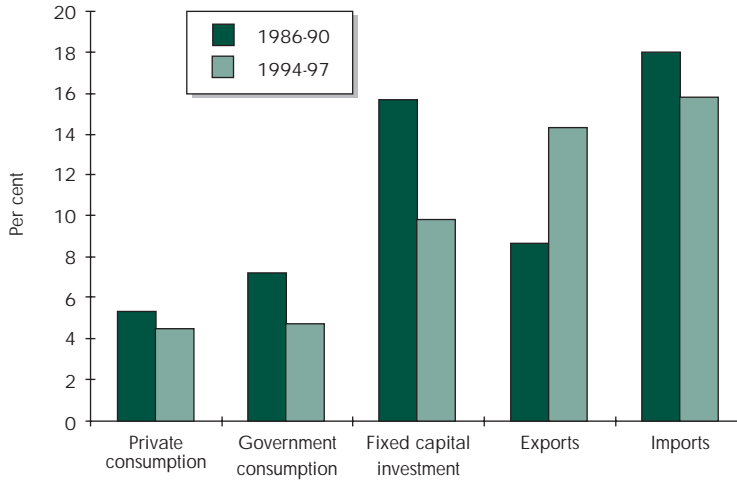
Until the peso's recent depreciation, inflation had been falling since 1991 (Figure 2.3) due a dramatic improvement in the consolidated public sector deficit from 4.8 per cent of GNP in 1990 to a surplus of 0.3 per cent of GNP in 1996 (Table 2.1). Increased competition flowing from domestic deregulation and trade liberalisation has also reduced inflation. The steep rise in both consumer and wholesale price inflation in late 1995 largely resulted from sharp food price rises caused by severe drought and a short period of higher money supply growth.³

² Net exports contributed 0.5 percentage points to growth in 1994, -2.9 percentage points in 1995, -2.5 percentage points in 1996 and -1.0 percentage points in 1997.

³ As food accounts for 59 per cent of the overall CPI basket, it strongly influences overall inflation.

Figure 2.2

Exports Surge in the Mid 1990s
Average Growth by Type of Expenditure



Source: National Statistical Coordination Board, 1997; Bangko Sentral ng Pilipinas, 1998a.

Figure 2.3

Inflation Performance Improving
Consumer and Wholesale Price Inflation
(Per cent Change through the Year)



Source: International Monetary Fund, 1998.

Table 2.1
Most Indicators Improve after 1993
Selected Economic Indicators, Selected Years

	1991	1993	1994	1995	1996	1997
Population and income						
Population (million)	63.7	67.0	68.6	70.3	71.9	73.1
GNP (US\$ billion)	38.7	40.1	42.2	44.3	47.4	50.2
GNP per capita (US\$)	608.0	599.0	616.0	631.0	660.0	682.0
Rates of growth (real per cent change)						
GNP	0.5	2.1	5.3	5.0	6.9	5.8
GDP	-0.6	2.1	4.4	4.8	5.7	5.1
Private consumption spending	2.3	3.0	3.7	3.8	4.6	5.0
Government consumption spending	2.1	6.2	6.1	5.4	5.2	3.6
Fixed capital investment	-14.2	8.7	7.5	4.7	12.0	12.2
Exports of goods and services	6.2	6.2	19.8	12.0	20.3	8.9
Imports of goods and services	-1.1	11.5	14.5	16.0	21.1	8.7
Unemployment						
Per cent of workforce	10.5	9.3	9.5	9.5	8.6	8.7
Government budget (per cent of GNP)						
Revenue (total)	17.6	17.4	19.4	18.4	18.0	18.3
Expenditure (total)	19.7	18.8	18.4	17.8	17.7	18.3
Current expenditure	15.7	15.1	15.4	14.2	13.9	n.a.
Capital expenditure	3.2	3.0	2.5	3.3	3.0	n.a.
Budget surplus/deficit (-)	-2.1	-1.5	0.9	0.6	0.3	0.1
Consolidated public sector deficit (-)	-2.0	-1.7	-0.4	-0.1	0.3	-0.9
Prices and inflation (per cent)						
Consumer price index	18.7	7.6	9.0	8.1	8.4	5.1
Wholesale price index	13.4	-1.1	8.2	3.3	9.1	1.1 ^a
Financial indicators						
Money supply M3 ^f (per cent change)	15.5	24.6	26.4	25.3	15.6	24.2 ^d
Bank lending rate (per cent)	23.5	14.6	15.0	14.6	14.8	16.2
Exchange rate (pesos:US\$)	27.5	27.1	26.4	25.7	26.2	29.5
Foreign trade (US\$ billion)						
Merchandise exports	8.8	11.4	13.5	17.5	20.5	25.2
Merchandise imports	12.1	17.6	21.3	26.4	31.9	35.9
Balance of trade	-3.2	-6.2	-7.9	-8.9	-11.3	-10.7
Net services balance	1.5	2.5	4.0	4.8	6.8	4.7 ^e
Net transfers balance	0.8	0.7	0.9	0.9	0.6	0.4 ^e
Current account balance	-0.9	-3.0	-3.0	-3.3	-3.6	-3.2 ^e
Per cent of GNP	-1.9	-5.5	-4.5	-4.3	-4.5	-4.7 ^e
Foreign direct investment						
US\$ billion	0.5	0.9	1.3	1.4	1.3	1.0 ^e
Foreign debt and debt servicing						
Foreign debt (US\$ billion)	30.0	34.3	37.1	37.8	41.9	46.2
As per cent of GNP	65.7	62.0	56.4	49.6	48.1	53.1
Debt service cost ^b (US\$ billion)	2.8	3.2	4.2	5.0	5.0	3.7
Debt service ratio ^c (per cent)	19.5	17.1	17.4	15.8	12.5	10.4

Note: a First semester 1997. b Debt service cost is the value of total interest and principal repayments on foreign debt. c Debt service ratio is the ratio of interest and principal repayments on foreign debt to total exports. d July 1997 on July 1996. e January to September 1997. f Money supply measure is M3, consisting of cash in circulation and demand and time deposits.

Source: Bangko Sentral ng Pilipinas, 1998a; International Monetary Fund, 1998.

A major policy challenge in 1998 is constraining the inflationary impact of the peso's depreciation to retain the increased competitiveness it achieved. However, the authorities may need to relax macroeconomic settings if the economy slows significantly due to the failure of companies and financial institutions with exposure to unhedged foreign borrowing.

Money supply growth was reduced in 1996 (Table 2.1) and buoyant agricultural production restrained inflationary pressures in early 1997. High interest rates and subdued economic activity since mid 1997 contained inflation in the second half of 1997. However, given the lagged flow-through from depreciation into prices and wages the main inflationary impact of peso depreciation will occur in the first half of 1998.⁴

The metro Manila Wage Board's 6.5 per cent minimum wage rise decision on 6 February 1998 will increase inflation. Petrol price increases flowing from depreciation induced rises in the cost of imported oil also will push up inflation and exacerbate wage pressures. Petrol prices rose 10 per cent in mid January, but with oil companies claiming imported oil costs have risen 20 per cent, further increases are likely (*Far Eastern Economic Review*, 29 January 1998, pp. 50-51). The El Niño's impact on food production and prices, and increased public spending before the presidential election also may fuel inflation. The consensus private sector forecast for inflation is for 11.2 per cent in 1998 and 7.8 per cent in 1999, while the latest official 1998 forecast is from 7 to 8 per cent (Consensus Economics, 1998).⁵

Three factors moderating inflationary pressures flowing from peso depreciation are the more competitive nature of the increasingly deregulated Philippine economy, high interest rates and slowing demand resulting from the crisis. These factors are forcing companies to cut margins to absorb some of the effects of depreciation.

Employment

Competitiveness pressures on labour intensive industries due to high wages and the overvalued peso slowed employment growth in the 1990s. Between 1985 and 1990, the average real output of textiles and clothing grew at 10 per cent per year, but between 1991 and 1997, annual clothing output grew by less than 1 per cent, while annual textiles output fell by over 4 per cent (National Statistical Coordination Board, 1996; Bank Sentral ng Pilipinas, 1998a).

Nevertheless, due to economic reforms, unemployment fell from 8.4 per cent in 1990 to 7.7 per cent in the first quarter of 1997, before the currency crisis took effect. For 1997 as a whole, the rate rose to 8.7 per cent (Bangko Sentral ng Pilipinas, 1998a) and in 1998, unemployment is likely to rise further as companies hit by the second round of peso depreciation and rising interest rates reduce employment to cut costs.

Productivity performance, which is vital if the Philippines is to sustain increased rates of growth has also improved due to economic reforms (Tables 1.9 and 1.10). From 1986-89 and 1993-96 total factor productivity growth was 2.1 per cent per

⁴ Money supply growth also picked up in 1997 (Table 2.1).

⁵ Consensus Economics forecasts are an average of reputable private sector economic forecasts.

year, well above productivity growth rates recorded in earlier periods and approaching levels in other ASEAN economies (Austria, 1997; Sarel, 1997).⁶ (See Chapter 1 - *Development Policies*.)

Regional wage boards base wage increases mainly on inflation and the peso's value, causing a poor link between wages and productivity increases. They find it difficult to make relevant awards based on productivity growth, as this varies by firm and industry and is hard to measure. The continued spread of collective bargaining and performance based bonuses should help strengthen wage and productivity links.

PESO DEPRECIATION

The peso's 1997-98 depreciation will influence significantly Philippine prospects for short and medium term growth.

Background

As discussed in Chapter 1, peso overvaluation for most of the postwar period caused serious structural problems for the balance of payments and economy overall. These pressures intensified between April 1995 and March 1997 when the peso appreciated by 27 per cent in real trade weighted terms, more than in other ASEANs (Figure 2.4). This real appreciation was driven by yen depreciation in late 1995 and early 1996; increased capital inflows resulting from net foreign borrowing by Philippine companies and commercial banks in response to increasingly attractive interest rate differentials; and a stable US dollar to peso exchange rate throughout the 1990s. This appreciation was sharply corrected and overshot from mid 1997 to early 1998 when the peso depreciated rapidly on a trade weighted basis and against the US dollar (Figure 2.5).

Causes of the Depreciation

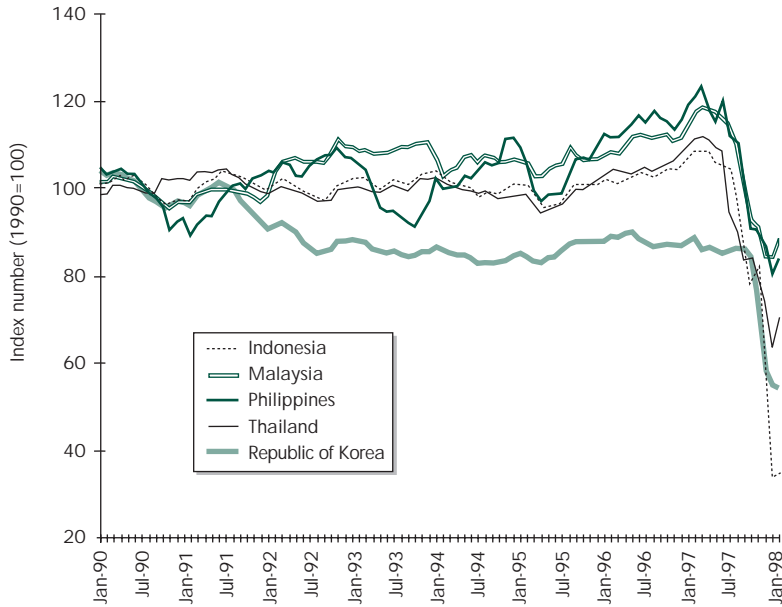
The main cause of this depreciation was the peso's real trade weighted appreciation between April 1995 and March 1997. This severely eroded Philippine international competitiveness, leading to the rising trade and current account deficits discussed later in this chapter. The contagion effect from depreciation of the baht, ringgit, rupiah and won also adversely affected market sentiment.

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⁶ Between 1991 and 1996, Philippine total factor productivity growth of around 1 per cent compared to total factor productivity growth in other ASEANs (excluding Indonesia) of around 2.5 per cent. This contrasted to 1978-91 when negative Philippine total factor productivity performance was much worse than other ASEANs (Sarel, 1997). Strong correlation between wage increases and productivity increase is characteristic of all successful East Asian economies. (See Chapter 1 - *Development Policies*.)

Figure 2.4

Most Regional Currencies Depreciate Well below Long Term Averages

Real Trade Weighted Exchange Rates for Selected ASEANs (1990 - Feb 1998)
(Index of Units of Local Currency per US Dollar,
Corrected for Inflation 1990 = 100)



Source: JP Morgan, 1998.

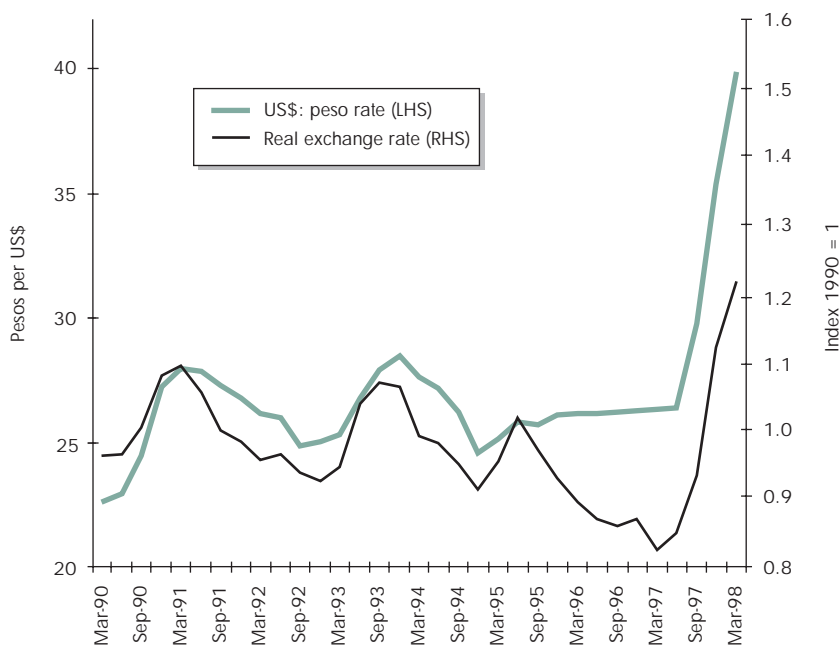
A further related set of factors weakening confidence about the peso's future value was significant private borrowing, including unhedged US dollar denominated borrowing, that had grown rapidly in the past three years, and concerns about the impact on banks and real estate developers of potential property price corrections. The Supreme Court decision overturning the bidding outcome for the Manila Hotel, uncertainty surrounding possible constitutional changes, the presidential election outcome and stalled mining and oil sector reforms also dampened investor sentiment.

Negative investor sentiment caused net portfolio flows to turn negative in 1996 for the first time since 1990, with gross resident and non-resident portfolio outflows increasing by 53 per cent and 82 per cent respectively in the first nine months of 1997 (Bangko Sentral ng Pilipinas, 1998a).⁷ The stock market also started to fall in February well before the peso depreciation began in June.

⁷ In net terms, portfolio flows went from a net inflow of US\$71 million in the first nine months of 1996 to a net outflow of US\$3.3 billion in the first nine months of 1997.

Figure 2.5

Sharp Real Depreciation since mid 1997 Peso:US\$ Rate and Philippine Real Exchange Rate



Note: Real exchange rate data for March quarter 1998 are the average of January and February data. Peso:US\$ exchange rate data are based on period averages.

Source: JP Morgan, 1998.

Against this background, Thailand's intensifying crisis in mid 1997 triggered market sentiment to shift further against the Philippines and other regional economies. After accumulating substantial reserves in past years to prevent nominal appreciation of the peso against the US dollar, the Bangko Sentral ng Pilipinas spent about US\$2.5 billion between April and 10 July trying to defend the peso, mainly after Thailand's shift to a managed float on 2 July (World Bank, 1997a, p. 7).

To defend the peso, the Bangko Sentral ng Pilipinas's key overnight borrowing rate was raised successively from 15 per cent on 1 July to 32 per cent by 10 July. On 11 July, when the Bangko Sentral ng Pilipinas allowed the peso to float within a wider band, the peso depreciated 11.5 per cent to P 29.45:US\$1 before trading halted. Continued pressure on the peso led to measures to tighten domestic liquidity, boost foreign exchange supply and discourage speculation. In particular:

- interest bearing (liquidity) reserve requirements were raised progressively to 8 per cent⁸

⁸ Liquidity reserve requirements were raised from 2 to 3 per cent on 31 July 1997, to 5 per cent on 15 August, then to 8 per cent on 29 August. They were then lowered in stages to 4 per cent on 15 November. In addition the statutory (non-interest bearing) reserve requirement of 13 per cent was maintained throughout this period.

- the authorities decreased banks' over the counter foreign exchange availability from US\$100 000 to US\$25 000
- previous limits on banks' foreign exchange assets and liabilities were changed in a bid to raise the supply of foreign exchange.⁹

The peso fell to new lows of below P 35:US\$1 in early October. On 7 October, the Bankers Association of the Philippines introduced a volatility band for the peso, consisting of a series of intermediate circuit breakers and limits on overall daily trading volatility of 4 per cent.

The next major episode of depreciation occurred in mid December with the peso slipping below P 40:US\$1. A number of factors were at work here, particularly:

- financial markets gradually realising that the peso:US dollar exchange rate was becoming increasingly misaligned with regional currencies, especially those of Thailand and Indonesia.¹⁰ For instance, by the end of November the peso had depreciated against the US dollar by 31 per cent from its end of June level, compared to the baht's depreciation of 56 per cent and the rupiah's depreciation of 49 per cent¹¹
- a vicious circle was developing whereby dollar holders, such as exporters and overseas contract workers, were not converting their dollars because of expectations of further peso depreciation
- the Bangko Sentral ng Pilipinas became increasingly reluctant to defend the peso with higher interest rates (see below).

By early April 1998, the peso was trading at P 37:US\$1. This is well above its low of P 45.20:US\$1 of January 1998 but still a 40 per cent depreciation against the US dollar since the start of 1997. On a real trade weighted basis, it had depreciated by 29 per cent by February 1998 from January 1997 levels (Table 2.2). The main factors driving the peso's appreciation in March included returning foreign portfolio capital and improving sentiment about the region in general and the Philippines in particular as President Ramos continued to push on with key reforms, deregulating the oil industry and tightening banking system prudential controls in the run up to the presidential election.

.....

⁹ The extent to which foreign exchange assets could exceed foreign exchange liabilities (the overbought position) was reduced from 10 per cent to the smaller of 5 per cent or US\$10 million - the overbought position had earlier been lowered from 20 to 10 per cent. The extent to which foreign exchange liabilities could exceed foreign exchange assets (the oversold position) was increased from 10 to 20 per cent of unimpaired capital. Monitoring of banks' forward foreign exchange position was also tightened and access to the Bangko Sentral ng Pilipinas' overnight lending window was closed between mid August and mid October. For two weeks between mid July and mid August, six major foreign banks were requested not to participate in the spot forex market and instead to use forward contracts of up to 90 days.

¹⁰ See for instance *Business World*, 15 December 1997, Internet edition.

¹¹ However, this misalignment was not apparent comparing real effective exchange rates; between June and November, the Philippines' real effective exchange rate depreciated by 25 per cent compared to 22 per cent for Indonesia, 26 per cent for Thailand and 21 per cent for Malaysia.

Table 2.2

Heavy Real Trade Weighted Depreciation of Worst Affected Economies

Real Trade Weighted Depreciation of Regional Currencies,
January 1997 - February 1998
(Negative Figures Represent Appreciation)

Indonesia 68	Malaysia 23	Philippines 29	Thailand 35	Republic of Korea 38	
Japan -7	Taiwan 3	Hong Kong -11	Singapore 4	Australia 3	China -11 ^a

Note: ^a EAAU estimate.

Source: JP Morgan, 1998.

Effects of the Peso's Depreciation

Based on historical patterns, the peso's real depreciation should improve substantially the Philippine trade balance (Figure 2.6). For every percentage point depreciation of the real exchange rate, the trade balance should improve by 2.4 per cent (Asian Development Bank, 1997a, p. 11).

The Philippines has not depreciated as heavily on a real trade weighted basis as Thailand, the Republic of Korea or Indonesia, largely due to its sounder financial system (Table 2.2). However, it will become more competitive against Chinese, Latin American and Caribbean exports, particularly in its key US markets.

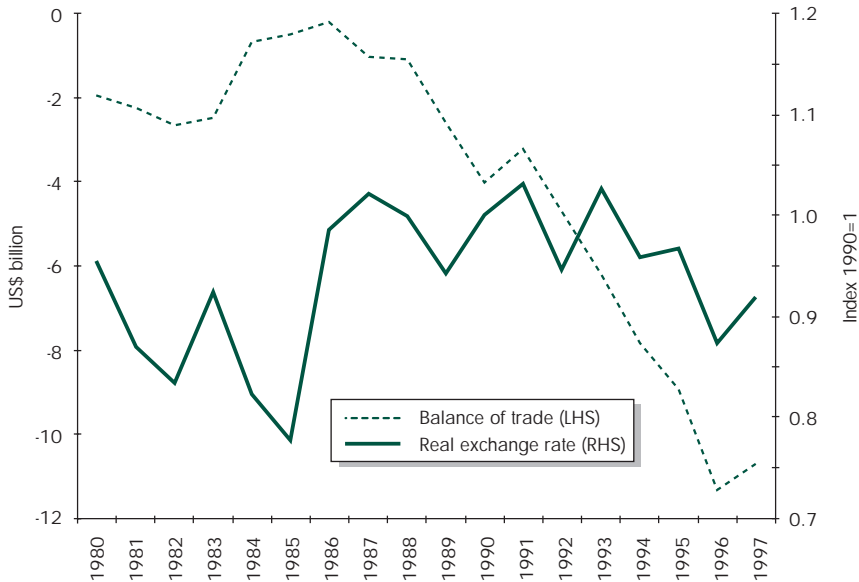
Exports with a lower import content, such as agricultural commodities, will benefit most. The immediate benefits flowing to exports with a lower domestic value added, such as electronics will be smaller. Over the medium to long term, increasing import prices due to depreciation will create incentives for increased domestic input sourcing by these exporters.

The latest official forecast anticipates significantly weaker short term GDP growth of 2.5 to 3.5 per cent in 1998. Private forecasters predict growth of 2.3 per cent in 1998 and 3.9 per cent in 1999 (Consensus Economics, 1998). In the short term, higher interest rates and reduced investment by corporations with unhedged foreign currency loans will weaken growth. Weaker economic activity in North and South East Asia, a result of the more general regional financial market problems, also will reduce growth. However, the USA and EU collectively take over half of Philippine exports, and these markets are likely to expand post depreciation cushioning the impact of reduced growth prospects elsewhere in Asia. Reduced wealth, a result of the stock market falls, also will reduce consumption and investment, weakening growth, although the recent stock market recovery should help mitigate this effect.

Figure 2.6

Close Long Term Relationship between Real Exchange Rate and Exports

Philippine Real Exchange Rate^a and Balance of Trade, 1980-97



Note: ^a The real exchange rate is inverted in this figure so an increase in the index represents a depreciation. This makes it easier to discern the relationship between the real exchange rate and the trade balance.

Source: International Monetary Fund, 1998; JP Morgan, 1998.

The depreciation also will increase the bad debts of Philippine banks from US dollar borrowers who have mainly peso revenues and firms affected by high interest rates. (See the section on the Philippine financial sector later in this chapter.)

Public finances are also suffering from the peso's depreciation. Lower company tax, sales and personal tax revenue; reduced profits from government enterprises; and higher public foreign and domestic debt service costs far exceed tariff revenue increases from the higher peso prices of imports.

The greatest threat to growth flowing from the peso's depreciation is continuing high interest rates, introduced to combat pressure on the peso. From July to October 1997, increases in short term interest rates engineered by the Bangko Sentral ng Pilipinas flowed across the maturity spectrum (Figure 2.7). In November 1997, the Bangko Sentral ng Pilipinas moved to decrease interest rates by easing liquidity, cutting its overnight lending rate and reducing the required liquidity reserves of banks. On 10 December, the Bangko Sentral ng Pilipinas decreased its overnight borrowing rate from 12 per cent to 11 per cent, then refused to raise interest rates even as the peso fell to record lows. Interest rates decreased in response to these moves, with rates on the benchmark 91 day treasury bill falling from 19.1 per cent in January 1998 to 15.5 per cent by 6 April 1998. An informal agreement between the major Philippine

banks to hold lending rates within a band of 3 to 8 per cent above the 91 day treasury bill rate has largely held and is bringing down lending rates.

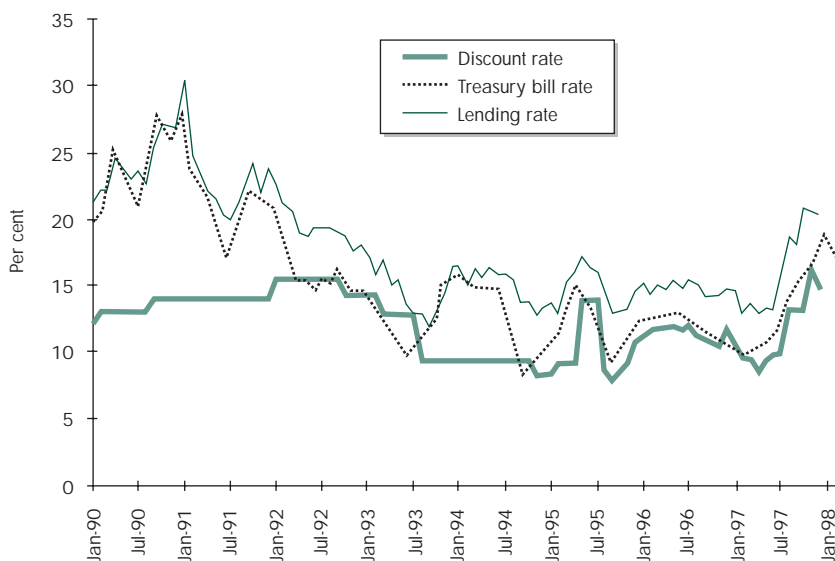
However, interest rates remain well above pre-crisis levels, putting extreme pressure on companies with high levels of domestic debt, reducing growth in new private investment and slowing domestic producers' ability to expand export and import substitute production in response to the depreciation.

THE FINANCIAL SECTOR

The health of the Philippine financial sector also is crucial to growth prospects.

Figure 2.7

Big Increase in Interest Rates from Mid 1997 Philippine Interest Rates



Note: The discount rate is the rate at which the Bangko Sentral ng Pilipinas lends or discounts eligible commercial paper for deposit taking banks. The lending rate is the average rate for meeting the short and medium term financing needs of the private sector. The treasury bill rate is the rate at which short term government paper is traded in the market. The treasury bill rate for February 1998 is for 23 February; the March 1998 treasury bill rate is from the treasury bill auction on 23 March.

Source: International Monetary Fund, 1998.

FINANCIAL SECTOR STRUCTURE AND REFORMS

Commercial banks dominate the Philippine banking sector. Regular commercial banks can take deposits and make loans while expanded commercial banks also can invest in and underwrite equities. The seventeen expanded commercial banks account for 80 per cent of commercial bank assets (IMF, 1996, p. 32).

Three other types of banks are thrift banks, rural banks and specialist government financial institutions. Thrift banks accept time and savings deposits and provide loans and other financial services to predominantly small and medium sized enterprises. Rural banks provide similar services to farmers and rural cooperatives.

From 1994 to early February 1997, the stock market dominated new nonbank financial activity, with 16 initial public offerings by newly listed companies in 1995, 13 in 1996 and six in early 1997. After the stock market's 40 per cent fall in mid to late 1997, most firms delayed initial public offerings (IMF, 1996, p. 34; Economist Intelligence Unit, 1997).

Major Reforms

One of the Ramos administration's achievements was reforms to the inefficient and protected financial sector including:

- beginning in 1993, lifting regulations restricting the opening of new bank branches¹²
- in May 1994, granting approval to ten new foreign banks to establish branches, in addition to the four existing foreign banks
- in March 1994, unifying the Makati and Manila Stock Exchanges, facilitating market trading
- since 1994, developing the securities market by authorities introducing 2 year fixed rate treasury notes and 3 year floating rate securities followed by 5 and 7 year issues. Market participants in the Philippine Central Depository Corporation established automated securities transaction settlements, allowing faster transaction clearance and improving bad debt data bases
- from October 1994, allowing well established foreign insurers or other intermediaries to enter the domestic market either by purchasing up to 100 per cent of existing or new insurance companies or establishing new companies or branches
- from June 1995, allowing expanded commercial banks to become majority stock holders of insurance companies
- from September 1995, allowing expanded commercial banks to invest in related privatised government assets (IMF, 1996, p. 33)

¹² These regulations included restrictions on location and required that bank capital be increased for each branch.

- from 1998, allowing finance companies to conduct trust, money market and quasi banking operations including direct lending, bond issuing and foreign currency lending, and allowing finance companies to be majority foreign owned.¹³

Allowing new foreign banks entry was a bold reform, as many Asian nations are reluctant to allow fully fledged foreign bank entry (*The Economist*, 12 April 1997, p. 37). Foreign banks increase competition, encouraging domestic banks to improve services and products, globalise their operations and increase their capitalisation. They are also important trainers of skilled financial sector personnel.¹⁴ However, the operations of new foreign bank entrants are still heavily constrained; they can only open six new branches, effectively limiting them to wholesale banking and can only borrow \$4 dollars of head office funds for every \$1 of domestically held capital (La Brooy, 1997).

Rapid Loan Growth

In recent years, two key causes of concern in the financial sector have been the pace of loan growth and the degree of exposure to foreign exchange liabilities. Commercial bank loan growth averaged over 30 per cent per year between 1993 and 1995, then accelerated further to 52 per cent in 1996, before declining to 27 per cent in 1997 (Bangko Sentral ng Pilipinas, 1998b).¹⁵ However, this growth was from a relatively low base prior to 1993.¹⁶ Rapidly growing foreign exchange bank deposits, from reverse capital flight and strong remittance flows from Philippine overseas workers after 1993 also fuelled strong credit expansion. Increases in bank equity capital averaging 30 per cent per year between 1993 and 1996, including from the newly licenced foreign banks, also stimulated bank lending growth (Ma, 1997). Statutory reserve requirements were reduced progressively from 25 per cent in 1992 to 13 per cent by July 1997 freeing extra funds for lending. Increasing competition in the Philippine banking sector and improving economic activity also stimulated lending growth.

However, this rapid growth in bank credit surpassed private investment growth (Figure 2.8) leading to potential problems maintaining lending quality, particularly with increasing real estate and share lending fueling asset price inflation. The strong growth in foreign exchange deposits, discussed further below, also caused concern that Philippine banks and their domestic borrowers were heavily exposed to foreign exchange risk.

¹³ Allowable foreign equity in financing companies increased from 40 to 60 per cent, but rights are restricted to companies from countries giving Philippine investors reciprocal rights.

¹⁴ For instance, three of the biggest domestic banks are run by ex Citibank staff (*The Economist*, 12 April 1997, p. 37 of supplement on banking in emerging markets).

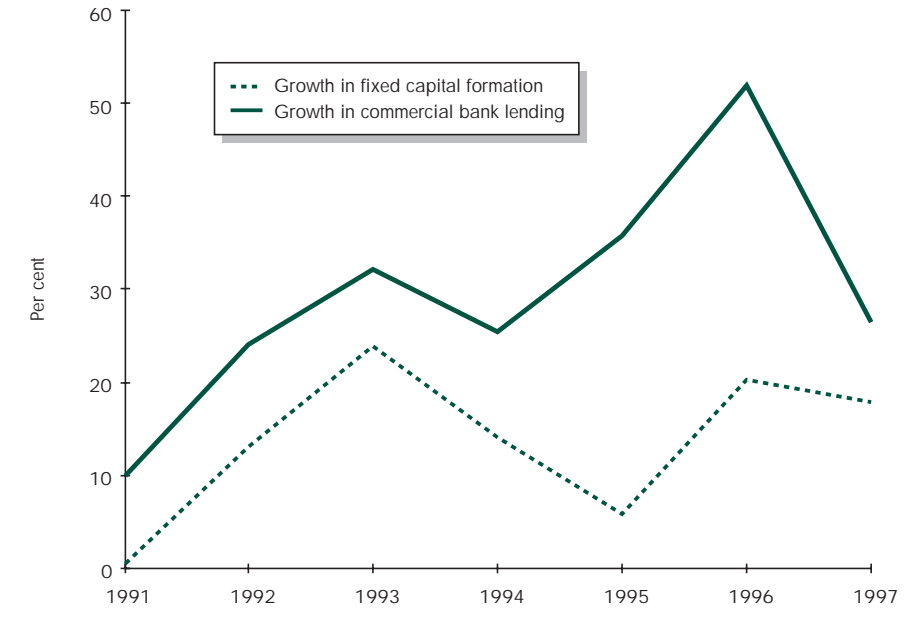
¹⁵ Credit growth accelerated in 1996 notwithstanding substantial sterilisation of capital inflows by the Bangko Sentral ng Pilipinas and rising interest rates.

¹⁶ The Philippine ratio of bank loans to GDP was only 63 per cent in 1996 compared to 114 per cent in Thailand and 128 per cent in Malaysia (Bangko Sentral ng Pilipinas, 1997a).

Figure 2.8

Rapid Bank Lending Outpaces Investment Growth

Growth in Bank Lending and Gross Domestic Fixed Capital Formation



Source: Bangko Sentral ng Pilipinas, 1998a; Bangko Sentral ng Pilipinas, 1998b.

Asset Quality and Lending to Real Estate

A 1996 Bangko Sentral ng Pilipinas survey indicated banks' exposure to real estate rose from 9 per cent in the first quarter of 1996 to 13 per cent by the end of 1996; the June 1997 fall to 11.5 per cent was due to tightened Bangko Sentral ng Pilipinas regulations. Increased bank lending to financial institutions, real estate and business services accelerated between 1991 and 1996, reaching an annual growth rate of 91 per cent in 1996 before decelerating in 1997 (Figure 2.9).¹⁷ The ratio of bank loans going to real estate compares favourably with finance companies in Thailand, but is higher than exposure of Malaysian financial institutions and Thai banks (Figure 2.10). High ratios for Hong Kong and Singapore reflect the absence of many sectors, like agriculture and mining. However, 90 per cent of all Philippine commercial banks have kept their individual real estate exposure ratios at or below the 20 per cent ceiling set by the Monetary Board (Bangko Sentral ng Pilipinas, 1997a).

¹⁷ Data on loans by sector do not specifically isolate real estate, with the sector being lumped in with bank lending to financial institutions and business services.

Figure 2.9

Rapid Real Estate Loan Growth Slows by 1997

Growth in Loans to Financial Institutions, Real Estate and Business Services



Source: Bangko Sentral ng Pilipinas, 1998b.

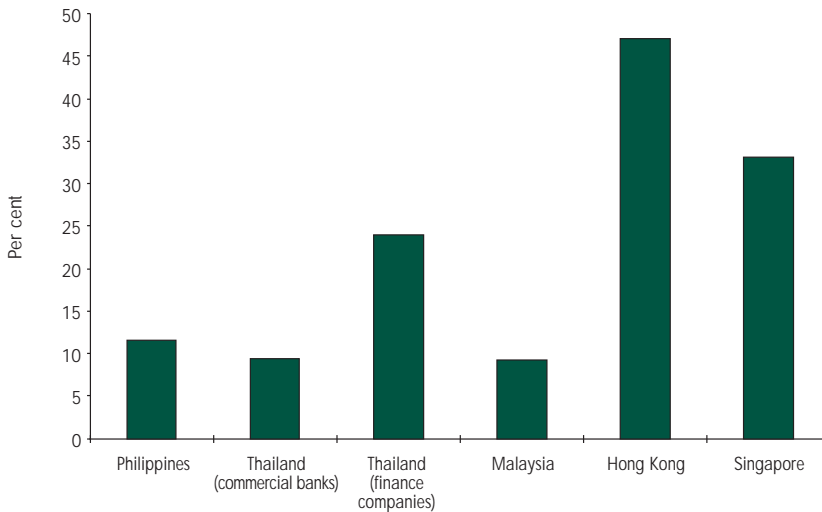
Overall, the ratio of nonperforming loans to total loans in the Philippines was 3.8 per cent in 1996, but had increased to 4.7 per cent by September 1997 (Bangko Sentral ng Pilipinas, 1998b) and could well climb higher in 1998. While concerning, these figures are still well below levels experienced in the 1980s and compare well with ratios of 15 per cent for the Republic of Korea, 8.4 per cent for Thailand, 8.8 per cent for Indonesia and 3.9 per cent for Malaysia (de Ocampo, 1997, p. 6; Bangko Sentral ng Pilipinas, 1997a, p. 27).¹⁸

¹⁸ Nonperforming loans are difficult to measure and different definitions will yield different results. However, estimates from the Bank for International Settlements and Jardine Fleming quoted in *The Economist* (15 November 1997, p. 19) still show bad loans in the Philippine banking system to be markedly below the equivalent ratios in Thailand, Indonesia, the Republic of Korea and Malaysia.

Figure 2.10

Philippine Banking Sector Has Relatively Low Exposure to Real Estate

Share of Loans Going to Real Estate by Country



Note: Data for the Philippines are for June 1997, for Thailand for 1995 and for Malaysia for 1996. Figures for Hong Kong and Singapore are as quoted in de Ocampo (1997).

Source: de Ocampo, 1997; Bangko Sentral ng Pilipinas, 1997a.

Factors Maintaining Asset Quality

The financial sector's relatively low exposure to real estate and bad loans can be partly explained by the absence of a long boom in real estate demand. Unlike other ASEAN economies, property demand was flat between the coup attempt in 1989 and the resolution of the electricity crisis in 1994. Consequently, an excess supply of real estate in the Philippines had not developed; the Manila (Makati) office vacancy rate of 2 per cent in early 1997 was far lower than equivalent figures for Bangkok and Jakarta (Figure 2.11). Over supply may develop in prestige condominiums but, underpinned in part by ongoing deregulation in many areas of the economy, demand for office space remains strong (*Far Eastern Economic Review*, 8 January 1998, p. 44). Even as new office space becomes available, supply is unlikely to be excessive. Moreover, demand should continue to exceed supply for medium and low income residential housing.

The relatively low share of real estate lending is also explained by:

- the prevalence of presold projects, increasing project viability and decreasing reliance on bank funds

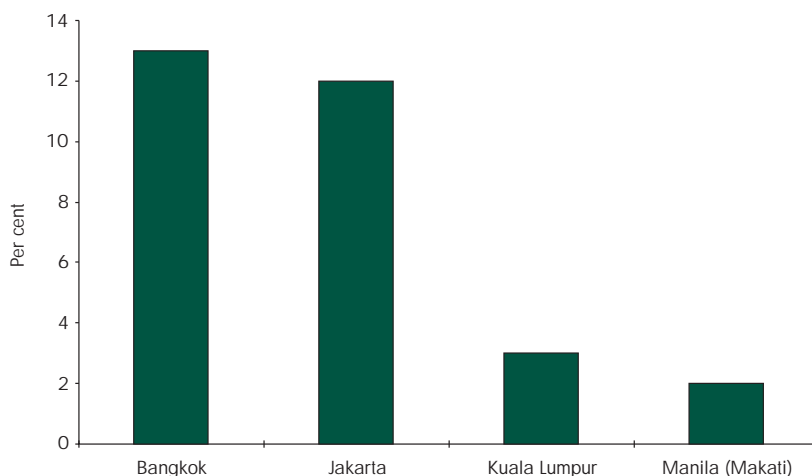
- many big Philippine construction companies having foreign partners who provide some funds
- many property companies obtaining finance via the stock market.

While the share of bank loans going to financial institutions, real estate and business services rose 8 percentage points to 25 per cent between 1990 and 1997, the loan share going to high priority infrastructure projects also rose by 6 percentage points (Figure 2.12). The main sectors losing bank loan shares were agriculture, fisheries and forestry, and manufacturing.¹⁹

Figure 2.11

Office Vacancy Rates Low in the Philippines

Office Vacancy Rates in ASEAN Capital Cities, March 1997



Source: de Ocampo, 1997.

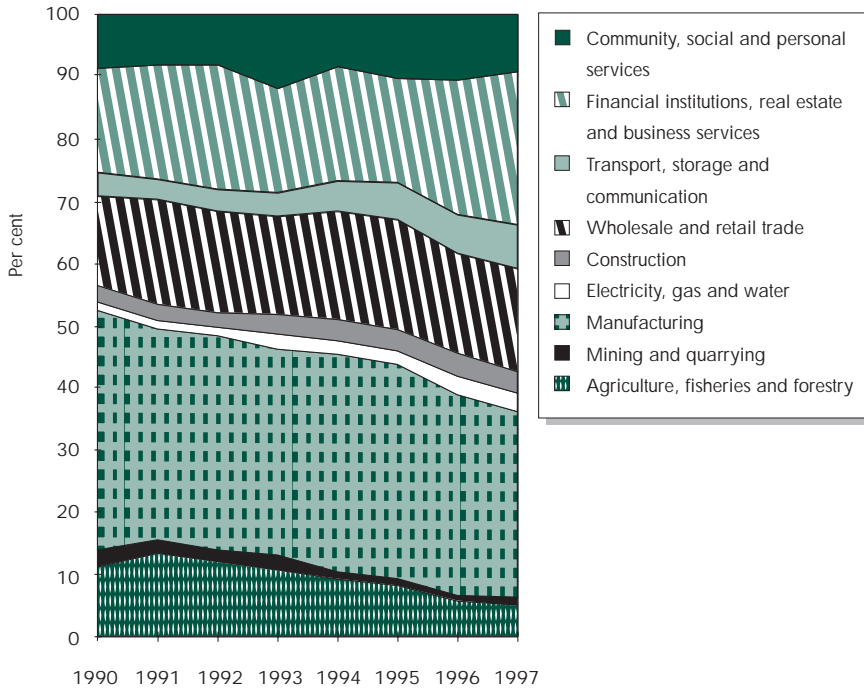
Philippine prudential standards in mid 1996 were strong compared to most in the region and required:

- provisions of 25 per cent for unsecured substandard loans, 50 per cent for doubtful loans and 100 per cent for nonperforming loans
- maximum bank exposure to a single borrower of 25 per cent of the bank's unimpaired capital and surplus, and outstanding loans to bank directors, officers or stockholders of 15 per cent of the total loan portfolio or 100 per cent of net worth, whichever is lower.

¹⁹ The share of loans going to agriculture, fisheries and forestries dropped from 11 per cent in 1990 to 5 per cent in 1997; manufacturing's share dropped from 38.5 per cent to 30 per cent (Bangko Sentral ng Pilipinas, 1998b).

Figure 2.12

Priority Sectors Expand their Borrowing Share
Distribution of Bank Loans by Sector, 1990-97



Source: Bangko Sentral ng Pilipinas, 1998b.

Prudential regulations have been further tightened since the currency crisis. In April 1997, the Bangko Sentral ng Pilipinas lowered the ceiling on the exposure of individual banks to real estate from 30 per cent to 20 per cent of their loan portfolio, giving banks one year to comply. It also directed commercial banks to reduce the value of real estate used as bank loan collateral from 70 to 60 per cent of appraised value.²⁰ At the beginning of October 1997, it redefined overdue loans as those in arrears for three months (down from six). Concurrently, banks were required to put up 2 per cent of the gross loan portfolio as a general allowance for probable losses, less loans considered nonrisk under existing regulations. This loan loss provision was originally to be phased in over three years but in March 1998, compliance was brought forward to October 1999. At the same time, the central bank significantly increased banks' minimum required capital, requiring large commercial banks to increase their capital from P 3.5 billion to P 5 billion by the end of 2000. This is likely to increase pressure on small banks to merge. Most recently, limits on loans to directors, officers and stockholders were further tightened.

²⁰ Loans to acquire or improve residential units of P 3.5 million or less and housing loans extended or guaranteed under the government's National Shelter Program are excluded from these provisions. This ensures that the medium to low end of the property market, where substantial pentup demand exists, is unaffected by attempts to curb speculation at the top end of the market.

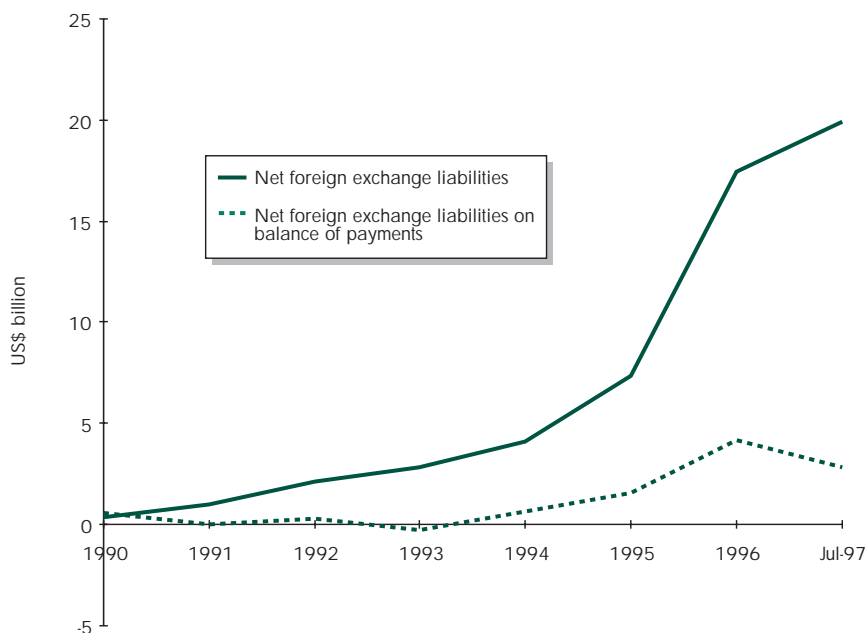
Bank Exposure to Foreign Currency Deposits and Borrowing

Given the extent of the peso's depreciation, bank exposure to foreign liabilities, deposits and borrowing is another major concern. Commercial bank net foreign exchange liabilities are actually much greater and have grown much faster than data on net foreign exchange liabilities shown in the balance of payments (Figure 2.13). The difference is largely due to rapidly growing commercial bank liabilities in the form of foreign currency deposit units, FCDUs, held at Philippine banks. By June 1997, deposit liabilities from foreign currency deposit units amounted to US\$16.9 billion, raising the net foreign exchange liabilities of the commercial banks to 52 per cent of their total liabilities, up from just 3 per cent of bank liabilities in 1990 (Figure 2.14) (World Bank, 1997a, p. 5).

Foreign currency deposit units allow Filipinos to deposit and borrow in foreign currencies (largely US dollars). They were first introduced in 1971 to encourage Filipinos to keep their money in the country. Over time, various incentives were introduced to make these accounts more attractive but their basic rationale was a lack of confidence in the Philippine economy and the peso in particular.

Figure 2.13

FCDU's Rapid Growth Spurs Big Rise in Foreign Currency Exposure Growth in Commercial Bank Foreign Exchange Liabilities

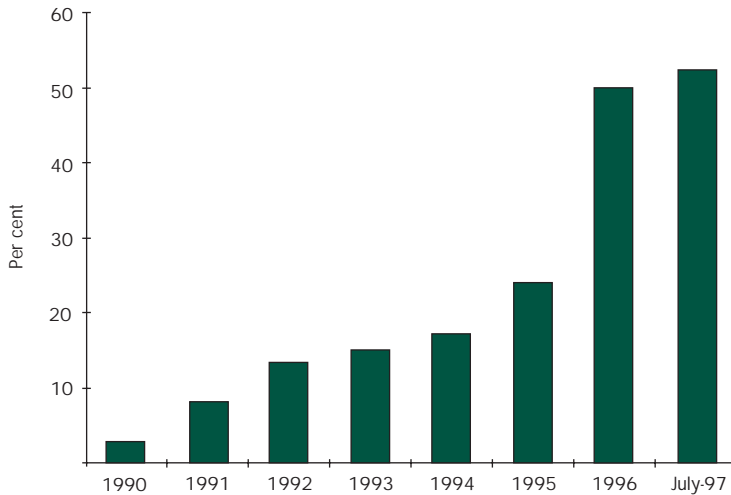


Source: Bangko Sentral ng Pilipinas, 1997b.

Figure 2.14

Foreign Exchange Liabilities Now Dominate Total Philippine Bank Liabilities

Share of Foreign Exchange Liabilities in Total Commercial Bank Liabilities



Source: Bangko Sentral ng Pilipinas, 1997b.

Strong prudential requirements limit the impact of the Philippine financial sectors' heavy exposure to foreign exchange liabilities. Since 1972 all foreign currency deposit liabilities must have 100 per cent foreign currency cover. By June 1997, the Bangko Sentral ng Pilipinas noted that banks were diluting their foreign currency asset cover by borrowing foreign exchange using foreign currency deposits as security, then lending pesos to local firms. To address this issue and moderate the growth in foreign exchange loans, the Bangko Sentral ng Pilipinas required all banks to maintain at least 30 per cent of all foreign currency deposit unit liabilities in liquid foreign exchange assets from December 1997 (Bangko Sentral ng Pilipinas, 1998c).²¹

Also the amount by which foreign exchange liabilities, which include both bank borrowings and deposits, could exceed foreign exchange assets (the oversold position) was limited to 10 per cent of unimpaired capital. In July 1997, the authorities increased this to 20 per cent in an effort to encourage banks to sell more of their dollar holdings for pesos thus boosting the peso's value.²²

²¹ This 30 per cent requirement was reduced to 15 per cent for an interim period (Bangko Sentral ng Pilipinas, 1997).

²² There were similar limits on the extent to which foreign exchange assets could exceed foreign exchange liabilities (the overbought position). Until July 1997 this limit was 20 per cent. It then was reduced to 10 per cent, then to 5 per cent of unimpaired capital or US\$10 million whichever was lower.

Because most of the Philippine banking sector's high foreign liability exposure is to domestic residents, the Bangko Sentral ng Pilipinas believes banks are not vulnerable to capital flight (Bangko Sentral ng Pilipinas, 1997a). As of September 1997, residents held 63 per cent of Philippine banks' foreign liabilities and 80 per cent of their foreign currency deposit unit liabilities (Bangko Sentral ng Pilipinas, 1997c). This contrasts with the situation in Thailand where residents held only 1 per cent of the financial sector's foreign exchange liabilities in the first quarter of 1996 (Bangko Sentral ng Pilipinas, 1997a). However, in the first 9 months of 1997, Philippine residents accounted for almost 60 per cent of gross portfolio outflows, indicating that residents will send their money offshore if circumstances warrant it. It is important to note, however, that the negative impact of peso depreciation on aggregate wealth and demand is reduced by the fact that foreign currency liabilities are mostly owned by Filipinos; over 60 per cent of the foreign exchange losses suffered by residents holding US dollar loans have been offset by foreign exchange gains by Filipino depositors in foreign currency deposit units, causing a redistribution of national wealth, rather than a total loss, as in Thailand and Indonesia.

Nevertheless, the foreign exchange exposure of domestic holders of US dollar loans still is potentially serious for the companies concerned. By the March quarter of 1997, exporters held 60 per cent of foreign currency deposit unit loans, so providing these borrowers are sufficiently export oriented to repay loans from export receipts, they will be naturally hedged. However, oil companies and public utilities accounted for a further 16 per cent of foreign currency deposit unit loans. Court restrictions imposed on oil price rises will decrease oil company profits and make debt servicing onerous. Public utilities also have no natural foreign exchange hedge and limited capacity to raise tariffs. The remaining 24 per cent of foreign currency deposit unit loans were to firms who had foreign currency deposits they could borrow against. However, their foreign currency loans presumably exceeded their foreign currency deposits or they would have no need to borrow.²³

Mid-sized companies cause particular concern. A Caspian Securities study of the financial health of the 7 000 largest Philippine companies shows that while the largest have maintained fairly constant gearing ratios (loans as a proportion of capital), medium sized firms' gearing ratios have increased dramatically. Among nonmanufacturers, who are less likely to be hedged on foreign exchange loans, the gearing ratio rose from 124 per cent at the end of 1994 to 224 per cent by the end of 1996 (*Far Eastern Economic Review*, 29 January 1998, pp. 50-51). Overall, more individual borrowers with unhedged foreign currency liabilities will probably encounter difficulties in 1998, as will smaller banks that have lent to these companies, or banks heavily exposed to these companies because of poor risk management.

The challenge will be to ensure these problems do not spill over into the financial sector as a whole. To do this, the Bangko Sentral ng Pilipinas needs to continue to improve its means of detecting and addressing corporate and banking weakness at an

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²³ The Bangko Sentral ng Pilipina assesses the impact of the increased dollar exposure of domestic borrowers more optimistically. It does not explore the possibility that firms with foreign currency deposits would have borrowed well in excess of their deposits. (See Bangko Sentral ng Pilipinas, 1997a, pp. 23-24.)

early stage (Asian Development Bank, 1997a, p. 15). Also tougher bankruptcy laws are needed. At present, creditors of bankrupt companies must wait 12 months before they can begin the process of claiming assets. In addition the cumbersome legal system makes extensive litigation likely. (See Chapter 5 - *Business Environment*.) Together these factors increase the risk that a few large failed companies could bring down others and thus create system-wide financial sector problems. The need to strictly enforce tightened restrictions on loans granted to bank directors, officers and stockholders was highlighted by the Orient Bank collapse in February 1998.²⁴

Medium Term Challenges and Opportunities

Over the medium term, tighter prudential control and continuing reforms stimulated by the currency crisis should yield significant national benefits.

Benefits from the Peso's Float

Greater exchange rate flexibility should increase the effectiveness of monetary policy by allowing domestic demand and employment levels to be the main targets when influencing interest rates. Banks and corporations also will have a greater incentive to adequately hedge their exposed foreign exchange positions against exchange rate fluctuations and should be unwilling to borrow unhedged foreign currency merely on the basis of domestic and foreign interest rate differentials. This in turn should increase the share of longer term investment in future foreign capital inflows, with foreign exchange generating objectives hopefully replacing speculative aims.

Finally and importantly, resistance to further trade liberalisation should be reduced by the increased competitiveness due to the depreciated peso.

High Bank Intermediation Costs

An important medium term challenge facing the financial sector is reducing the wide spreads between bank lending and deposit rates. In the 1990s, this gap ranged from 4 to 5.4 percentage points, well above the spreads in Malaysia, the USA and Singapore (Figure 2.15). The Government has instructed the Department of Finance to establish a task force to try to resolve this problem.

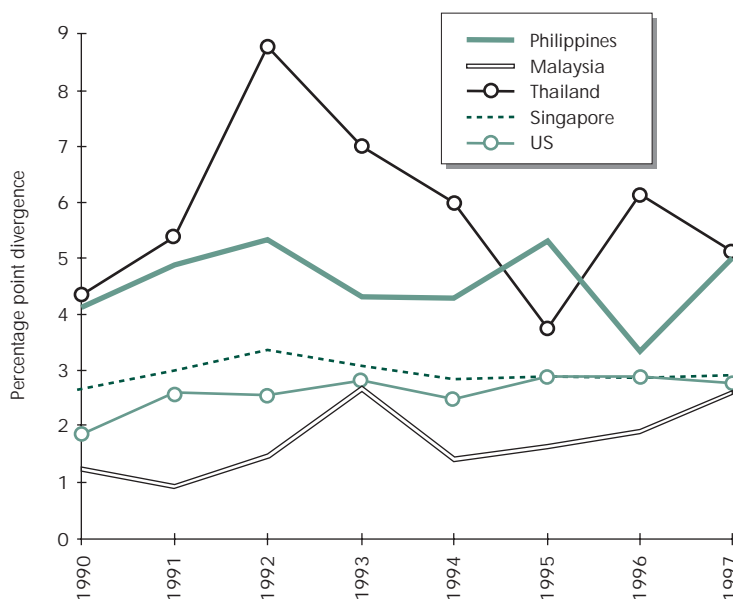
Many factors contribute to these wide spreads, including de facto taxes on the banking system imposed by high statutory reserve requirements. As banks get no return on 75 per cent of reserve requirements and only a 4 per cent return on the other 25 per cent, reducing statutory reserve requirements is essential to lowering high bank intermediation costs. The Bangko Sentral ng Pilipinas has reduced banks' statutory reserve requirement from 25 per cent of bank deposits in July 1992 to 13 per cent by July 1997; the medium term goal is to reduce these further to single digit levels in line with the regional average of 10 to 11 per cent (Ma, 1997). Furthermore, since 1994, banks have been allowed to maintain their liquid reserves in short term, market yielding government securities, while previously these reserves were included in overall statutory reserve requirements and earned low returns.

²⁴ Jose Go brought the Orient Bank in 1994. Nonperforming loans to companies associated with him were major factors in the Orient Bank's demise in February 1998 (Economist Intelligence Unit, 1998b; *Far Eastern Economic Review*, 26 March 1998, p. 72.)

Figure 2.15

Philippine Lending and Deposit Rate Spread One of Region's Highest

Regional Lending and Deposit Rate Differentials, 1990-97



Note: 1997 data are the latest available data for each country. For Indonesia, deposit data are for January to November and lending data from January to August. For Thailand, deposit data are for January to November and lending data from January to April. For Singapore, deposit data are for January to September and lending data are for the full year. For Malaysia, lending data are for January to October and deposit data are for the full year. For the Philippines and the USA, both sets of data are for the full year.

Source: Bangko Sentral ng Pilipinas, 1998a; IMF, 1998.

Mandatory credit allocations force banks to lend 25 per cent of funds to agriculture and agri-processing and 10 per cent to small and medium sized enterprises, also increasing lending and deposit rate spreads. These regulations are circumvented to some degree, as any lending to a large corporation, such as San Miguel, undertaking food processing may count as lending for agriculture and agri-processing. As a result, lending to these sectors has fallen over the past seven years despite these mandatory allocations (Figure 2.12). Nevertheless, intervening to prevent banks from allocating credit to maximise returns widens the spread between deposit and lending rates.

Mandatory credit allocations also increase default risks in the Philippine banking sector. The large commercial banks typically are poorly informed about the agricultural sector and small and medium sized enterprises, but must make substantial loans to these sectors, exposing themselves to unnecessary default risks. Ideally, these regulations should be abolished so credit can be used most productively and the effective return on funds can be maximised, but political pressures in Congress have prevented repeal of this requirement to date. The Bankers Association of the Philippines is pursuing an alternative strategy of encouraging institutions like the Land Bank of the Philippines and the Small Business Guarantee Finance Corporation, which do have relevant sectoral expertise, to issue market based

securities that banks can buy in lieu of direct lending to these sectors. These institutions could then on lend the funds to appropriate agricultural and small business clients.

Dominance of the banking sector by a few large commercial banks limits competition also keeping interest rate spreads high. Liberalising and preferably abolishing restrictions on the number of branches foreign banks can operate, removing restrictions on their access to head office capital to underwrite lending and encouraging further rationalising and merging of small and medium sized banks would help increase competition.

Further Prudential Controls

While the Philippines has reasonably strong prudential regulations by ASEAN-4 standards, they are probably still insufficient. In open, developing economies prudential regulations need to be more stringent than in industrialised countries since the volume of foreign capital flow often can be large compared to domestic capital markets, financial flows can be more volatile and local savers' opportunities for diversification fewer (World Bank, 1997a, p. 12). Priority areas include:

- moving to supervise banks on a consolidated basis to help reduce rapidly growing off-balance sheet activity
- strengthening efforts to incorporate a risk-weighting scheme into the definition of capital adequacy, including off-balance sheet risks²⁵
- promoting stronger representation on bank boards by outside shareholders, including in small and medium sized banks.

The increasing focus on institutional strengthening through Australia's aid program could be used to fund building of both public and private sector capacity to strengthen prudential regulations (Simon, 1997). (See Chapter 9 - *Implications*.)

BALANCE OF PAYMENTS

Since 1945, periodic balance of payments crises caused major swings in GDP growth. (See Chapter 1 - *Development Policies*.) In the second half of 1997 and early 1998, capital account instability again threatened economic growth, although this time the problem was regional. Understanding the Philippines' balance of payments position therefore is crucial in assessing the economy's prospects.

Current Account

The deficit in merchandise trade widened substantially between 1991 and 1996; imports substantially exceeded exports, and imports were on average growing somewhat faster than exports (Figure 2.16).²⁶ However, peso depreciation in 1997 radically altered this picture; exports grew by 22 per cent while imports grew by only 11 per cent, resulting in an 8 per cent fall in the trade deficit.

²⁵ A bill to amend the General Banking Act currently submitted to Congress calls for this measure.

²⁶ In 1996 Philippine merchandise imports were worth US\$31.9 billion, while merchandise exports were worth US\$20.5 billion. Between 1990 and 1996 Philippine imports grew at an annual average rate of 18.8 per cent while Philippine exports grew at 17.2 per cent.

AUSTRALIAN PRESENCE IN THE PHILIPPINE FINANCIAL SECTOR

Two Australian companies with a strong presence in the Philippine financial sector are ANZ and the Colonial Mutual Group.

ANZ

ANZ, the only Australian bank in the Philippines, opened a representative office in 1990 and in February 1995, was one of ten foreign banks to be granted a full commercial banking licence. In March 1996, ANZ opened its first branch in Manila offering services including:

- corporate and commercial lending to cater to the needs of major companies doing business in the Philippines and surrounding regions. Key activities include providing term and revolving lending facilities with multi-currency options and providing project finance and loan syndication as an arranger/participant or participant only
- trade finance including issuing of letters of credit, negotiation of documents, discounting of bills, documentary collections and pre and post shipment finance
- deposit taking involving accounts in pesos or other major currencies, remittance services and cheque issuance facilities
- private banking services such as assisting clients in overseas investment, portfolio management, securities trading and property.

ANZ's licence allows it to eventually open in six locations. Its priority region for the second branch is Mindanao.

ANZ remains optimistic about the Philippines because of a surge in the manufacturing sector, renewed foreign investor interest in the Philippines as an export base, government success in stabilising the power supply and initiatives to deregulate the banking, mining, telecommunications, power and building and construction industries.

Colonial Mutual Group

The Colonial Mutual Group, CMG is one of the top 500 corporations in the Philippines and the only Australian insurer operating in the life insurance industry. CMG's presence in the Philippines began in 1990 with a joint venture; in 1997 it bought out its joint venture partner.

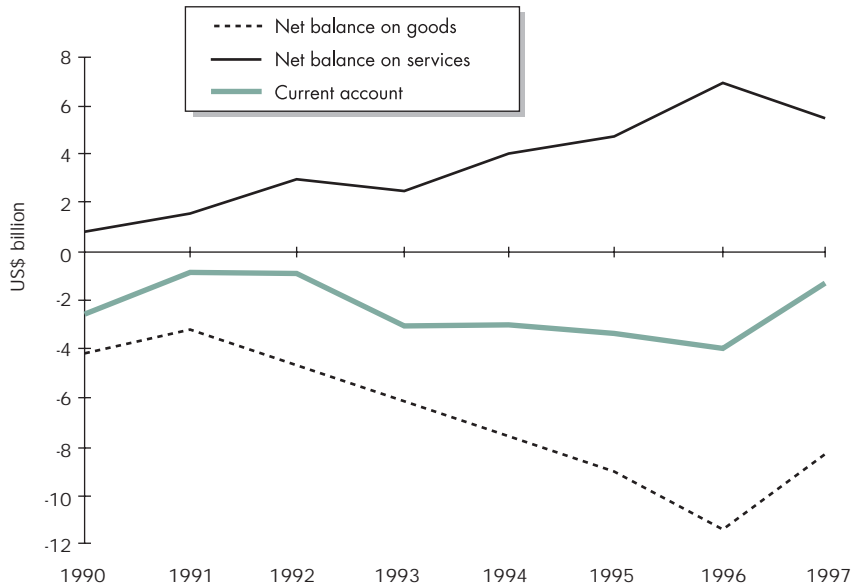
CMG offers corporate and individual clients in the Philippines life insurance, personal accident and medical insurance. Pension and education products and services are a newer, rapidly growing part of CMG's business attracting the growing Philippine middle class.

With a Manila head office and 13 offices throughout the country, CMG employs more than 1 700 agents and staff. Its strategy is to develop a range of flexible and client-focused products, for individuals and corporations.

Source: Bryant, 1997.

Figure 2.16

Trade Balance on Goods Persistently in Deficit Key Components of the Current Account^a



Note: ^a Figures for 1997 are for January to September only.

Source: Bangko Sentral ng Pilipinas, 1998a.

During the 1990s, the improved balance on services trade helped stabilise the current account deficit. Increased remittances from Filipino workers abroad (including peso conversions of foreign currency deposit units) drove this improved balance, rising from less than US\$4 billion per year between 1990 and 1993 to US\$10 billion in 1996. In the first nine months of 1997 remittances further increased.²⁷ Strong remittance growth in the banks at the expense of informal and nonbank channels is driven by greater confidence in Philippine economic fundamentals and 1992 foreign exchange reform measures easing conditions on overseas Filipinos depositing in foreign currency deposit unit accounts and exempting accounts from the 20 per cent withholding tax on peso deposits' interest.

However, by including all peso conversions of foreign currency deposit units as service receipts in current account transactions, the official statistics probably overestimate the size of service exports from foreign workers and therefore underestimate the current account imbalance. Some growth in foreign currency deposit units probably is driven by the return of flight capital which left the Philippines in the 1970s and 1980s and should be regarded as capital inflows rather than service receipts.²⁸

²⁷ In the first nine months of 1997 receipts from personal income and peso conversions of foreign currency deposit units were US\$8.7 billion compared to US\$7.7 billion in the first nine months of 1996.

²⁸ One estimate that takes one third of the foreign currency deposit unit peso conversions and half of the errors and omissions on the balance of payments as current account transactions puts the 1996 current account deficit at 6 per cent of GDP instead of the official figure of 4.5 per cent (Ma, 1997).

Capital and Financial Account

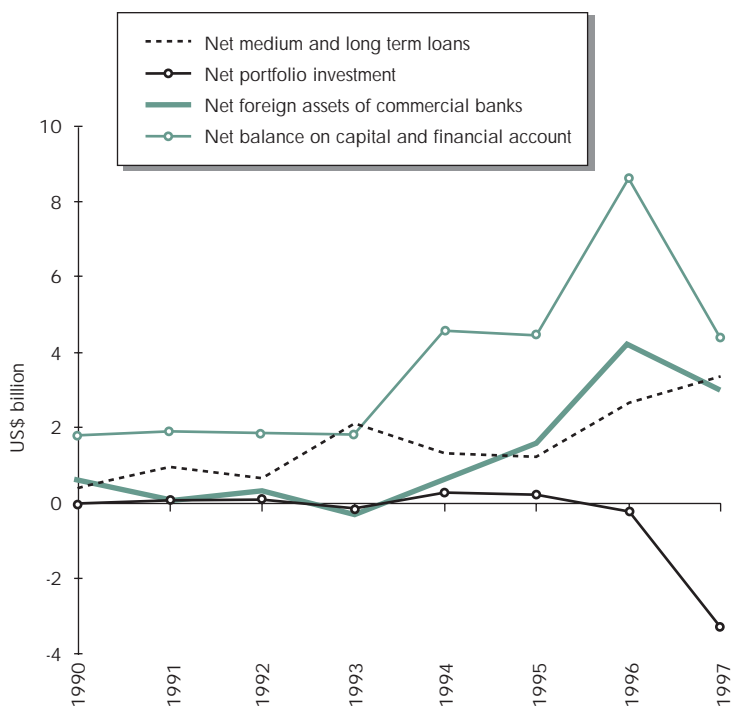
The capital and financial account surplus increased rapidly between 1993 and 1996, with the end of the power crisis, mainly driven by the rising net foreign liabilities of commercial banks; these increased by over 250 per cent in 1996 alone (Figure 2.17). The increase was driven by large interest rate differentials, with Philippine rates about 6 percentage points above benchmark international borrowing rates, and by the stable peso to US dollar exchange rate throughout the 1990s until mid 1997.

A very favourable incentive structure for foreign sourced funding, introduced when the Philippines had difficulty attracting foreign funds, also stimulated foreign borrowing (Ma, 1997; IMF, 1996). In 1996:

- foreign currency deposits carried no reserve requirements, while peso deposits carried a 17 per cent reserve requirement
- tax on onshore income from foreign exchange loans was 10 per cent, while other income was subject to the normal corporate income tax rate of 35 per cent.

Figure 2.17

Capital Account Surplus Surges in the Mid 1990s Key Components of the Capital and Financial Account



Note: Figures for 1997 are for January to September only.

Source: Bangko Sentral ng Pilipinas, 1998a.

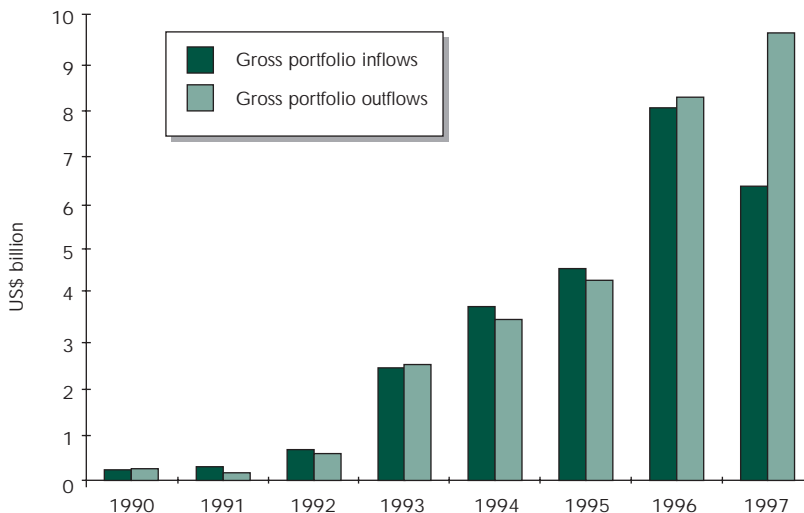
Net medium and long term loans more than doubled in 1996 and increased by a further 53 per cent in the first nine months of 1997. Driving this rise was the increased issue of international bonds by domestic corporations; in 1996 six private corporate borrowers issued US\$845 million in international bonds and the Philippine National Oil Company issued bonds worth a further US\$150 million (IMF, 1996, p. 38). There was no increase in concessionary aid loans prior to September 1997.

Between 1991 and 1996, gross portfolio inflows and outflows expanded extremely rapidly (Figure 2.18) while net portfolio inflows were positive but very small. Rising portfolio flows were largely directed at equities rather than debt, with foreign capital accounting for at least 60 per cent of the turnover in the stock market prior to mid 1997 (World Bank, 1997a, p. 5). In the first nine months of 1997, outflows rose, inflows fell and net portfolio outflows exceeded US\$3.3 billion (Figure 2.17) causing the fall in equity prices.

By contrast, net foreign direct investment inflows to the Philippines have been modest, averaging about US\$1.3 billion per year between 1994 and 1996, less than one quarter of total net capital flows (Figure 2.17 and Table 2.1). Provided the new administration maintains and builds business confidence, foreign direct investment should grow strongly in the next few years driven by the peso's large depreciation. Philippine assets are now cheap for non-ASEAN investors and the Philippines is now more competitive as an export producing base. (See Chapter 4 - *Investment*.) Initially, these inflows are likely to come largely from Europe, Taiwan and the USA.

Figure 2.18

Portfolio Inflows and Outflows Surge in the 1990s Gross Inflows and Outflows of Portfolio Investment



Note: Figures for 1997 are for January to September only.

Source: Bangko Sentral ng Pilipinas, 1998a.

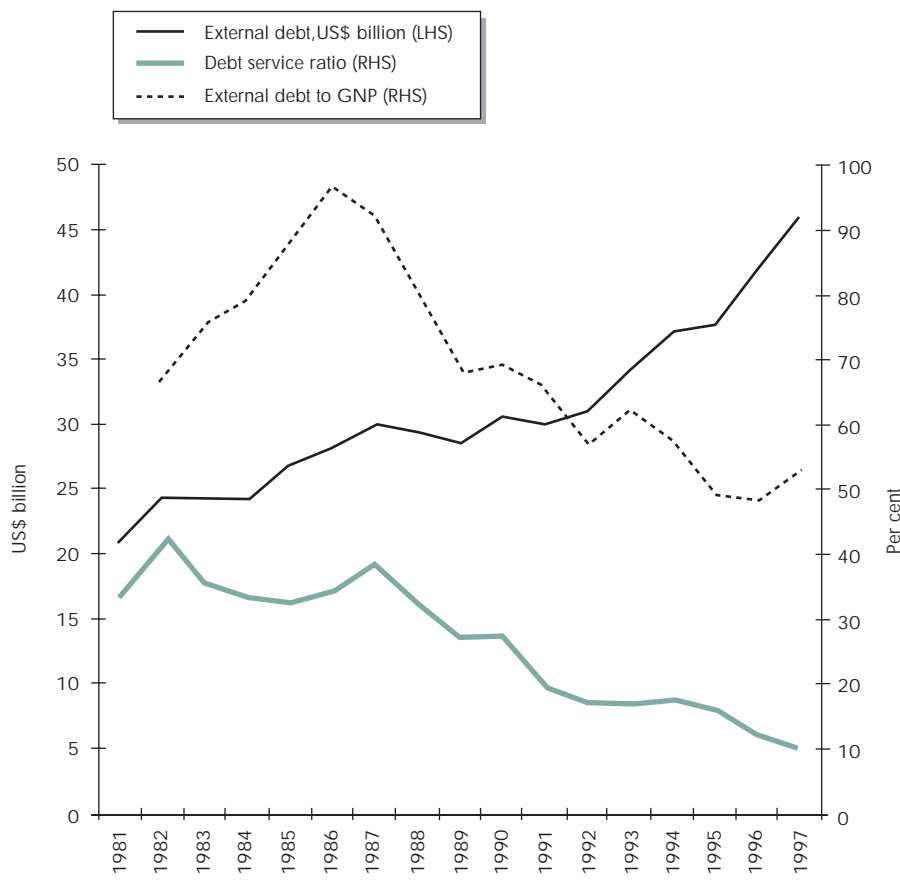
Foreign creditors and over extended local companies both may benefit from converting short term foreign exchange loans and bonds to longer term direct investment via debt to equity conversions and mergers and acquisitions. Foreign joint venture partners may take this opportunity to increase their equity in Philippine companies. (See Chapter 5 - *Business Environment*.)

Debt Servicing

Historically, Philippine balance of payments problems created substantial external debt service problems. In 1983, when the Philippines was unable to meet its debt repayment obligations, external debts were rescheduled and financial support provided under the Brady plan. The foreign debt situation continued to deteriorate until the end of the Marcos regime in 1986 but since then has improved steadily (Figure 2.19). The ratio of external debt to GNP fell rapidly to 1996, but rose in the

Figure 2.19

Debt Servicing Capacity Continues to Improve in the 1990s The Value of Philippine External Debt and as a Percentage of Exports and GNP^a



Note: a Figures for 1997 are for nine months only.

Source: Asian Development Bank, 1997b; Bangko Sentral ng Pilipinas, 1998a.

first nine months of 1997. The percentage of goods and service exports required for debt servicing (the debt service ratio) decreased steadily to around 10 per cent in the first nine months of 1997 (Figure 2.19). This improved debt servicing position occurred despite continued rises in the total external debt stock. As discussed, commercial bank borrowing abroad and bond issues drove increases in recent years.

Importantly, short term debt also fell sharply from above 40 per cent of total external debt in the first half of the 1980s to under 15 per cent in the second half of the 1980s. It has remained manageable in the 1990s, although it rose from a low point of 14 per cent in 1994-95 to 22 per cent by the end of 1997. This still compares favourably with the end of 1997 short term borrowing exposure of 31 per cent for Thailand, 39 per cent for the Republic of Korea and 36 per cent for Malaysia (Bangko Sentral ng Pilipinas, 1998a; Litan, 1998).

The peso's depreciation substantially increases the peso value of Philippine external debt and its debt servicing burden. However, in 1995, about 37 per cent of Philippine long term debt was denominated in yen, a further 32 per cent in multiple and minor currencies and only 31 per cent in US dollars (World Bank, 1997b). While individual companies may experience problems servicing their foreign debt, major problems are unlikely to emerge at the national level. One concern was that short term debt equalled total gross international reserves at the end of 1997²⁹ (Economist Intelligence Unit, 1998b) but by April 1998 reserves had accumulated to a more comfortable level.

FISCAL POLICY

Another Ramos administration achievement is steady improvement of the Government's consolidated fiscal position³⁰ achieving a small surplus in 1996 for the first time in 15 years (Figure 2.20). This is an essential element of Philippine economic recovery, helping to reduce and lengthen the maturity of still high public debt and reduce public debt service costs.

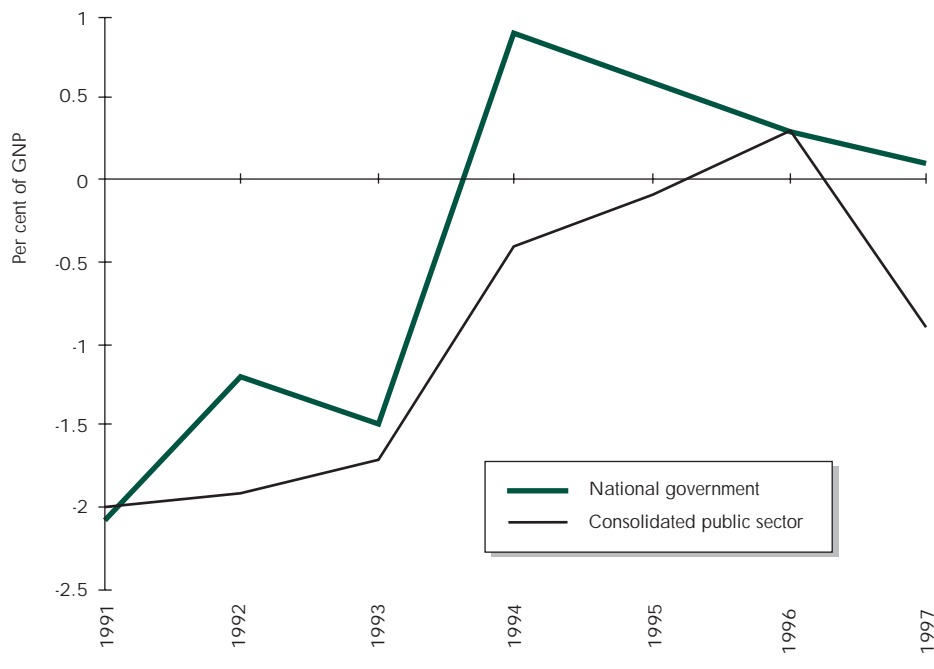
Revenue from privatisations dramatically improved the Government's consolidated fiscal position, but this revenue peaked in 1994-95 and dropped off sharply in 1996 (Figure 2.21). However, growth in tax revenue allowed the Government to remain in surplus in 1996 despite falling privatisation revenue. The Oil Price Stabilisation Fund moved from a deficit of P 9.2 billion in 1995 to a surplus of P 4.8 billion in 1996, significantly improving the consolidated fiscal position.

²⁹ Standard and Poors mentioned this factor in their February lowering of the Philippine long term credit rating outlook from 'stable' to 'negative'.

³⁰ The consolidated fiscal position includes the national Government, government owned corporations, the Bangko Sentral ng Pilipinas, government financial institutions and other institutions that add to the public sector's borrowing requirement.

Figure 2.20

Philippine Fiscal Position Improves Significantly in the 1990s Consolidated and National Budget Deficits Per cent of GNP^a



Note: ^a Figures are to September in 1997.

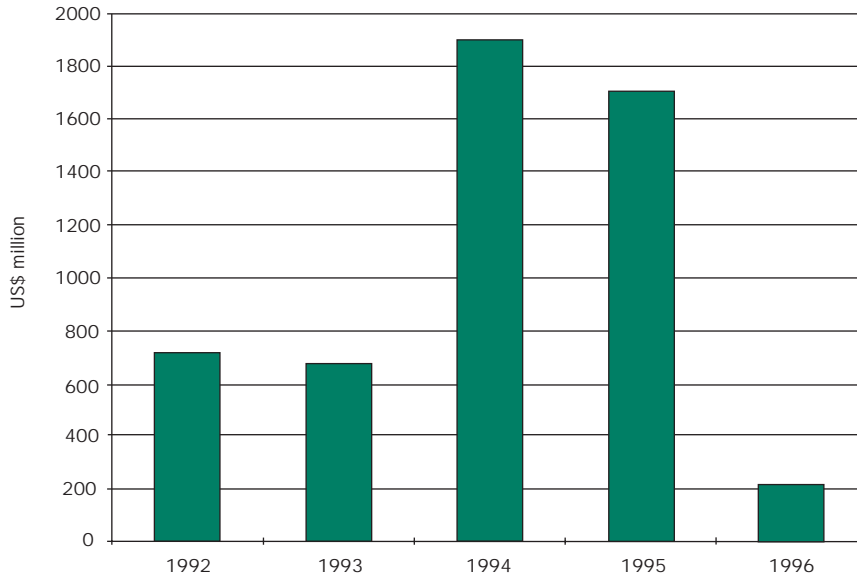
Source: World Bank, 1997a; Bangko Sentral ng Pilipinas, 1998a.

In 1997, the fiscal position of both the national Government and the overall public sector deteriorated sharply. The national Government remained in surplus while the overall public sector moved strongly into deficit (Figure 2.20) largely due to growing claims against the Oil Price Stabilisation Fund, due to court action stalling deregulation; the poor performance of the National Power Corporation, in part due to higher electricity costs from early BOT projects and constraints on tariff rises; and a weaker than expected national government surplus, due to higher foreign debt servicing costs. Although successfully completing oil industry deregulation in early 1998 should remove this drain on public finances, the fiscal position will continue to deteriorate in 1998 due to lower growth. The Government has responded to the deterioration by cutting departments' non personnel expenditure by 25 per cent.

Figure 2.21

Privatisation Revenue Peaks in 1994

Privatisation Revenue, 1992-96



Source: Balbosa, 1997a.

Tax effort improved considerably over the 1990s; the share of taxes in GDP increased, becoming comparable with other ASEANs (Figures 2.22 and 2.23). The Government expected passage of the final stage of the comprehensive tax reform package in late 1997 would boost net revenue by a further P 6 billion (0.3 per cent of GNP) in 1998 (Balbosa, 1997a).³¹ However, a more realistic assessment may be for a neutral revenue impact over the next year or two because of lower forecasts for 1998 economic growth and likely difficulties in implementing some of the new tax rules (Balbosa, 1997a).

Over the medium term the package should yield significant gains as compliance should improve due to reduced company tax rates and the simplified tax regime.³² However, further efforts to improve tax administration and compliance will probably be needed. Out of a workforce of 27 million, the Philippines has 3.6 million tax filers and only 1 million tax payers (Economist Intelligence Unit, 1998d).

Company tax compliance also is poor; in 1997 corporate income tax revenue grew by only 1 per cent although peso GNP grew almost 12 per cent (Economist Intelligence Unit, 1998d). Strengthening the Bureau of Internal Revenue and Customs Department, the principal collection agencies, and further reducing corporate and personal income tax rates will increase the risks and decrease the rewards of tax evasion.

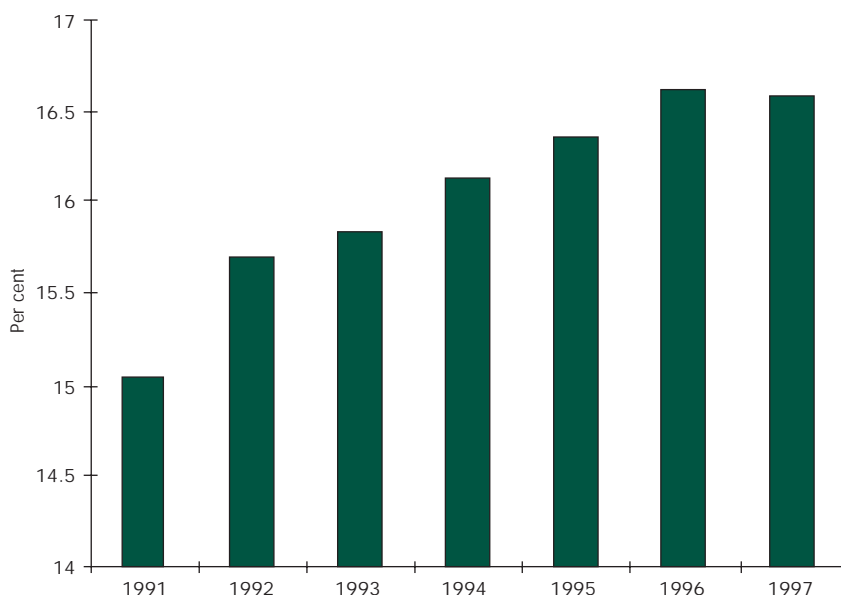
³¹ The calculation for the net revenue impact as a percentage of GNP assumes a 5 per cent growth rate.

³² Details on new company tax rates which will progressively come into force under the final stage of the comprehensive tax reform package are given in Chapter 5 - *Business Environment*.

Figure 2.22

Tax Take Improving

Philippine Tax Revenue as a Share of GNP



Source: Bangko Sentral ng Pilipinas, 1998a.

On the expenditure side, the main problem is the need to increase funds allocated to public investment. The public investment share of GNP fell from 3.7 per cent in 1992 to 3.0 per cent in 1996. While this was well above late 1980s levels, it was still the lowest in ASEAN (Figure 2.24). Notwithstanding the Philippines' relatively high share of private investment in health and education and its relatively advanced policy framework for private investment in infrastructure, this relatively low level of public investment is a concern. The backlog of public investment needs in infrastructure is large and education and health standards are deteriorating. (See Chapters 1 - *Development Policies*, Chapter 6 - *Infrastructure* and Chapter 8 - *Agriculture*.)

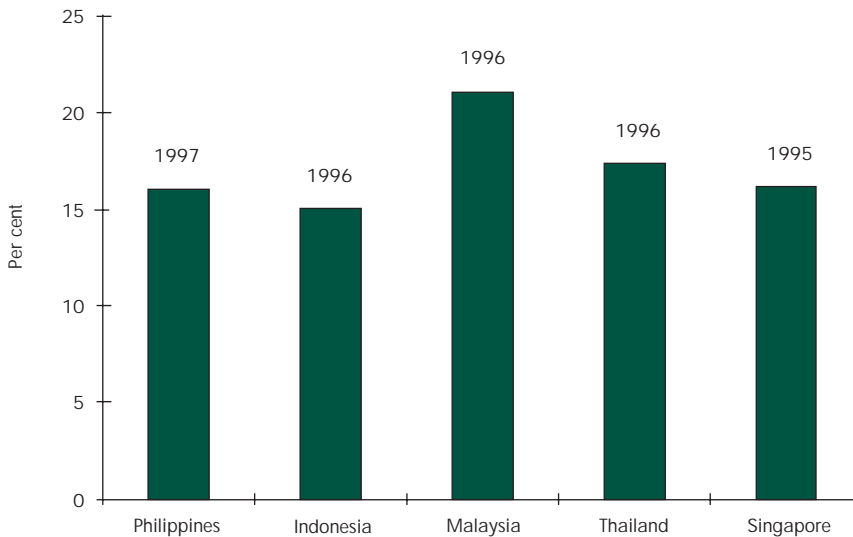
As it is also important to maintain a balanced budget, expenditure must be shifted into infrastructure from other areas. In 1996, over 67 per cent of national government spending went to personnel, local government unit allotments and interest payments (World Bank, 1997a, p. 14). As the Local Government Act requires 40 per cent of inland revenue goes to local government,³³ personnel and interest payments are the main areas of potential savings.

³³ As local government units are small and lack the institutional capacity to absorb these funds, wastage is a potential danger.

Figure 2.23

Philippine Tax Take Compares Well with Other ASEAN Nations

Tax Revenue as a Share of GNP in ASEAN Nations



Note: Data for each country are the latest available year (indicated above the respective column). Philippine data are from Bangko Sentral ng Pilipinas, 1998a. Data for other countries are from IMF, 1998 and IMF, 1997.

Source: Bangko Sentral ng Pilipinas, 1998a; IMF1998; IMF, 1997b.

Personnel expenditure rose 87 per cent between 1991 and 1996 to equal one third of national government expenditure despite the transfer of about 70 000 national government health, agricultural extension, public works and social welfare staff to local government payrolls as part of decentralisation under the 1991 Local Government Act.³⁴ Although public service salaries rose, senior executive salaries are still uncompetitive; there also are too many low quality junior staff (World Bank, 1997a, p. 14).

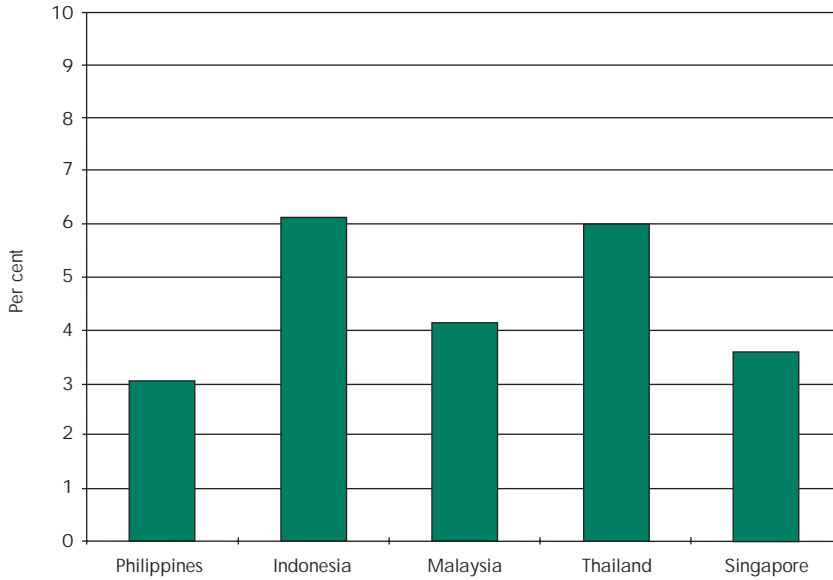
In 1996, interest payments amounted to P 77 billion or almost 20 per cent of total national government expenditure. While absolute levels of public sector debt have barely stabilised, the ratio of public sector debt stock to GNP fell from 119 per cent in 1992 to 95 per cent in 1996, due to improved fiscal performance and growing GNP. Around two thirds of the 1996 debt of P 2.2 trillion was domestic, with the remainder owed to foreigners (World Bank, 1997a, Table 9). The recent peso depreciation increases the US dollar value of the external portion of government debt by 40 per cent. Moreover, with 90 per cent of domestic debt being in 90, 180 and 360 day treasury bills, recent interest rates increases will quickly raise the cost of refinancing this debt (Balbosa, 1997b).

³⁴ Allotments to local government units increased from P 3.1 billion in 1991 to P 12.8 billion in 1996 (World Bank, 1997).

Figure 2.24

Philippine Public Investment Rate Still Lowest in ASEAN

Public Investment as a Share of Gross National Product in ASEAN, 1996



Note: Philippine public expenditure data are from World Bank, 1997a. Singapore data are for 1995.
 Source: World Bank, 1997a; IMF, 1998; IMF, 1997.

It is also important to more efficiently spend public investment funds. Eliminating pools of resources, such as the Countrywide Development Fund and the Public Works Fund, which congressional members spend at their discretion is necessary, as these can be a serious source of pork barrelling (Monsod, 1997).³⁵ Expanding development assistance allocated to building institutional capacity within local governments and improving their access to quality economic advice deserve consideration. (See Chapter 9 - *Implications*.)

A further priority is continued fiscal consolidation. Over the next year or two, weakness in the economy will constrain the Government's capacity to improve its consolidated fiscal position and public savings. However, in the medium term, the fiscal position needs further improvement to increase public savings, keep interest rates down, encourage domestic investment and make the Philippines a more attractive destination for increasingly discriminating domestic and international investors.

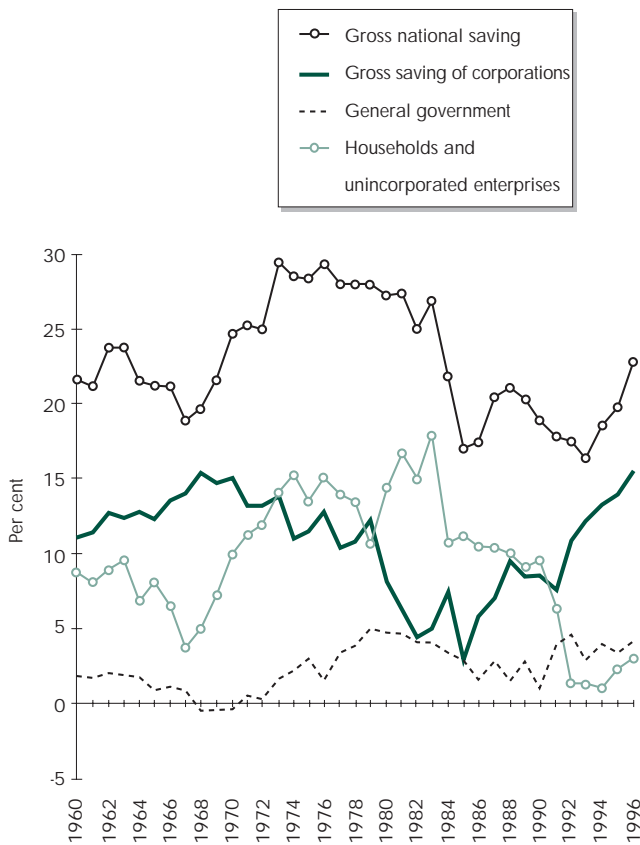
³⁵ In the 1998 budget, P 55 billion or 10 per cent of the total budget, will reportedly be spent at congressional members' discretion, 80 per cent more than in 1997 (Balbosa, 1997c).

SAVINGS PERFORMANCE

While Philippine savings performance has improved considerably in recent years, savings rates still remain well below those of the mid 1970s to early 1980s and of most economies in the region (Figure 2.25). Since the mid 1980s, corporate savings have improved but slower growth in Asian markets and increased costs in repaying US dollar denominated debt are likely to reduce corporate profits and savings performance in the next few years. General government saving also increased sharply in the early 1990s and is now at mid 1970s to early 1980s levels (Figure 2.25). However, increased debt servicing costs, a slowing economy and decreased privatisation revenue are all likely to reduce government savings over the next year or two.

Figure 2.25

Savings Performance is Improving Philippine Savings Performance, 1960-96 Per cent of GDP



Source: Intal, 1997.

Household and unincorporated enterprise savings fell sharply from the early 1980s to early 1990s and remain well below their mid 1970s to early 1980s levels. With weak growth likely over the next year or two, household savings also are unlikely to rise dramatically. Combined with the likely downward pressure on corporate and government savings, overall savings are unlikely to rise and could fall over the next year or two.

Over the medium term, the Philippines must increase household savings. Key factors in achieving this goal include raising income levels, maintaining low inflation, reducing population growth, increasing the efficiency of the banking sector and continuing the spread of banks and credit cooperatives into rural areas to help channel savings into the formal financial system.

OUTLOOK FOR THE ECONOMY

The Philippines has a relatively healthy financial sector by the standards of many of its Asian neighbours. This should help it to maintain growth momentum after the turbulence in Asian financial markets settles.

However, on its own, a relatively healthy financial sector will not be enough. President Ramos' successor will need to show strong commitment to continued vigorous reform and willingness to tackle long term problems such as poor savings performance, weak tax administration and inadequate public expenditure on infrastructure. In addition, the Philippines needs to control wage and price pressures resulting from the peso's depreciation so a real depreciation can be maintained. As soon as possible, interest rates also must decline to the levels prevailing before depreciation and spreads reduced to allow investors to respond to opportunities arising from the depreciation. Furthermore, the problems of individual borrowers in servicing US dollar loans need to be isolated and prevented from generating a system wide impact.

In dollar terms, official development assistance flows to directly strengthen governance and the macroeconomy are modest compared to similar flows for infrastructure, agriculture and basic human needs projects. However, well directed programs to help build capacity in local government, financial markets, and taxation reform could contribute significantly to Philippine economic development over the next decade. (See Chapter 9 - *Implications*.)

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Chapter 3

TRADE POLICIES AND DIRECTIONS

Philippine trade policies and performance have advanced impressively in the last decade, reversing years of inward looking stagnation. The Ramos administration continued and expanded Aquino administration reforms, deepening trade liberalisation and further opening industries to foreign investors. While some interest groups, particularly protected industry, resist the reforms, the Government recognises the major benefits of outward orientation. The continuity of reforms and Philippine commitments to the World Trade Organisation, ASEAN Free Trade Area and Asia-Pacific Economic Cooperation, APEC, clearly signal to local and foreign investors the Government's commitment to keeping the economy open.

This chapter examines the recent trade regime reforms and their effects on trade structure. It analyses the expected short and long term impact of the peso's recent depreciation on trade performance and opportunities for Philippine-Australian trade from recent trade liberalisation.

TARIFF REFORM PROGRAM

Until the early 1980s, the pattern of protection was uneven, with high protection for finishing and assembly operations and low protection for raw materials, intermediate goods and capital goods production. Together with the overvalued peso, this seriously discriminated against the agricultural sector and intermediate and capital goods, and favoured consumer goods produced for the local market. (See Chapter 1 - *Development Policies*.)

From the early 1980s, trade reforms through tariff and import liberalisation programs lowered and established more uniform tariff levels, gradually removing import restrictions. The tariff reform program has had three broad phases, 1981 to 1985, 1991 to 1995 and 1996 to 2003. The third phase, 1996 to 2003 aims for uniform tariff rates of 5 per cent by 2004 except for a few 'sensitive commodities'.

This aim will be achieved in three major steps:

- a first stage beginning in 1995 to have four tariff levels by 2000: 3 per cent, 10 per cent, 20 per cent and 30 per cent.¹ Around 84 per cent of tariff lines will fall under the 3 per cent and 10 per cent tariff rates (Philippine Tariff Commission, 1996)
- a second stage of only two tariff rates in 2003: 3 per cent for raw materials and intermediate goods and 10 per cent for finished products
- a third stage of uniform tariffs of 5 per cent except on several sensitive commodities like rice.

¹ This reform was initiated under Executive Order No. 264, effective August 1995. This executive order progressively increases the number of tariff lines under 3 per cent from 316 to 2 143 between 1995 and 2000, and decreases the number of tariff lines in the 10-20 per cent and 20-30 per cent ranges.

In January 1998 some further 'recalibration' of tariff rates was undertaken. In general these adjustments only smoothed tariff reductions in 1998 and 1999, with no effect on the post 2000 outcome.²

While overall effective rates of protection³ are falling significantly due to these reforms, they remain relatively high for importables. (A sector is classified as importable if its undistorted domestic price is greater than its world price at the country's border, the border price, or exportable if its undistorted domestic price is less than its border price.) In contrast, exportables, particularly agricultural and forestry products, still are penalised by low and often negative protection and will remain so in 2000 (Table 3.1).

Between 1995 and 2000, effective protection in manufacturing will drop except in food processing, where protection is expected to increase from 32 to 36 per cent because of the tariffication of quantitative restrictions on meat preparations and cereals (Tan, 1997). To mitigate the effect of peso depreciation on imported food prices, the Government recently reduced tariffs on imported raw materials food processors use but this reduction could actually increase the sector's effective protection.⁴ Manufacturing sectors with effective rates of protection less than 10 per cent in 2000 will include:

- textiles and garments
- leather and leather products
- chemical and chemical products
- petroleum refineries
- non-metallic products
- metal and metal products
- machinery including electrical machinery
- scientific equipment.

.....
² Some commodities did have their tariff rates in 2000 adjusted either upwards or downwards. The key changes from Australia's perspective relate to agricultural products and are discussed later in the chapter.

³ The effective rate of protection is the net rate of protection after accounting for both the protection accorded to final products and the higher costs associated with protected inputs.

⁴ These tariff reductions, which included significantly liberalising beef imports, are discussed later in the chapter. To the extent that unprocessed food tariffs are reduced and processed food tariffs remain constant, the effective protection of food processors will increase.

Table 3.1

Protection Declines but Exportables Still Penalised
Effective Rates of Protection^a, 1983-2000
(Per cent)

Sectors	Tariff reform program I		Tariff reform program II		Tariff reform program III	
	1983	1985	1990	1995	1995 - post EO 264	2000 ^b
All sectors	44.2	38.0	29.4	24.1	20.4	16.7
Importables	87.4	76.0	57.0	47.0	28.5	23.4
Exportables	-4.0	-4.5	-1.4	-1.4	-3.5	-1.8
Agriculture	24.2	19.5	9.8	9.4	22.1	20.6
Importables	88.4	76.4	31.7	30.4	35.0	32.7
Exportables	-4.4	-5.9	0.0	0.0	-0.5	-0.4
Fishing	8.1	9.2	6.0	4.4	16.8	6.2
Importables	103.2	79.7	48.3	35.0	24.6	8.6
Exportables	-5.4	-0.9	0.0	0.0	-2.6	-1.5
Logging and other forestry	-19.1	-19.7	-20.4	-21.0	10.6	3.2
Importables	75.9	58.2	41.7	24.7	10.9	3.0
Exportables	-22.8	-22.8	-22.8	-22.8	-2.0	-1.9
Mining	7.2	6.1	4.5	6.0	1.1	-0.3
Importables	27.7	23.6	17.3	23.0	13.6	2.1
Exportables	0.1	0.1	0.1	0.1	-1.7	-1.1
Manufacturing	64.7	55.9	45.5	37.3	22.2	18.4
Importables	88.1	77.0	61.2	50.0	28.6	23.9
Exportables	3.1	0.1	3.8	3.8	-4.9	-2.4

Note: a The effective rate of protection is the net rate of protection after accounting for both the protection accorded to final products and the higher costs associated with protected inputs. b The effective rates of protection in 2000 were those prevailing before the recalibration of tariff rates on 22 January 1998. However, with recalibration largely smoothing the path of tariff reductions in 1998 and 1999, the effective rates of protection in 2000 should not be affected significantly.

Source: Tan, 1995; Tan, 1997.

IMPORT LIBERALISATION PROGRAM

The import liberalisation program began in earnest in 1986,⁵ complementing the tariff reform program. It was designed to gradually remove non-tariff barriers on imports including import licensing requirement quotas and outright import bans.

⁵ The import liberalisation program was initiated in 1981 but the balance of payments crisis derailed it in 1983.

Between 1986 and 1989, the program reduced the proportion of regulated imports from 34 to 8 per cent of total Philippine import lines, and controlled items fell further to 3 per cent by 1996. Areas where imports are still restricted include:

- agriculture, where all restrictions are in cereal and cereal preparations
- mineral fuels (largely petroleum)
- chemicals
- rubber and rubber articles
- motor vehicles.

PHILIPPINE COMMITMENTS IN WTO, AFTA AND APEC

In addition to significant unilateral reforms, the Philippines made several multilateral commitments to trade liberalisation in the 1990s. These include commitments prior to its accession to the World Trade Organisation, WTO, in 1994, under the ASEAN Free Trade Area, AFTA, and within the Asia Pacific Economic Cooperation, APEC.

World Trade Organisation

The Senate ratified the Philippines' accession to the WTO in December 1994.⁶ With few exceptions, trade liberalisation flowing from the WTO accession did not exceed unilateral reforms. However, new commitments did include:

- binding⁷ tariff rates at a ceiling rate of 10 percentage points above the 1995 applied rate on some 2 800 industrial tariff lines and 744 agricultural tariff lines; this represented 63 per cent of total tariff lines⁸
- converting all existing quantitative restrictions on agricultural imports to tariff equivalents (except rice for which a 10 year delay was agreed). Agricultural products affected include corn, sugar, coconut oil, onions, garlic, potatoes, cabbage, pork, poultry meat, beef and live pigs, poultry and cattle
- binding all current restrictions on market access for financial services, communications, transport services and tourism.

Enhanced export opportunities from trading partners reducing their tariffs under the Uruguay Round should yield the Philippines from \$2.2 billion to \$2.7 billion per year (Department of Trade and Industry, 1995).⁹

.....
⁶ Prior to this the Philippines was a member of the General Agreement on Tariffs and Trade.

⁷ When tariffs are bound for a particular product, they cannot be raised above the specified rate. Bound rates are often higher than the rate which is actually used (the applied rate).

⁸ Exceptions to the binding commitment involve 66 tariff lines or 0.01 per cent of total tariff lines. These include 42 agricultural and 24 textiles and clothing products; tariff rates on these will be reduced by 2004.

⁹ The Philippines' major trading partners committed to reduce tariffs for their imports from the Philippines as follows: 35 per cent for USA, 56 per cent for Japan and 34 per cent for the European Union.

ASEAN Free Trade Area, AFTA

AFTA's main goal is to increase ASEAN's competitiveness as an export oriented production base. From 1 January 1993, AFTA's Common Effective Preferential Tariff, CEPT, scheme reduced intra-ASEAN tariffs, eliminating non-tariff barriers and waiving foreign exchange restrictions on CEPT products. CEPT originally was designed to reduce tariffs to 0 to 5 per cent on all intra-ASEAN trade in manufactured products, including capital goods and processed agricultural products, by 2008. However, in September 1994, CEPT was accelerated and broadened:

- to realise free trade within ASEAN by 2003, the time frame was reduced
- to expand the coverage of CEPT, excluded products were phased in, starting 1 January 1996 in five equal instalments
- to include unprocessed agricultural products under the scheme.

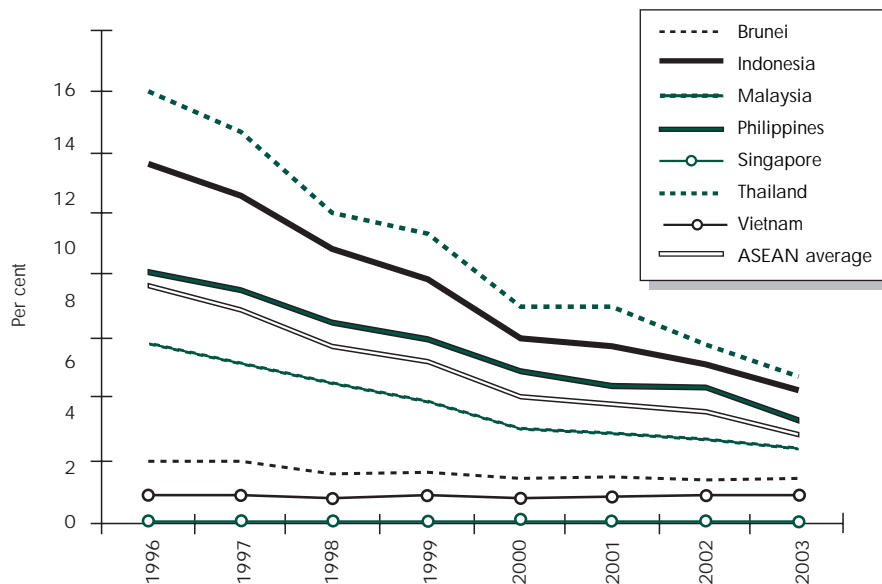
These changes make CEPT one of the most comprehensive free trade arrangements in the world. In addition, Vietnam acceded to the CEPT Agreement in December 1995 and Laos and Burma joined in 1997.

In 1996, the Philippine CEPT package consisted of 4 694 tariff lines under the Inclusion List, 562 under the Temporary Exclusion List and 28 under the General Exclusion List (ASEAN Secretariat, 1996). While the Philippine average CEPT rate will fall from above 8 per cent in 1996 to 4 per cent by 2003, its CEPT rates will remain above the ASEAN average (Figure 3.1).

Figure 3.1

CEPT Rates Set to Fall Rapidly

Projected Average CEPT Rates of ASEAN Members, 1996-2003
(Per cent)



Source: ASEAN Secretariat, 1996a.

At least initially CEPT is likely to have a relatively modest overall impact on the Philippines, as the ASEAN's share of Philippine trade is still low. However, Philippine trade with ASEAN increased more rapidly than inter-ASEAN trade between the other ASEANs between 1993 and 1996 (Tables 3.2 and 3.3).

Table 3.2

Philippine Exports to ASEAN Growing Rapidly from Low Base
Intra-ASEAN Exports of CEPT Products, 1993-96
 (Per cent)

Country	Per cent distribution				Annual growth rate		
	1993	1994	1995	1996	1993-94	1994-95	1995-96
Brunei	1.3	1.0	0.9	0.7	6.9	13.3	-17.1
Indonesia	12.8	10.9	10.0	11.2	18.4	18.6	23.6
Malaysia	33.0	27.4	27.0	27.5	16.1	16.7	11.8
Philippines	1.8	2.5	3.7	4.3	92.1	76.5	26.9
Singapore	43.0	50.3	49.1	48.3	62.9	15.9	8.1
Thailand	8.1	7.9	9.3	8.0	33.8	39.4	-4.2
ASEAN	100.0	100.0	100.0	100.0	39.2	18.7	9.8

Note: Data for Vietnam are not available.

Source: ASEAN Secretariat, 1996a; AFTA Council, 1997.

Table 3.3

Philippine Imports from ASEAN also Growing Strongly
Intra-ASEAN Imports of CEPT Products, 1993-95
 (Per cent)

Country	Per cent distribution			Annual growth rate	
	1993	1994	1995	1993-94	1994-95
Brunei	2.4	2.4	2.1	19.7	-2.0
Indonesia	6.9	6.4	6.6	12.7	18.2
Malaysia	22.1	23.1	22.0	28.7	8.0
Philippines	3.5	3.6	5.3	28.2	63.7
Singapore	57.5	55.7	54.2	18.8	10.0
Thailand	7.6	8.8	9.8	41.9	26.2
ASEAN	100.0	100.0	100.0	22.7	13.2

Note: Data for Vietnam are not available.

Source: ASEAN Secretariat, 1995; AFTA Council, 1997.

Effects of AFTA/CEPT

CEPT will only reduce the effective rate of protection on Philippine manufacturing industries by around 2 percentage points (Pineda, 1997). CEPT will affect individual industries depending on their competitiveness, current effective protection rate and whether the Philippines is a net exporter or importer of the commodity. Major regional currency shifts experienced in 1997-98 will affect relative sectoral competitiveness much more than these very small tariff reductions.

GAINERS AND LOSERS FROM CEPT

CEPT Beneficiaries

CEPT tariff reductions will benefit Philippine exporters to ASEAN by increasing their price competitiveness in ASEAN markets relative to non-ASEAN exporters. This will expand demand for Philippine exports. The top commodities in this category include semiconductor devices, fertilisers, motor vehicle parts and accessories, and vegetable fats and oils.

Non-vulnerable Industries

Some industries are not vulnerable to ASEAN competition even though the Philippines is a net importer from both ASEAN and the world. This is either because these sectors are competitive (for example food manufacturing, paper and printing, chemicals, fabricated metal products and electrical machinery) or because CEPT does not alter their effective rate of protection (for example non-electrical machinery and transport equipment).

Vulnerable Industries

Some industries could be affected adversely by ASEAN competition because they are uncompetitive; CEPT significantly reduces their effective rate of protection; and the proportion of ASEAN imports is high. These industries include hardboard and particleboard, glass containers, non-metallic mineral products and general hardware.

However, overall, the Philippines will benefit from long run dynamic gains from CEPT, with lower effective protection rates improving resource allocation. The reciprocal nature of trade liberalisation among ASEAN members should enhance these gains.

Source: Pineda, 1997.

Asia-Pacific Economic Cooperation

The Philippines' APEC individual action plan commitments are bolder than those pledged under the WTO and AFTA. This is mainly because APEC commitments are voluntary and usually extend unilateral liberalisation initiatives; whereas, WTO and AFTA commitments entail legal sanctions on non-compliance. The Philippines' APEC commitment involves phasing down tariffs to a uniform rate of 5 per cent by

2004, except for sensitive agricultural products.¹⁰ Since 1997, APEC has permitted non-tariff measures only for reasons of public security, health and safety.

Commitments in the service sector also go beyond the WTO's General Agreement on Trade in Services, GATS, which merely involve not imposing additional restrictions. These additional commitments include:

- *Telecommunications* - to progressively privatise government telecommunications facilities; review the radio spectrum to allow entry of new service providers; and eliminate franchising requirements for value added service providers¹¹
- *Transport* - to open up auxiliary maritime services such as managing shipping agencies and multimodal operation
- *Energy* - to remove regulations on oil price setting and government-provided foreign exchange cover compensating oil companies for exchange rate fluctuations; lift restrictions on coal imports; and privatise the National Power Corporation
- *Tourism* - to review existing laws on tourism movement and investment; liberalise existing restrictions on investments and employment of foreign nationals
- *Distribution* - to open retail trade to foreign participation
- *Financial* - to review restrictions on foreign equity participation in investment companies, investment banks and financing companies; and review restrictions on foreign membership in boards of directors of investment companies and financing companies.

OTHER FACTORS AFFECTING PHILIPPINE TRADE PERFORMANCE

The exchange rate regime operating since World War II and the overvalued peso it supported seriously hindered trade policy reform and export performance. (See Chapter 1 - *Development Policies* and Chapter 2 - *Macroeconomic Environment*.) Other factors influencing trade performance include fiscal policy, especially fiscal incentives for exporters, foreign direct investment policies and the establishment of export processing zones. (See Chapter 4 - *Investment*.) The availability of trade finance continues to affect trade performance.

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¹⁰ This is considerably more liberal and immediate than the WTO commitment to bind tariffs at their 1995 levels. CEPT commitments are more ambitious; an average CEPT rate of 3.3 per cent by 2003, but this only applies to intra-ASEAN trade. Because the Philippines is committed to extensive tariff reduction, it is one of four APEC economies whose progress against their individual action plan, IAP which includes unilateral, Osaka down payments and the IAP commitments is ahead of the commitments inherent in the Bogor Declaration (PECC, PIDS and the Asia Foundation, 1996). The other three economies in this position are Chile, China and Indonesia.

¹¹ Philippine telecommunications is currently heavily regulated, requiring potential new service providers to meet numerous conditions to obtain licences from the Philippine Congress and the National Telecommunications Commission.

Trade Finance

The lack of an efficient, effective and accessible export financing scheme constrains the growth of the export sector. Export loans from bank foreign currency deposit unit accounts and the central bank are credit-line and collateral based rather than export transaction-based, limiting access to a minority of exporters. Small exporters have particular difficulty obtaining export finance.

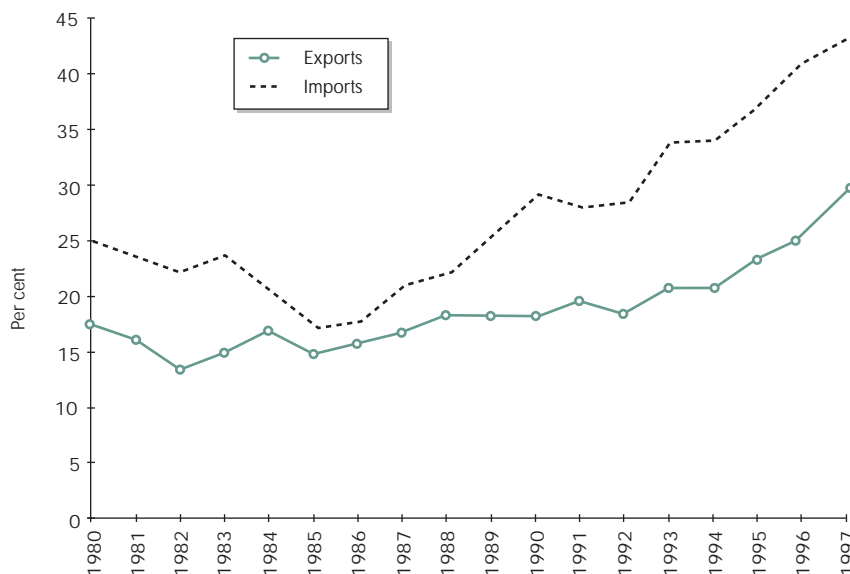
With the peso's large depreciation in the second half of 1997 and early 1998, manufacturers' ability to finance raw material imports in the prevailing high interest rate environment will critically influence the export response to the depreciation. Financing problems are likely to be less where exporters can access foreign credit lines through foreign parent companies or joint venture partners, or where domestic value added is high, reducing imported input requirements.

THE CHANGING PATTERN OF TRADE

Since the mid 1980s, trade reform has substantially increased the ratios of exports and imports to GDP (Figure 3.2). The ratio of imports to GDP has grown faster due to the combination of trade liberalisation and an overvalued peso. Trade reform also has radically changed the commodity composition of imports and exports.

Figure 3.2

Rapidly Opening Economy Ratio of Exports and Imports to GDP, 1980-97 (Per cent)



Source: National Statistical Coordination Board, 1998.

Imports

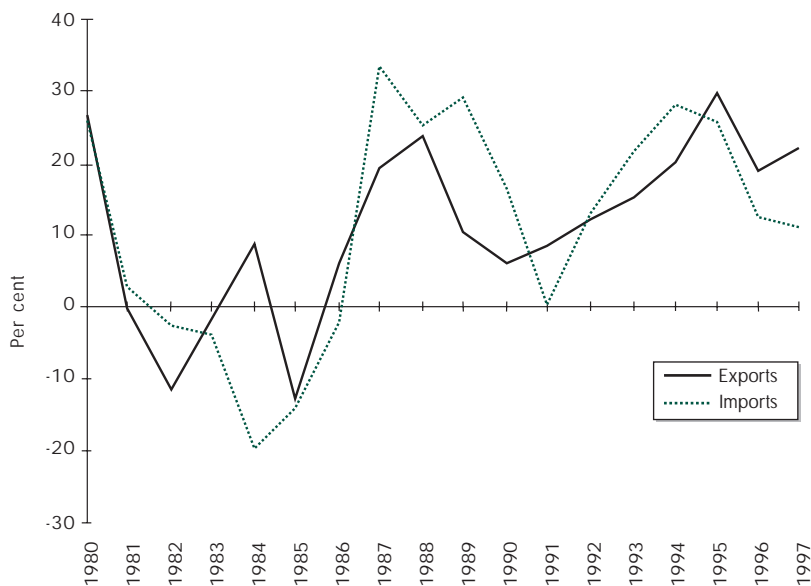
Since the late 1980s, merchandise imports have expanded rapidly except during the recession and energy crisis from 1990 to 1992, growing from US\$5.2 billion in 1986 to US\$35.9 billion in 1997. Import growth of 11 per cent in 1997 represents only a slight slowing from the 12 per cent growth recorded in 1996 (Figure 3.3).¹² Over the next year or two, overall import growth is likely to slow further in response to the substantially depreciated peso.

The key trend in merchandise imports has been the declining share of mineral fuels and the increasing share of non electrical machinery and electrical machinery, apparatus and appliances (Figure 3.4). The strong growth in imports of latter products reflect the economy's on-going recovery and associated investment expenditure in the 1990s, lower tariff protection, rising per capita incomes and growing exports of manufactured products which involve processing manufactured imports.

Figure 3.3

Strong Import Growth since Trade Reform

Annual Growth Rate of Merchandise Exports and Imports, 1980-97 (Per cent)



Source: International Monetary Fund, 1998.

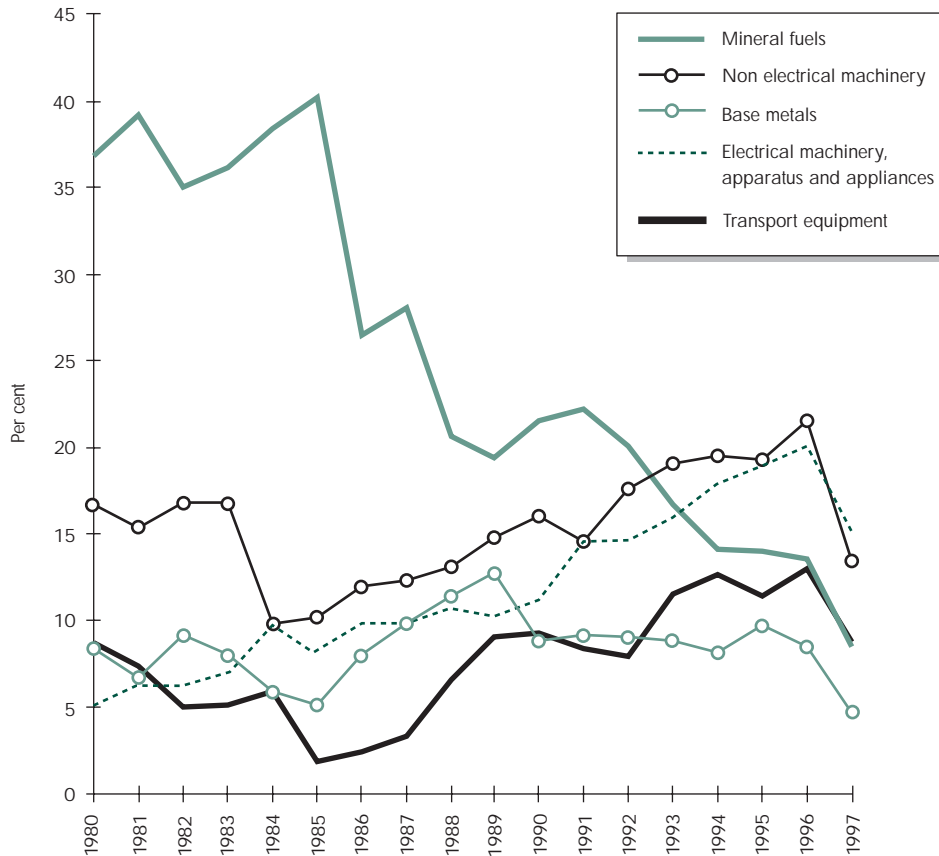
¹² All growth rates reported in this chapter are nominal growth rates, that is they include inflation.

Figure 3.4

Fuel Declining, Capital Goods Growing in Importance

Share of Principal Merchandise Imports, 1980-97

(Per cent)



Note: Transport equipment data only available until 1996. For non electrical machinery, electrical machinery, apparatus and appliances and base metals data was only available until October 1997. Import values for 1997 as a whole are derived by assuming import levels in November and December equal to average monthly levels between January and October. Given that the peso did not start to depreciate until July this is likely to be overstating import growth.

Source: National Statistical Coordination Board, 1998.

Mineral fuel and lubricant imports continue to lose share. However, between 1994 and 1996 their average annual growth rate rose sharply due to faster economic activity (Table 3.4).

Imports of electrical machinery, apparatus and appliances have expanded rapidly (Table 3.4), with their share in total imports increasing from 8 per cent in 1985 to 20 per cent in 1996 (Figure 3.4).¹³ Strong growth has continued into 1997 (Table 3.4). The fastest growing imports in this category include electronics and components, telecommunication equipment, sound recording and reproducing apparatus and equipment, and office and electronic data processing machines. Strong electronic component growth reflects rapid expansion of the export oriented electronics industry. The peso's recent sharp depreciation should stimulate further growth in these export oriented industries which will in turn import additional components; trade finance should be available as mostly these imports are intra-enterprise and export orientation is high. However, the peso's depreciation and slowing economic activity are likely to sharply reduce luxury electronic imports for domestic consumers in the short to medium term.

Table 3.4

Equipment Growth Rapid, Fuel and Food Growth Slower

Growth of Principal Imports, 1980-97^a

Commodity	Average annual value (US\$ million)				Average annual growth rate (per cent)			
	1985- 90	1991- 93	1994- 96	1997	1985- 90	1991- 93	1994- 96	1997
Electrical machinery, apparatus and appliances	592	1 619	3 625	4 850 ^b	29.0	26.8	31.6	15.7
Machinery, except electrical	794	1 873	3 861	5 396 ^b	33.0	39.3	30.1	-3.3
Base metals	567	973	1 682	1 696 ^b	38.3	19.4	26.5	-14.3
Mineral fuels, lubricants and related materials	1 406	2 084	2 646	3 074	8.0	5.6	21.2	-2.8
Food								
Cereals and cereal products	314	340	681	767	16.4	21.2	43.9	-20.2
Dairy products	169	312	395	405	27.1	9.9	11.3	-2.6

Note: a This table focuses on selected Philippine imports. In total these imports represent about half of the Philippines' imports in 1997. b For these commodities 1997 import data are only available until October. Import values for 1997 are derived by assuming import levels in November and December equal average monthly levels between January and October. Given that the peso did not start to depreciate until July, this probably overstates import growth.

Source: National Statistical Coordination Board, 1998.

¹³ In 1997 the share of electrical machinery, apparatus and appliances dropped back to around 15 per cent, although strong import growth continued (Table 3.4).

The average annual value of non-electrical machinery imports increased from US\$794 million between 1985 and 1990 to US\$5.4 billion in 1997 (Table 3.4); their share in total imports rose from 10 per cent in 1985 to almost 22 per cent in 1996 but has fallen back to around 14 per cent in 1997 (Figure 3.4). Imported machinery used in domestic sales oriented industries are likely to be hit by the peso depreciation while imported capital goods for export oriented industries, goods for processing and goods for re-export are likely to increase strongly.

Between 1985-90 and 1994-96, the average annual value of base metal imports increased threefold (Table 3.4). Major imports of base metals include copper, lead, zinc and nickel. In 1997, imports fell by around 14 per cent, mainly because US dollar prices of most metals fell in response to the Asian currency crisis. Trends in imports over the next 12 to 18 months will depend on the end uses of these base metals. Copper, while used domestically, is an essential intermediate input in manufacturing semiconductors, electronic microcircuits, electrical and heavy machinery for export markets so import growth may well continue at high levels. However, zinc imports are largely used domestically in construction, transport and public infrastructure while lead is used primarily in car batteries (Office of the Chief Commodity Analyst, 1997).¹⁴ Import growth in these commodities could weaken over the next 12 to 18 months.

Major food imports include cereals and cereal products and dairy products. Imports of cereal and cereal products have grown rapidly over the last decade or so (Table 3.4). Growth was particularly rapid between 1994 and 1996 due to poor domestic harvests in 1995 (Asian Development Bank, 1996).

Dairy product imports grew more slowly in the 1990s than in the late 1980s (Table 3.4). Food imports, which are largely for domestic use, will be adversely affected by the depreciated peso and prospective slowing of economic activity. However, recently reduced food import restrictions are likely to open up new opportunities over time, as real and nominal exchange rates stabilise and adjust; key liberalisation measures affecting Australian producers are discussed below. A fuller discussion of agricultural trade is included in Chapter 8 - *Agriculture*.

Exports

The value of merchandise exports increased from US\$4.6 billion in 1985 to US\$25.2 billion in 1997. Export growth has accelerated steadily throughout the 1990s (Figure 3.3), driven largely by exports of microcircuits and semiconductors.

The peso's large depreciation since July 1997 is likely to boost exports further. In the short term, areas where import content is lowest and financing problems are least significant will benefit most. However, if a substantial real depreciation can be sustained, cheaper local inputs will create incentives to increase the local content of Philippine exports.

The commodity composition of Philippine exports has changed markedly since the early 1980s (Table 3.5). Traditional resource-based exports of coconut, sugar, forest products, mineral products, fruits and vegetables, abaca and tobacco accounted for about 59 per cent of total exports in 1980. However, because of the growing

¹⁴ The Philippines does not export significant numbers of cars.

population, the overvalued peso, weak world demand and the Philippines' deteriorating international competitiveness in producing these products, the export share and even the export value of these products fell sharply. By 1996, they accounted for less than 9 per cent of total exports.

Between 1980 and 1996, exports of non-traditional manufactures steadily increased their share from 40 to 85 per cent of total exports (Table 3.5). Within this export category, semiconductors and electronic microcircuits, garments and most recently, electrical machinery dominate (Table 3.6). Some domestic analysts are concerned at the high import content and low value added of these industries (Austria, 1995).¹⁵ However, the anti-export bias the overvalued peso created prior to its 1997 depreciation meant export oriented producers had little incentive to source inputs locally; they merely employed competitively priced local semi-skilled and skilled labour to assemble imported components. Peso depreciation should encourage component producers to establish in the Philippines, gradually increasing domestic value added.

Table 3.5

Non-Traditional Manufactured Exports Grow Rapidly Growth of Major Export Categories, 1980-96

Category	Value (US\$ million)				Share of total exports (per cent)			
	1980	1985	1990	1996	1980	1985	1990	1996
Traditional exports	3 431	1 301	1 437	1 831	59.3	28.1	17.6	8.9
Non-traditional manufactures	2 320	2 767	5 995	17 409	40.1	59.8	73.2	84.7
Non-traditional non-manufactures	37	561	754	1 303	0.6	12.1	9.2	6.4
Total	5 788	4 629	8 186	20 543	100.0	100.0	100.0	100.0

Note: Traditional exports include resource based products such as coconut, sugar, forest products, minerals, fruit and vegetables, abaca and tobacco. Non-traditional manufactures include electronics, electrical equipment, garments, chemicals and machinery and transport equipment. Non-traditional non-manufactures are mostly primary commodities and include nickel, bananas, fish, and iron ore agglomerates. Data on non-traditional non-manufactures include special transactions and re-exports.

Source: National Statistical Coordination Board, 1997.

¹⁵ The average local content is only 20 per cent in semiconductors, 25 per cent in simple circuit products and even lower at 15 per cent in more complex products. The bulk of garment exports were made from raw materials consigned from abroad (Austria, 1995).

Table 3.6

Strong Electronics, Electrical Machinery Growth, Slackening Garment Growth

Growth of Principal Exports, 1980-97^a

Commodity	Average annual value (US\$ million)				Average annual growth rate (per cent)			
	1980- 85	1986- 90	1991- 93	1994- 97	1980- 85	1986- 90	1991- 93	1994- 97
Semiconductors and electronic microcircuits	905	1 135	1 652	4 856	11.6	13.9	3.8	37.6
Garments	570	1 292	2 097	2 295	3.5	22.2	10.0	-7.7
Electrical machinery	na ^b	na	na	1 490	na	na	na	34.7

Note: a Export data for 1997 are only available until November. 1997 figures are derived assuming exports in December 1997 equal the monthly average between January and November. b In years marked 'na', exports of electrical machinery were negligible.

Source: National Statistical Coordination Board, 1998.

The average annual value of semiconductor and electronic microcircuit exports increased more than five fold between 1980-85 and 1994-97 (Table 3.6) lifting this category from 11 per cent to 27 per cent of total exports (Figure 3.5).¹⁶ This reliance on semiconductor exports may cause concern as semiconductor technologies are subject to rapid change and new technologies may be more competitively operated in locations with more advanced production, design and supply capabilities (World Bank, 1997).

The finished electrical machinery industry which includes computers and office equipment, quickly became a major export earner in the 1990s. Between 1994 and 1997, annual growth averaged almost 35 per cent (Table 3.6). These exports, accounting for 11 per cent of total exports in 1996, help reduce reliance on semiconductor exports.¹⁷ This sector uses relatively skilled local labour, which is more competitively priced than unskilled local labour (Table 3.7).

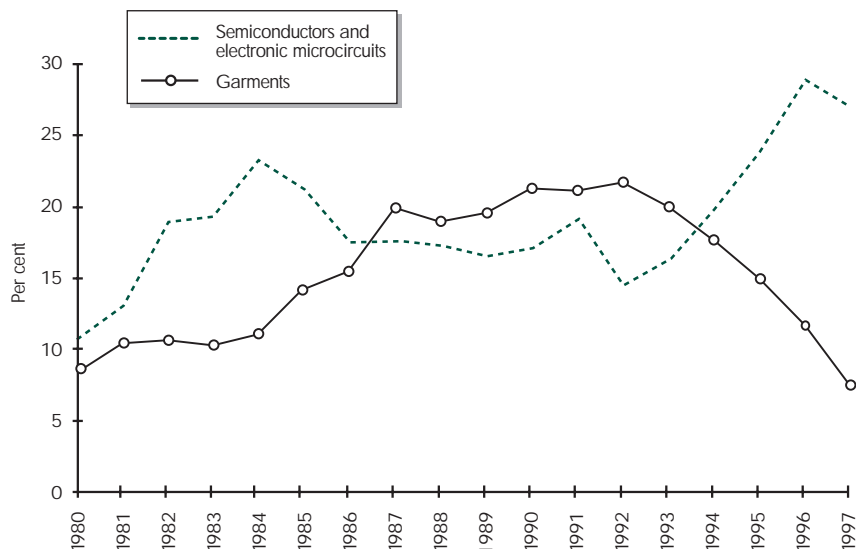
¹⁶ Total exports of all electronic products accounted for 52 per cent of export revenue in 1997.

¹⁷ Exports of finished electrical machinery were 6 per cent of total exports in 1994, 9 per cent in 1995 and 8 per cent in 1997.

Figure 3.5

Electronics Overtake Garments as Major Export

Share of Garments and Semiconductors in Total Merchandise Exports, 1980-97
(Per cent)



Note: All figures for 1997 are until November.

Source: National Statistical Coordination Board, 1998.

Table 3.7

Philippine Wage Levels High Compared to Indonesia, Thailand

Wage Levels in Selected Asian Economies, 1996

Economy	Minimum wage for unskilled labour (US\$/day)	Unskilled labour (US\$/day)	Skilled labour (US\$/day)	Technicians (US\$/month)	Engineers (US\$/month)	Middle management (US\$/month)
Indonesia	0.70-2.85	2.00-3.00	6.10	250	380	560
Malaysia	no minimum wage	7.97	13.28	578	1 395	1 992
Philippines	4.19-5.65	4.00-6.70	7.00-9.17	350-550	650-962	1 076-1 307
Taiwan	28.50	37.50	51.50	1 378	1 568	2 225
Thailand	5.07-6.25	5.12-6.13	6.61-7.28	282-560	584-749	700-1 221
Vietnam	0.78	1.29-1.37	2.15-2.38	100-185	195	220
China	na	2.50 ^a	na	na	na	na

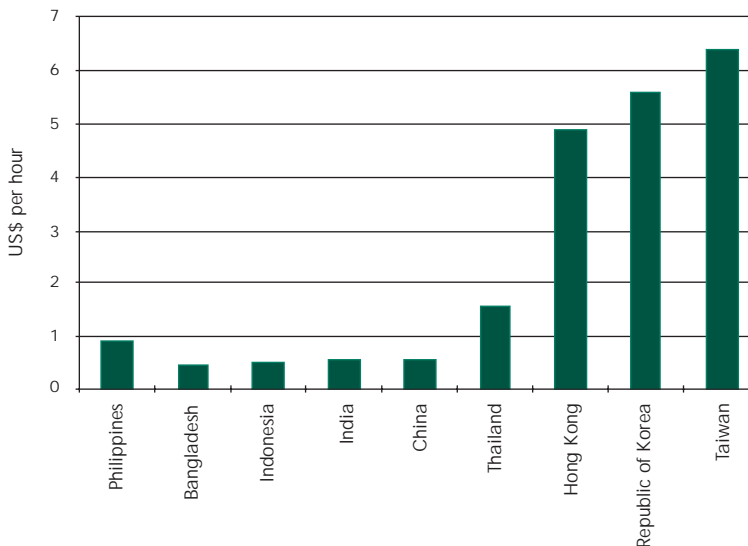
Notes: ^a Average wage of formal sector employees, 1995.

Source: World Bank, 1997; China, State Statistical Bureau, 1997.

Among the major garment products, children's wear and knitted and crocheted outer garments have remained top exports. Garment exports grew strongly from 1986 to 1990 but growth rates have fallen progressively since then (Table 3.6) sharply reducing their export share after 1992 (Figure 3.5). The poor performance of garment exports was due partly to the peso's appreciation prior to 1997 which raised the US dollar price of Philippine labour compared to regional competitors like China, Vietnam and Indonesia (Table 3.7, Figure 3.6). As well, Mexico and the Caribbean countries emerged as new clothing export competitors in the USA, the Philippines' major garments market.¹⁸ The Philippine garment producers who were able to survive did so by raising their capital and labour productivity (Table 3.8).

As the garment industry is very labour intensive, with a constant capital-labour ratio of only US\$100 per employee (Table 3.8), it is an important source of employment. Prior to the peso's 1997-98 depreciation, analysts doubted the garment industry's continued capacity to compete internationally. Maintaining the real depreciation of the peso will be critical to the sector's survival. Reducing the cost of textile inputs is also important. Falling textile industry protection will reduce imported textile costs and create an incentive to restructure and modernise the domestic industry which has poor productivity and antiquated technology due to years of tariff protection. The Government is attempting to assist this process through a program of textile industry technology upgrading to be completed in 1998.

Figure 3.6
Philippine Wages Cost More than Main Competitors'
Labour Cost per Hour, Garments Industry, 1996
(US dollars)



Source: Werner International, 1997.

¹⁸ The emergence of these new competitors in the US market was largely driven by large inflows of US foreign direct investment after the signing of North American Free Trade Agreement, NAFTA (World Bank, 1997).

Table 3.8

**Garments' Productivity Grows Strongly,
Electronics Increasingly Capital Intensive**
Productivity and Factor Intensity of Major Philippine Exports

Commodity	1980	1985	1990	1993
Capital productivity (US\$'000 of value added per US\$'000 of capital expenditure)				
Electrical equipment/parts and telecommunications	5.1	5.8	4.4	3.9
Garments	11.0	21.1	24.4	30.1
Labour productivity (US\$'000 of value added per person employed)				
Electrical equipment/parts and telecommunications	5.3	5.3	10.2	10.6
Garments	1.3	1.5	2.8	4.0
Capital-labour ratio (US\$'000 of capital expenditure per person employed)				
Electrical equipment/parts and telecommunications	1.0	0.9	2.3	2.7
Garments	0.1	0.1	0.1	0.1

Note: Most electrical and electrical equipment/parts and telecommunications are semiconductors and microcircuits.

Source: National Statistical Office, 1995.

DIRECTION OF TRADE

The Philippines' main export markets are the USA and Japan (Figure 3.7). The ASEAN share of total exports rose substantially in the 1990s, reaching 14 per cent in 1997. This rise was due largely to the growing components trade within ASEAN and weak garment exports to the USA. The share of exports going to Japan also rose markedly in 1995 and 1996, in response to rising levels of Japanese foreign direct investment. (See Chapter 4 - *Investment*.) The still relatively low level of exports to ASEAN is important in protecting Philippine exports from the sharp drop in ASEAN imports evident by the end of 1997 due to the regional economic crisis.

The USA and Japan are also the Philippines' most important sources of imports (Figure 3.8). The increasing share of the ASEANs in Philippine imports is more modest than for exports (Figure 3.7 and Figure 3.8).

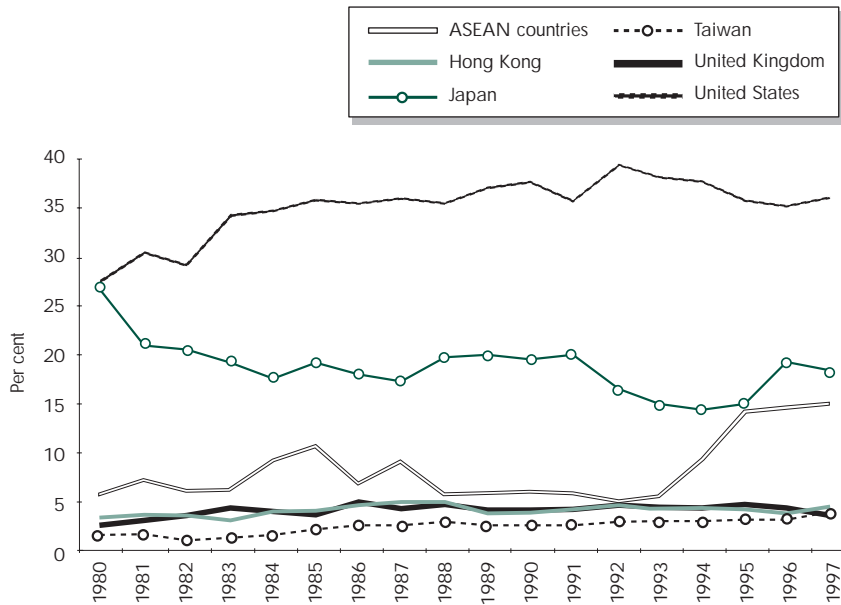
TRADE IN SERVICES

After stagnating between 1990 and 1994, Philippine service imports grew strongly at an average annual rate of over 16 per cent between 1994 and 1996. In the first nine months of 1997, growth was 49 per cent above the corresponding period in 1996. This growth spurt is due largely to faster economic growth and deregulation in the Philippine service sector.

Figure 3.7

ASEAN Export Markets Grow at Expense of USA

Major Markets for Philippine Exports, 1980-97 (Percentage Share)



Note: All figures for 1997 are until November.

Source: National Statistical Coordination Board, 1997.

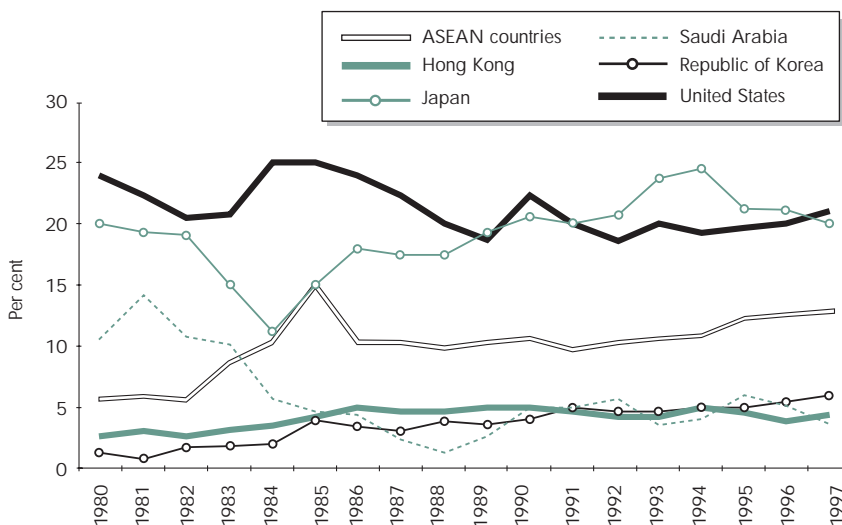
The most important service import categories in the first nine months of 1997 were merchandise freight and insurance, travel and investment expenses (Figure 3.9). Other service imports, including commissions and fees for consultancy and other professional and business services, construction activity by foreign companies in the Philippines and remittances from foreign workers in the Philippines¹⁹ averaged 65 per cent growth between 1994 and 1996, while travel and merchandise freight and insurance also grew strongly with average annual growth rates of 45 per cent and 18 per cent.²⁰

¹⁹ Other services also include government and other travel but they only have shares of around 0.2 per cent each.

²⁰ In the first nine months of 1997, imports of freight and merchandise insurance rose by 14 per cent over the first nine months of 1996 while travel imports rose by 66 per cent and imports of other services rose by 82 per cent. Payments of investment income fell at an average annual rate of 6 per cent between 1994 and 1996.

Figure 3.8

Japan Primary Supplier of Philippine Imports in the 1990s
Major Import Suppliers, 1980-97
(Percentage Share)

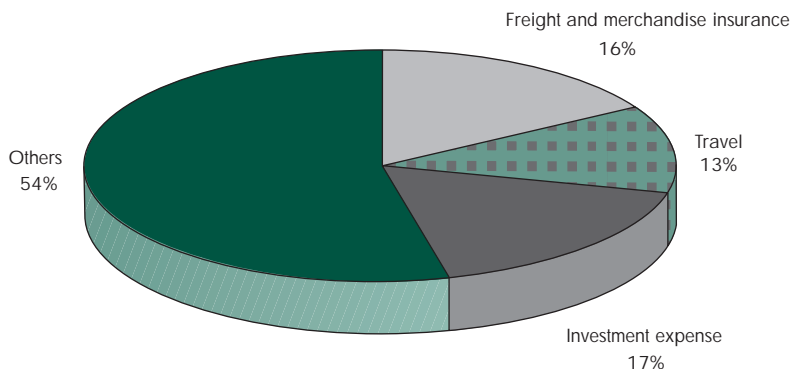


Note: All figures for 1997 are until October.

Source: National Statistical Coordination Board, 1997.

Figure 3.9

Other, Freight, Merchandise, Insurance and Travel
Dominate Service Imports
Philippines Main Service Imports, 1997 (to September)



Note: Other services include commissions and fees, construction activity, remittances from foreign workers in the Philippines, government and other travel.

Source: Bangko Sentral ng Pilipinas, 1998.

Remittances by overseas contract workers dominate Philippine service exports. In the first nine months of 1997, personal income transfers accounted for 24 per cent of service receipts and peso conversions of foreign currency deposit units a further 27 per cent. Including all peso conversions of foreign currency deposit units as service receipts probably overstates their contribution to this export category,²¹ and hence overstates the service trade surplus. (See Chapter 2 - *Macroeconomic Environment*.)

Exports of both travel and freight and merchandise insurance grew at an average annual rate of around 34 per cent between 1994 and 1996 but their share in total services exports remained small at around 8 per cent and 2 per cent respectively in 1996.²²

PHILIPPINE-AUSTRALIAN TRADE

Of the ASEAN 4 (Philippines, Indonesia, Malaysia and Thailand), the Philippines has the smallest share in Australia's total exports and imports (Table 3.9). However, the high growth rate of Australia's exports to the Philippines between 1994 and 1997 reflected Australia's increasing recognition of Philippine opportunities. Given the rapid growth of Philippine imports in recent years, Australia's share of total Philippine imports has been constant at around 3 per cent (Figure 3.10).

Table 3.9

Philippine-Australian Trade Relatively Small but Now Growing Strongly Australia's Trade with the ASEAN 4, 1994-97

Country	Values (A\$million)			Share (per cent)			Growth rate (per cent)
	1994	1996	1997	1994	1996	1997	1994-97
Exports							
Philippines	724	1 133	1 324	1.1	1.5	1.3	21.4
Indonesia	1 977	3 149	3 455	3.1	4.0	3.6	21.3
Malaysia	1 948	2 213	2 352	3.0	2.9	2.6	5.8
Thailand	1 368	1 678	1 647	2.1	2.2	2.0	5.4
Imports							
Philippines	231	283	377	0.3	0.4	0.5	18.2
Indonesia	1 038	1 712	2 267	1.5	2.2	2.7	29.5
Malaysia	1 219	1 705	2 102	1.8	2.2	2.5	18.8
Thailand	876	1 081	1 332	1.3	1.4	1.6	14.1

Source: Department of Foreign Affairs and Trade, STARS data base.

²¹ Some peso conversions from foreign currency deposit units are reverse capital flight reflecting the growing confidence in the economy of residents and Filipinos abroad.

²² In the first half of 1997, exports of merchandise and freight insurance grew by 35 per cent over the first half of 1996, with the equivalent figure for travel being -1.4 per cent.

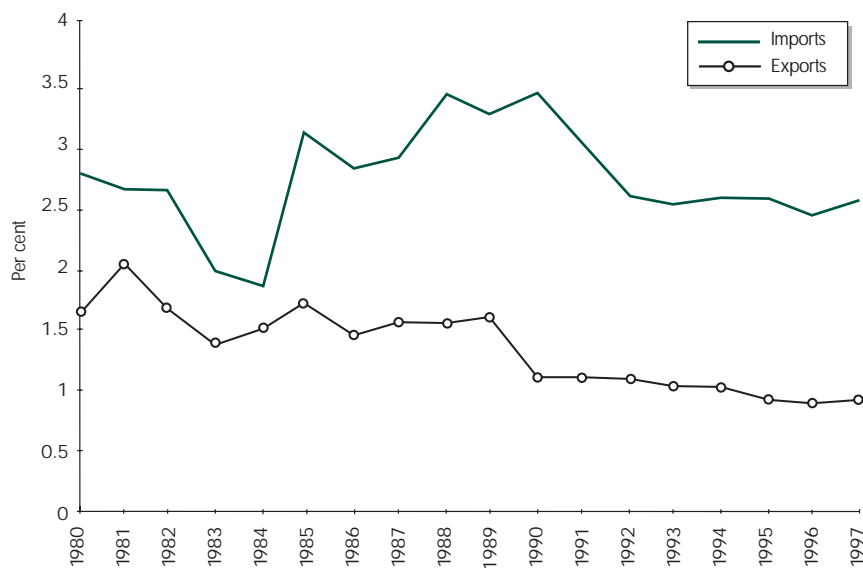
Australia's imports from the Philippines also are well below imports from Indonesia, Malaysia and Thailand, with import growth below that recorded from Indonesia and Malaysia between 1994 and 1997 (Table 3.9). Australia receives only about 1 per cent of total Philippine exports, with this share declining steadily since the early 1980s (Figure 3.10). However, rapid growth of Philippine computer exports may change this situation in future.

Just as the Philippines runs an overall balance of trade deficit, it also runs a balance of trade deficit with Australia (Figure 3.11). Due to the peso's large depreciation, this overall and bilateral deficit is likely to fall considerably over the next one to two years.

Figure 3.10

Australia's Share of Philippine Trade Remains Small

Australia's Share of Philippine Trade, 1980-97
(Per cent)



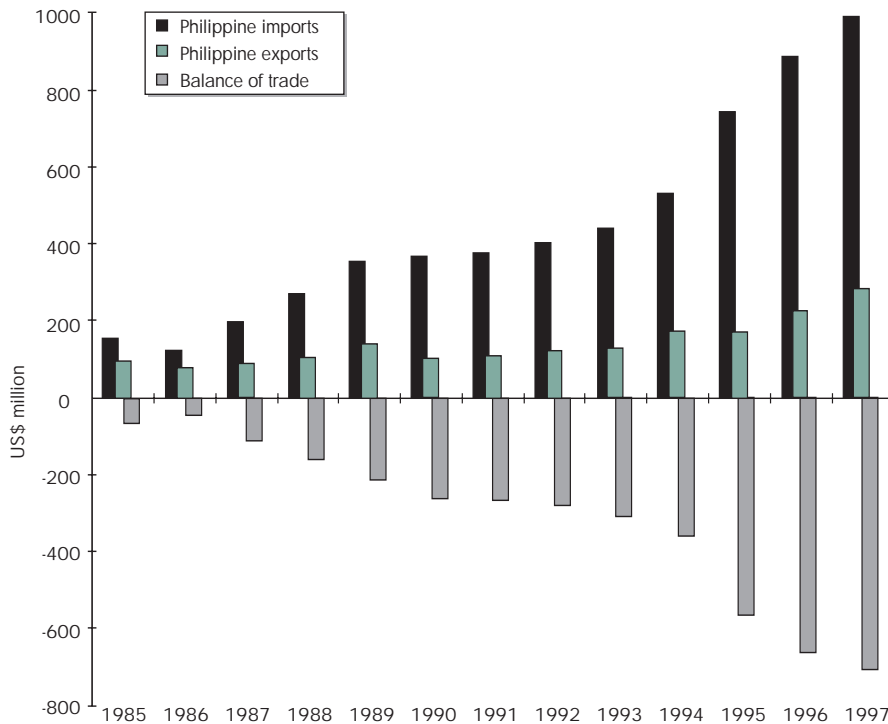
Note: Export and import figures for 1997 are until November and October respectively.

Source: National Statistical Coordination Board, 1997.

Figure 3.11

Bilateral Trade Favours Australia

Australian-Philippine Merchandise Trade, 1980-97 (US\$ million)



Source: Department of Foreign Affairs and Trade, STARS data base.

AUSTRALIA'S EXPORTS TO THE PHILIPPINES

Total Australian exports to the Philippines expanded from US\$155 million in 1985 to US\$983 million in 1997. Growth was most rapid between 1985 and 1990 and 1994 and 1996.²³ In 1997, Australia's exports to the Philippines rose by 11 per cent.

Food and live animals, basic manufactures and machinery and transport equipment dominate Australia's exports to the Philippines, accounting for almost 70 per cent of total exports in 1997. Values of food and live animal exports in 1997 were five times their average values in the second half of the 1980s, while exports of basic manufactures were four times their level then (Table 3.10). From a lower base exports of machinery and transport equipment have also grown rapidly throughout the last decade to become the third most important category of Australian exports.

²³ Between 1991 and 1993, the weak growth in the Philippines associated with the energy crisis reduced overall import growth, including from Australia.

Table 3.10

Food and Basic Manufactures Dominate Australia's Exports
Australian Exports to the Philippines, by Major Categories 1980-97
Average annual value

	Average annual value (US\$ million)				Average annual growth rate (per cent)			
	1985- 90	1991- 93	1994- 96	1997	1985- 90	1991- 93	1994- 96	1997
Total	244	404	719	983	24.8	8.5	29.4	11.0
Food and live animals	77	157	320	379	31.5	20.0	32.2	-5.9
Beverages and tobacco	0	1	1	1	33.3	68.2	13.5	-21.4
Crude materials, excluding fuels	33	27	33	67	33.2	-40.3	16.9	95.0
Mineral fuels	45	19	27	116	-1.5	-42.5	656.2	97.3
Animal and vegetable oil and fats	1	1	2	2	-20.0	113.8	34.2	16.8
Chemicals and related products	18	37	67	73	52.1	8.4	18.3	-3.6
Basic manufactures	41	104	143	163	55.1	6.0	8.0	13.2
Machinery, transport equipment	11	34	80	128	41.1	28.3	35.3	15.1
Miscellaneous manufactured goods	7	10	11	33	10.4	-11.8	25.0	119.3
Goods not classified by kind	11	14	35	21	-1.3	113.9	35.5	-48.0

Source: Department of Foreign Affairs and Trade, STARS data base.

Food and Live Animals

Australia's most important food and live animal exports to the Philippines are milk and cream products. These are followed by live animals, cereal preparations and meat (Table 3.11). Australia is increasingly becoming an important source of imports of these products (Figure 3.12). (See Chapter 8 - *Agriculture*).

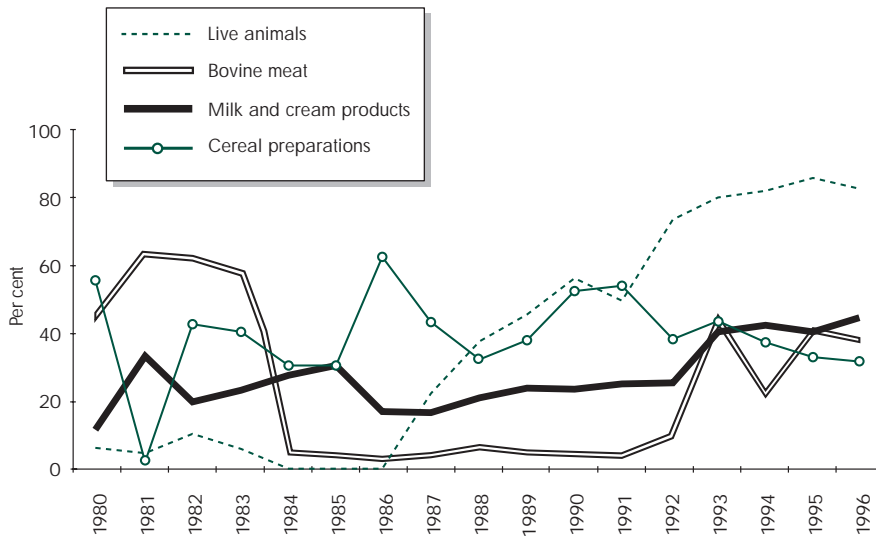
Australian exports of milk and cream products to the Philippines have expanded rapidly over the decade to 1996. Between 1994 and 1996, imports from Australia expanded at twice the rate of those from the rest of the world (Table 3.11), but with the currency crisis, in 1997 imports from both Australia and the rest of the world fell (Table 3.4 and Table 3.11).

Australia's exports of live animals to the Philippines have increased significantly since the mid 1980s (Table 3.11 and Figure 3.12) driven by the importing, especially by agricultural cooperatives, of fattening cattle and breeding stock. Imports of live cattle from Australia (and the rest of the world) have grown faster than the Philippines' beef imports because live cattle imports have much lower tariffs and no quantitative restrictions; whereas, beef imports were tightly controlled. Quantitative restrictions on beef imports are scheduled for abolition in 1998.

Figure 3.12

Australian Share of Meat and Milk Markets Significant

Australia's Share of Total Philippine Food and Live Animal Imports, 1980-96 (Per cent)



Source: Department of Foreign Affairs and Trade, STARS data base.

Australia's share of total Philippine cereal imports declined in the 1990s because of falls in Australian exports of around 29 per cent per year between 1991 and 1993 and growth in the US share of the Philippine cereal market.²⁴

As agricultural imports are largely for domestic consumption rather than reprocessing for export, they are already being negatively affected by the substantially depreciated peso and slowing economic activity. These forces could cause Australia's exports of some agricultural products to the Philippines to fall over the next one to two years. However, beef and live cattle exports appear to be holding up at present.

²⁴ The US share of the Philippine cereal market grew from 8.7 per cent in 1991 to 15.5 per cent in 1995.

Table 3.11

Meat, Live Animals and Copper Exports Growing Strongest Australia's Principal Exports to the Philippines, 1980-97

	Average annual value (US\$ million)				Average annual growth rate (per cent)				Average annual growth in Philippine imports
	1985- 90	1991- 93	1994- 96	1997	1985- 90	1991- 93	1994- 96	1997	
Food and live animals									
Live animals	4.5	19.0	64.0	90.6	276.6	68.8	36.9	18.4	26.0
Bovine meat	1.4	5.6	20.9	39.8	64.7	106.6	72.0	34.7	26.7
Milk and cream products	40.2	78.9	137.5	144.4	26.5	8.9	24.3	-12.2	11.0
Cereal preparations	29.1	29.4	29.3	34.2	28.4	-28.7	11.9	3.6	5.8
Basic Manufactures									
Coal, lignite and peat	17.9	11.5	11.7	48.8	6.7	-18.1	nd	117.1	71.6
Copper	1.0	16.4	46.6	11.5	18.4	193.1	3.5	-75.2	8.0
Aluminium	13.1	16.8	25.1	31.6	58.6	-11.8	6.2	25.2	23.5
Zinc	12.0	15.6	13.7	21.5	39.8	-25.4	21.4	22.2	15.1

Note: nd denotes an undefined growth rate.

Source: Department of Foreign Affairs and Trade, STARS data base.

However, significant additional liberalisation of trade restrictions on agricultural products announced in early 1998 should lead to new and expanded export opportunities in the medium term. In particular:

- fresh, frozen and chilled beef has moved from a quota based system (with a 30 per cent tariff for in-quota imports and 50 per cent tariff for out-of-quota imports) to a tariff only regime with the tariff decreasing from 30 per cent to 10 per cent between 1998 and 2000
- all live cattle imports to the Philippines will now attract a 3 per cent tariff, with the previous 30 per cent tariff on cattle over 330 kilograms being abolished
- scheduled tariff reductions on fruit and vegetables have been accelerated. For example, authorities will reduce the flat 20 per cent tariff rate that would have applied to oranges, mandarins, grapefruit, apples and stone fruit over the next three years to 15 per cent in 1999 and 10 per cent in 2000
- tariffs on cereal preparations have been reduced. For instance, tariffs on roasted cereal preparations which were 30 per cent in 1998 and scheduled to fall to 20 per cent by 2000, will decline to 20 per cent in 1998 and 15 per cent in 2000.

However, from June 1997 to April 1998 the peso depreciated 40 per cent against the US dollar and 27 per cent against the Australian dollar, so these rather modest tariff and non-tariff reductions will do relatively little to prevent inflation of imported food prices. The Philippine tariff and quota regime now provides excess protection for domestic agricultural products; many tariffs could fall further without affecting domestic industry competitiveness. (See Chapter 8 - Agriculture).

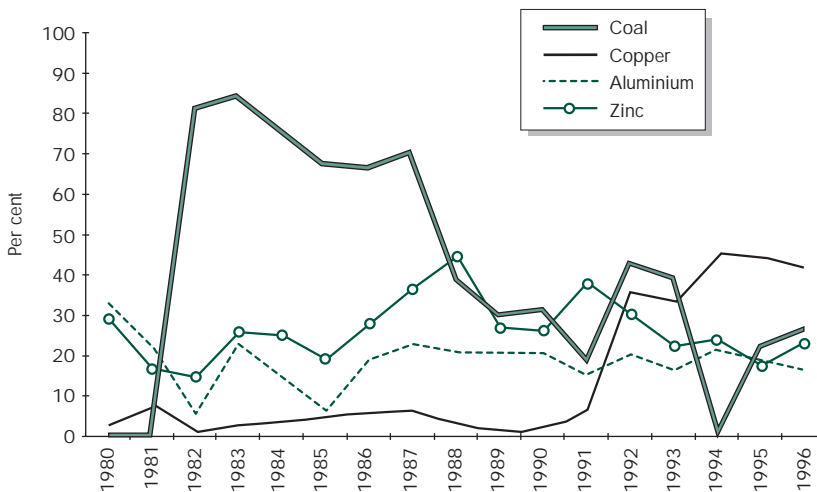
Basic Manufactures

Australia is an important source of imports of basic manufactures such as coal, copper, zinc and aluminium (Figure 3.13). Imports of Australian copper increased dramatically in the early to mid 1990s, with Australia supplying around 50 per cent of Philippine copper imports between 1994 and 1996 (Table 3.11 and Figure 3.13). These increases are primarily due to the closure of Philippine copper mines in the 1990s. In 1997 Philippine imports of Australian copper fell dramatically to US\$11.5 million from an average of US\$46.6 million in the previous three years. As discussed previously, copper use in the export oriented electronics industry should stimulate growth in demand over the next year or two. The challenge will be to rebuild Australia's export levels.²⁵

Figure 3.13

Australia's Share of Coal Market Falling Heavily

Share of Australia in Total Philippine Imports of Basic Manufactures, 1980-96



Source: Department of Foreign Affairs and Trade, STARS data base.

²⁵ In the medium term the Philippines has great potential to reemerge as a substantial copper producer if it can reinvigorate mining investment. (See Chapter 7 - Mining.)

Australia's share of Philippine coal imports has fallen sharply from 60 per cent in the mid 1980s to 25 per cent in 1996. Indonesia has become an increasingly competitive source of coal imports and increased its market share dramatically. The weak Indonesian rupiah, weak domestic demand in Indonesia and the sector's likely access to trade finance due to strong foreign involvement in Indonesia's coal sector are all likely to contribute to increasing Indonesian coal's export competitiveness. Maintenance of the peso's real 1997 depreciation may increase the impetus to expand exploration for natural gas as a medium term substitute for imported coal.²⁶

Australia's share of Philippine aluminium imports remains relatively stable while its share in zinc imports has fallen (Figure 3.13). Australia's exports of these commodities are likely to face weak demand over the next year or two; as discussed previously, end uses of these metals tend to be largely in the domestic economy (Office of the Chief Commodity Analyst, 1997).

Machinery and Transport Equipment

Australian machinery and transport equipment exports have grown the most strongly of all exports to the Philippines over the past decade (Table 3.10). By 1997 they were worth US\$128 million. Telecommunications equipment (both line telephony and cellular 'wireless' technologies) accounted for one third of these exports in 1997. Power generation equipment was another important component.

AUSTRALIA'S IMPORTS FROM THE PHILIPPINES

Australia's imports from the Philippines grew from an average of US\$100 million per year in 1985 to 1990 to US\$211 million per year in 1994 to 1997, with annual growth increasing from 8 per cent between 1985 and 1990 to 19 per cent between 1994 and 1997. Australia's Philippine imports still account for only around 0.4 per cent of Australia's total imports, but the peso's depreciation should spur significant new growth, as should the rapid expansion of major export oriented computer firms like Acer.

The composition of Philippine exports to Australia has changed significantly since the early 1980s. Basic manufactures, miscellaneous manufactured goods and food accounted for the bulk of Philippine exports to Australia in the 1980s while exports of machinery and transport equipment gained importance in the 1990s and were easily the dominant category between 1994 and 1997 (Table 3.12).

Among the imports of machinery and transport equipment, computers, radio-broadcast receivers, telecommunications equipment, electrical distribution equipment, valves and tubes, photocells and microcircuits and other electrical machinery ranked relatively high in terms of their shares in Australian imports from the Philippines (Appendix Table 3.1). Computers registered the highest average annual growth rate in the 1990s (Appendix Table 3.2). However, Australia's share in total Philippine exports of these products remains small (Appendix Figure 3.1). The only exception is exports of other electrical machinery to Australia, which often exceeded 10 per cent of total Philippine exports of these products and occasionally 20 per cent.

.....

²⁶ However, imported equipment would form the bulk of gas field development costs.

Table 3.12

Machinery and Equipment Dominate Australian Imports Australia's Imports from the Philippines, 1980-97

Commodity	Average annual value (US\$ million)			Average annual share (per cent)			Average annual growth rate (per cent)		
	1985- 90	1991- 93	1994- 97	1985- 90	1991- 93	1994- 97	1985- 90	1991- 93	1994- 97
Total	99.6	118.2	211.0	100.0	100.0	100.0	8.4	8.2	19.4
Food and live animals	13.3	14.3	15.2	13.4	12.1	7.2	2.7	3.8	10.7
Beverages and tobacco	0.0	0.7	0.0	0.0	0.6	0.0	2.7	nd	nd
Crude materials, excluding fuels	4.5	5.2	7.3	4.5	4.4	3.5	nd	86.9	6.4
Mineral fuels	2.8	1.6	2.3	2.8	1.3	1.1	nd	nd	nd
Animal, vegetable oil, fat	0.0	0.0	0.0	0.0	0.0	0.0	nd	nd	nd
Chemicals and related products	7.4	8.2	12.9	7.5	7.0	6.1	nd	10.5	10.5
Basic manufactures	19.7	17.7	31.1	19.8	15.0	14.7	10.1	-0.7	9.9
Machinery, transport equipment	9.6	28.4	98.2	9.6	24.0	46.5	6.5	67.7	38.6
Miscellaneous manufactured goods	34.8	37.0	40.1	35.0	31.3	19.0	15.1	-5.7	1.7
Goods not classified by kind	7.5	5.1	3.9	7.4	4.3	1.9	12.7	nd	nd

Note: nd means growth rates are either undefined for the relevant period or of no practical significance because of small, volatile import values.

Source: Department of Foreign Affairs and Trade, STARS data base.

After machinery and transport equipment, the next most important category of imports from the Philippines is miscellaneous manufactures. Among these items, furniture, mattresses, sporting goods, toys and games had the highest share in total exports to Australia (Appendix Table 3.1). The share of furniture and mattresses has declined reflecting a general decline in Philippine exports of furniture due to a ban on logging and bamboo exports which constrains the furniture industry's access to materials. Among sporting goods, toys and games, the Philippines lost its Australian market share to highly price competitive Chinese exporters in the 1990s. China's share of the Australian market in almost all traditional Philippine export categories has expanded rapidly in the 1990s (East Asia Analytical Unit, 1997). The depreciated peso should help the Philippines increase export volumes in these areas over the next year or two, particularly as the Chinese yuan appreciated by almost 10 per cent against the Australian dollar in 1997-98 while the peso depreciated 27 per cent.

PHILIPPINE-AUSTRALIAN SERVICES TRADE

Philippine service imports from Australia rose from US\$6.3 million in 1990 to US\$13.3 million in 1995. However, Australia's share of total Philippine service imports fell from 0.4 per cent to 0.1 per cent over the same period (Table 3.13). Imports of Australian travel rose dramatically to US\$6.6 million in 1995 but will be hit hard by the sharply depreciated peso. Australia's second major service export was other services, which include commissions and fees, remittances and construction activity (Table 3.13).

An area where Philippine service imports from Australia could be expanded is education. Filipinos value education. Australia is relatively close to the Philippines compared to US and British competitors. The current weakness of the Australian dollar relative to the US dollar and the pound sterling makes Australia a more affordable destination. Particular opportunities are likely to exist for the top tier of Australian universities to form linkages with Philippine universities. Colleges of Technical and Further Education will also have opportunities to build linkages into the Philippine educational sector, because of their technical and vocational focus (Hilton-Thorpe, 1997).

Philippine service exports to Australia were worth US\$92.2 million in 1995. These service exports vary considerably from year to year, and consist largely of remittances from contract workers who work as computer programmers and tradespeople in the mining industry.²⁷

Table 3.13

Tourism Is an Important Service Export Australian Service Exports to the Philippines, 1990-95 (US\$ million)

	1990	1991	1992	1993	1994	1995
Total	6.3	4.8	4.9	11.9	7.9	13.3
Insurance	1.9	1.7	1.2	0.0	0.3	0.3
Transport	0.1	0.2	0.2	0.0	0.0	0.0
Travel	2.6	1.4	1.3	1.0	1.8	6.6
Government	0.2	0.0	0.0	0.0	0.1	0.1
Others	1.5	1.5	2.2	10.9	5.7	6.3
Australian share of total Philippine service imports (per cent)						
Total	0.4	0.3	0.2	0.3	0.2	0.1

Note: Others includes remittances, commissions and fees and construction activity.

Source: Bangko Sentral ng Pilipinas, 1997.

²⁷ Philippine service exports to Australia in 1990 were US\$56.2 million, in 1991 were US\$22.3 million, in 1992 were US\$16.1 million, in 1993 were US\$17.5 million, in 1994 were US\$64.3 million and in 1995 were US\$92.2 million.

Table 3.14

Continuing Discrepancy in CEPT and MFN Rates Projected for Food Imports

Philippine CEPT and MFN Rates for Australia's Major Exports
to the Philippines, 1996-2000
(Per cent)

Commodity		1996	1997	1998	1999	2000
Dairy products and eggs	CEPT	9.3	9.1	6.9	6.5	5.9
	MFN	12.7	12.4	9.0	9.0	8.7
Live animals	CEPT	12.1	10.9	8.8	7.4	7.1
	MFN	32.8	29.6	27.7	24.7	24.5
Copper	CEPT	8.9	8.9	6.4	4.9	4.2
	MFN	11.9	11.9	7.9	6.1	5.2
Cereals and cereal preparations	CEPT	10.0	10.0	5.5	5.5	3.4
	MFN	30.1	27.6	24.4	23.4	22.3
Aluminium	CEPT	12.9	11.7	9.4	8.4	5.5
	MFN	19.2	17.8	12.0	10.5	8.7
Iron and steel	CEPT	7.4	7.3	4.7	4.5	4.2
	MFN	7.6	7.4	6.2	5.5	5.3
Coal, coke and briquettes	CEPT	3.0	3.0	3.0	3.0	3.0
	MFN	6.0	4.8	4.8	4.8	3.0
Cotton	CEPT	3.0	3.0	3.0	3.0	3.0
	MFN	3.0	3.0	3.0	3.0	3.0
Zinc	CEPT	7.5	7.5	6.2	6.2	4.8
	MFN	6.8	6.8	6.8	5.8	5.8
TV and radio parts and transmission equipment	MFN	14.3	14.3	7.7	7.7	7.7
	CEPT	5.3	5.3	5.3	5.3	5.7
Power generators (without internal combustion engines)	MFN	3.0	3.0	3.0	3.0	3.0
	CEPT	3.0	3.0	3.0	3.0	3.0

Note: CEPT rates should always be lower than MFN rates. If MFN rates are below CEPT rates, this is because not all tariff lines are included, in all instances in the CEPT and because of differences in the currency of the two sets of data. For instance, the Philippines have included only two-thirds of the lines in the live animals category in the CEPT. The MFN rates are based on Executive Order 465 which was released in January 1998. The CEPT rates are based on the latest available data provided in 1996, but based on 1995 commitments.

Source: ASEAN Secretariat, 1996; Department of Foreign Affairs and Trade, TNAS data base.

IMPACT OF PHILIPPINE AFTA COMMITMENTS ON PHILIPPINE-AUSTRALIAN TRADE

Philippine membership of AFTA and adoption of concessionary tariffs for ASEAN members is unlikely to affect Australia's major exports to the Philippines. While a discrepancy exists between the most favoured nation (for non ASEANs) and common effective preferential tariff rates (for ASEANs) for dairy products and live animals (Table 3.14), ASEAN's share of total Philippine imports of these products is small compared to Australia's share. This indicates a lack of substitution possibilities within ASEAN despite the existence of a preferential tariff. The average share of the ASEANs in Philippine imports of live animals and milk and cream products was less than 2 per cent during 1993 to 1995, while Australia's import share of live animals was over 80 per cent, with the equivalent figure for milk and cream products being 30 per cent.

For coal and aluminium, where ASEAN nations are significant suppliers, the discrepancy between most favoured nation and common effective preferential tariff rates is trivial (Tables 3.14 and 3.15). Among key Australian exports of machinery and transport equipment tariff discrepancies are also trivial (Table 3.14). Only for cereals, where ASEAN nations are significant suppliers to the Philippines will the marked discrepancy between the two rates negatively affect Australian exports. However, large recent depreciations of other ASEAN currencies will have far stronger effects on Australian competitiveness in the Philippines than the common effective preferential tariff.

Table 3.15

Except Coal, Few Major Australian Exports Compete with ASEAN ASEAN's Share of Total Philippine Imports, 1993-95 (Per cent)

Commodity	Share
Live animals	1.45
Milk and cream and milk products	1.66
Butter and other fats and oils derived from milk	5.08
Cheese and curd	0.42
Cereals, unmilled	0.19
Wheat and meslin flour and meal	0.29
Other cereal meals and flours	11.41
Cereal preparation	8.75
Coal	44.29
Aluminium	16.29
Zinc	4.39

Source: Pineda, 1997.

CONCLUSIONS AND OUTLOOK

Philippine openness to international trade flows has increased substantially since the mid 1980s. Trade reforms have considerably reduced diverging effective rates of protection across sectors, although exports are still penalised by low and often negative protection.

Both exports and imports have expanded considerably as a share of gross domestic product. The key trend in merchandise imports is the declining share of mineral fuels and the increasing share of non-electrical and electrical machinery, apparatus and appliances. The peso's large depreciation in the second half of 1997 and early 1998 makes imports more expensive. A key factor affecting import growth over the next one to two years will be whether imports are for final use in the domestic economy or for use in export oriented industries.

The main factor driving export growth is rapidly expanding exports of semiconductors and microcircuits. Over time, if the peso's real depreciation can be maintained, this will create incentives to increase the value added in Philippine exports.

Australia's bilateral trade with the Philippines is small compared to trade with Indonesia, Malaysia and Thailand. However, between 1994 and 1997, this trade was growing fast, particularly on the export side. Australia's exports to the Philippines are dominated by food and live animals, and basic manufactures, such as copper, coal, zinc and aluminium. The next most important category is machinery and transport equipment, with overall exports of these products growing rapidly throughout the last decade. Agricultural exports, which are largely for Philippine domestic use, are likely to be affected adversely by the peso's depreciation and slower economic activity. However, over the medium term, new and expanded opportunities are likely to arise, resulting from recent liberalisation of trade restrictions on agricultural products. Australia's imports from the Philippines are likely to increase strongly in response to the peso's depreciation and increased competitiveness of Philippine exporters against Chinese and Latin American competitors.

APPENDIX 3.1

ADDITIONAL DATA ON AUSTRALIA'S IMPORTS FROM THE PHILIPPINES

Appendix Table 3.1

Computers, Electrical Components and Equipment Gaining Significant Market Shares

Market Shares of Philippine Exports in Total Australian Imports, by Commodity, 1992-97

Commodity	Value (US\$ million)					Per cent share of Philippine imports in total Australian imports				
	1992	1994	1995	1996	1997	1992	1994	1995	1996	1997
Fruit and nuts, fresh or dried	7.6	4.3	4.8	5.2	5.6	6.2	2.6	2.8	2.3	2.0
Crude vegetable materials	2.4	3.7	4.4	7.1	6.2	2.0	2.2	2.5	3.2	2.2
Computers	8.3	7.0	4.7	13.3	35.5	6.8	4.1	2.7	6.0	12.7
Radio broadcast receivers	1.4	6.7	6.6	2.8	1.2	1.1	3.9	3.8	1.3	0.4
Other Telecommunications equipment	7.4	5.9	5.9	6.6	7.4	6.1	3.5	3.4	3.0	2.6
Electricity distributing equipment	0.0	18.7	37.7	41.7	32.3	0.0	11.1	21.9	18.7	11.5
Photocells and microcircuits	3.7	5.5	9.4	20.7	20.2	3.0	3.3	5.5	9.3	7.2
Electrical machinery	5.4	5.9	6.3	6.6	4.1	4.5	3.5	3.7	3.0	1.4
Furniture and mattresses	8.1	10.4	11.4	10.4	13.1	6.7	6.2	6.6	4.7	4.7
Sporting goods, toys and games	5.8	5.5	4.5	6.1	3.9	4.8	3.2	2.6	2.7	1.4

Source: Department of Foreign Affairs and Trade, STARS data base.

Appendix Table 3.2

Principal Philippine Exports to Australia, 1980-97

Commodity	Average annual value (US\$ million)			Average annual growth rate (per cent)
	1980-84	1985-90	1991-97	1990-97
Food and live animals	12.4	13.3	14.8	3.6
Fruits and nuts, fresh or dried	7.8	6.2	6.0	-3.2
Crude vegetable materials	0.0	0.4	4.0	18.4 ^a
Machinery and transport equipment	6.2	9.6	68.2	44.8
Computers	0.0	0.1	11.5	52.9
Radio broadcast receivers	0.0	0.4	3.5	8.5
Telecommunications equipment	0.0	1.4	6.1	12.1
Electricity distributing equipment	2.1	0.9	18.6	19.6 ^b
Photocells and microcircuits	0.4	1.9	9.3	41.6
Electrical machinery	0.7	3.7	5.3	2.8
Miscellaneous manufactures	33.2	34.8	38.8	0.6
Furniture and mattresses	5.6	7.0	9.5	8.1
Sporting goods, toys and games	3.8	3.6	5.3	-1.0

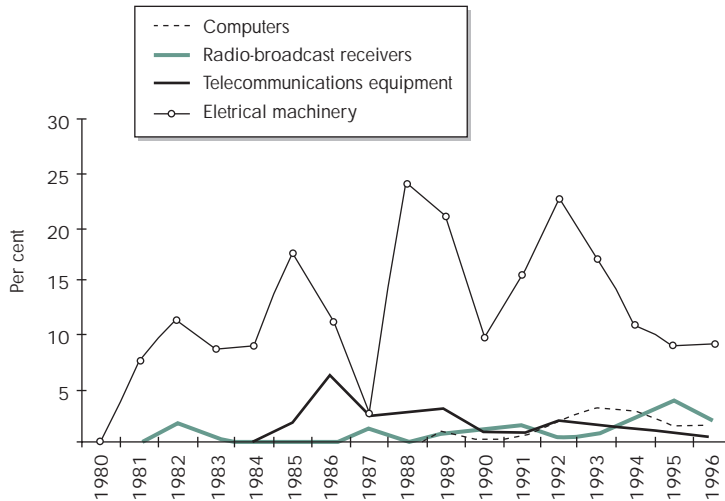
Note: a is the growth rate from 1992 to 1997; b is the growth rate from 1994 to 1997.

Source: Department of Foreign Affairs and Trade, STARS data base.

Appendix Figure 3.1

Australia Not Yet a Major Market, but Electrical Machinery Has Major Potential

Share of Australia in Total Philippine Exports of Machinery and Equipment, 1980-96 (Per cent)



Source: Department of Foreign Affairs and Trade, STARS data base.

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Chapter 4

FOREIGN DIRECT INVESTMENT IN THE PHILIPPINES

The Philippine Government has significantly reformed the environment for foreign investors during the last decade, reinforcing trade liberalisation to help create more contestable and efficient markets. While liberalised investment policies have built business confidence in the Philippines, foreign investment inflows are still well below those of regional neighbours. Maintaining strong inflows of foreign direct investment, FDI, will be vital if the Philippines is to attract the advanced management skills, technology and marketing knowledge it needs to sustain and build on its 1990s economic performance.

This chapter examines reforms in the FDI regime and recent trends in incoming FDI, analyses opportunities resulting from peso depreciation and resource reallocations within ASEAN, and examines Australian FDI in the Philippines. It also describes available investment incentives and examines aspects of their effectiveness.

FOREIGN INVESTMENT REGIME

Prior to 1991, eligibility for 100 per cent foreign equity was subject to approval by the Board of Investments. The Foreign Investment Act of 1991 allowed up to 100 per cent foreign equity participation except in all sectors except those specified on the foreign investment negative list. In 1996, further legislative change allowed greater foreign participation in previously prohibited sectors.

Restrictions on foreign direct investment now are limited to two areas:

- areas reserved wholly or partially for Filipino nationals by the constitution or specific legislation. Notable industries covered by these restrictions include mass media, various professional services, many infrastructure sectors, small scale mining, distribution and retailing
- areas restricted by defence, risk to health and morals, and protection of local small and medium scale industries. Activities covered by these restrictions include manufacturing firearms and gunpowder, running sauna and steam bathhouses, gambling and operating small businesses with paid in capital of less than US\$200 000 which export less than 60 per cent of their output.¹

The constitution guarantees foreign investors freedom from expropriation and requisition of investment. Provided foreign investments are registered with the Bangko Sentral ng Pilipinas, the constitution also guarantees full and immediate repatriation of capital and dividend remittance.

¹ Small businesses which export less than 60 per cent of their output but which use advanced technology or have at least 50 direct employees may have a minimum paid in capital of US\$100 000.

ECONOMIC AND POLITICAL INFLUENCES

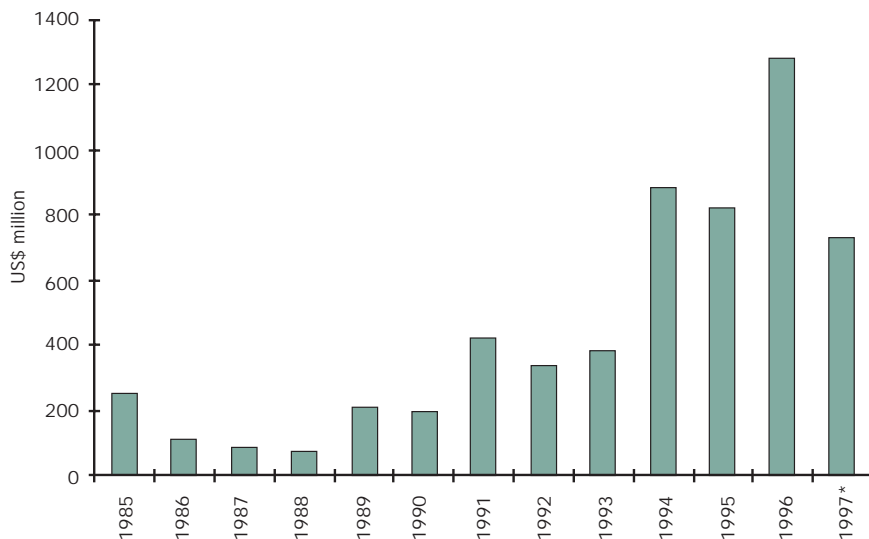
In the 1990s, improved policy in several key areas increased the attractiveness of the Philippines to foreign investors, including:

- increasing political stability under the Ramos administration (see Chapter 1 - *Development Policies*)
- lowering tariffs and removing other barriers to trade (see Chapter 3 - *Trade*)
- strengthening and improving macroeconomic fundamentals (see Chapter 2 - *Macroeconomic Environment*)
- introducing new laws, such as the Mining Act and the Build Operate Transfer law which were seen as pro-business.

The main strengths of the economy, including its relatively low cost, English-speaking skilled labour force and other aspects of the business environment are considered in Chapter 5 - *Business Environment*.

In the past, much FDI operated behind high tariff barriers, but in the 1990s with falling tariffs, this has not been an important incentive. As a result of past policies, a strong foreign presence remains in industries that were highly protected, especially Japanese direct investment in automotive manufacturing.

Figure 4.1
Sharp Rise in FDI Inflows since 1994
 FDI in the Philippines, 1985-97
 (US\$ million)



Note: * January to September 1997 only.

Source: Bangko Sentral ng Pilipinas, 1997.

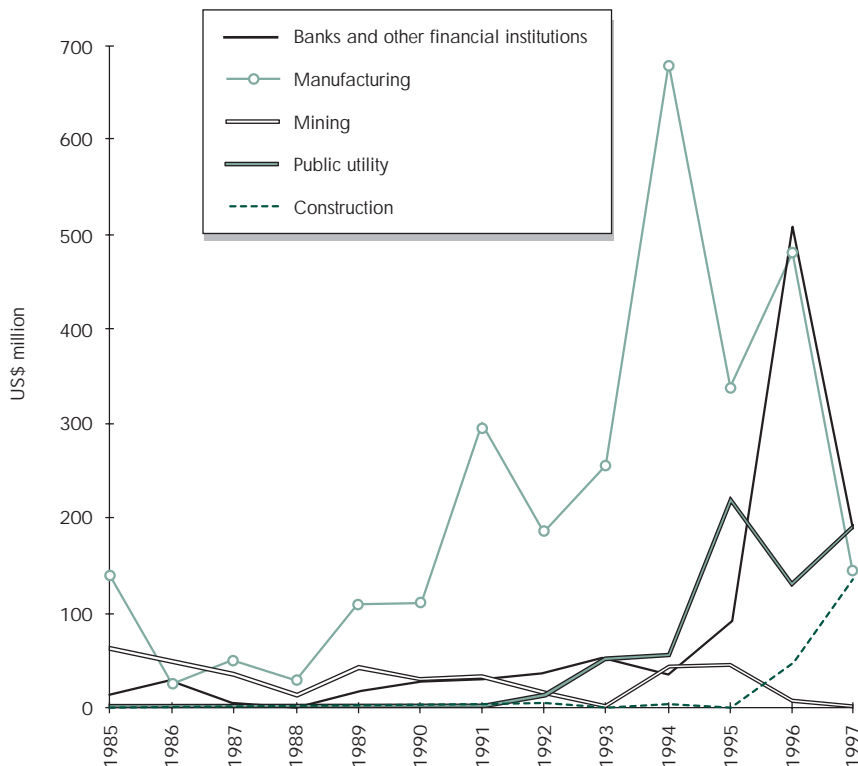
TRENDS IN FOREIGN DIRECT INVESTMENT

While growth in FDI was low in the 1980s through to the early 1990s, investment accelerated sharply after 1993 (Figure 4.1). FDI jumped from US\$378 million in 1993 to US\$1.3 billion in 1996. In the first nine months of 1997, FDI stood at US\$725 million. FDI grew at an average annual rate of 43 per cent between 1993 and 1996. By 1996 the share of FDI in total investment in the Philippines was 6.6 per cent, higher than at any time since the mid 1980s.

Sectoral Allocation

Manufacturing investment led the FDI recovery with a strong and reasonably sustained rise from 1990 to 1996 (Figure 4.2). Over this time, the sector attracted about 55 per cent of total FDI inflows. In 1997, manufacturing FDI appears to have fallen substantially, with only US\$139 million worth of inflows in the first nine months of the year.

Figure 4.2
Manufacturing and Financial Sectors Attract Most FDI
 FDI by Sector, 1985-97
 (US\$ million)



Note: 1997 data are for January to September only.

Source: Bangko Sentral ng Pilipinas, 1997.

MEASURING FDI IN THE PHILIPPINES

Board of Investments Data

The Board of Investments regards FDI as equity acquired by nonresidents and nonresident nationals. It does not include investment in the export processing zones and special economic zones.

Board of Investments data offer a highly disaggregated classification: data by country are disaggregated by industry. Also Board of Investments data distinguish between export and domestically oriented FDI.

However, Board of Investments data only pick up FDI registered with the Board of Investments. The data do not account for disinvestment and assume all approved projects are implemented.

Bangko Sentral ng Pilipinas

The Bangko Sentral ng Pilipinas defines FDI as foreign equity acquired by nonresidents (not nonresident nationals). All foreign equity investment registered with the Bangko Sentral ng Pilipinas is included, including investments not registered with the Board of Investments because investors did not use available fiscal incentives.² The Bangko Sentral ng Pilipinas data are classified by sectors and source country, although data on FDI by country are not classified by sector.³

Where possible this chapter uses Bangko Sentral ng Pilipinas data because they account for disinvestments and have a more comprehensive coverage. By necessity Board of Investments data are used for information on the sectoral composition of Australian FDI in the Philippines and in analysing the investment incentive system.

Reforming the banking industry and liberalising the overall FDI environment resulted in steadily increasing investment in banks and other financial institutions between 1990 and 1995. FDI surged in 1996 as expenditure by newly established foreign financial institutions peaked, particularly as new banks built up their capital asset bases (Figure 4.2). Probably because this was a one off event, FDI in finance and banking appears to have fallen substantially in 1997; however, FDI for the first nine months of 1997 is well above pre 1996 levels (Figure 4.2).

FDI in public utilities increased dramatically from 1992 and remained strong in 1997 with booming infrastructure investment, particularly to meet power shortages (Figure 4.2). Given continuing infrastructure sector reforms, prospects for future growth in FDI remain good. (See Chapter 6 - *Infrastructure*.)

² Registration of foreign investments with the Bangko Sentral ng Pilipinas will guarantee full and immediate repatriation of capital and remittance of dividends; this strongly encourages registration.

³ This FDI data differs slightly from that presented in Chapter 2 (which is also from the Bangko Sentral ng Pilipinas). The data used in Chapter 4 are used because they classify FDI by sector and country while the data used in Chapter 2 only classify FDI by country. The differences arise because of differences in sources and differences in reference periods. The data in Chapter 4 are based on registration statistics while the data in Chapter 2 are based on bank reports. The data in Chapter 4 take the date of registration as the reference period while the data in Chapter 2 use the date of deposit of funds in banks as the reference period.

FDI in construction was negligible before 1996, rose to US\$45 million in 1996, then surged to US\$133 million in the first nine months of 1997. Most FDI is in new construction projects (Wallace, 1998). This indicates that foreign investors still see opportunities in the Philippine construction sector; occupancy rates are quite high and depreciation makes Philippine assets cheaper for foreign investors.

In the second half of the 1980s, the mining sector was the second biggest FDI recipient after manufacturing (Figure 4.2). FDI in mining spiked to around US\$40 million in 1994 and 1995, a result of the new mining law, but increased investment was not sustained because of growing doubts about the administration's ability to implement the new mining investment regime. (See Chapter 7 - *Mining*.) Mining law reform has lagged considerably behind reforms in sectors like banking and infrastructure.

Within manufacturing, the key growth sector is electrical and electronic products, although its share of total FDI varies annually due to the lumpiness of big new investments (Table 4.1). In contrast, the FDI share of chemical and chemical products has decreased substantially and textiles' share is now minuscule. These shifts in FDI shares largely reflect profitability changes as tariff protection is removed. The large FDI share in petroleum and coal in 1993 and 1994 resulted from privatising the formerly government owned oil company, Petron.

Table 4.1

Electronics Dominates Manufacturing FDI
Share of Selected Industries in Total FDI, 1985-97
(Per cent)

Sector	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997 ^a
Chemicals and chemical products	11.1	26.2	19.5	13.7	9.9	8.4	10.8	8.7	9.2	3.6	4.4	4.1	3.1
Food	24.7	0.2	5.4	2.5	3.7	8.0	2.1	6.7	4.7	1.4	1.3	1.5	1.9
Textiles	1.2	1.6	2.0	5.8	4.1	4.8	3.5	5.1	1.7	0.5	1.5	0.2	0.2
Transport equipment	9.6	na	3.6	0.0	2.7	3.8	5.2	12.2	3.6	0.6	6.5	2.8	2.4
Petroleum and coal	0.9	2.1	1.1	0.0	0.0	0.0	3.0	0.0	34.2	63.7	5.4	0.0	0.1
Metal and metal products	0.1	1.4	0.1	0.1	0.4	0.8	3.4	2.2	1.1	0.9	2.9	4.9	1.8
Electric and electronic products	1.8	1.4	5.3	3.7	23.9	13.1	40.7	16.6	6.8	4.3	16.3	12.3	5.9

Note: ^a January to September 1997 only; na means a figure was not available.

Source: Bangko Sentral ng Pilipinas, 1997.

Likely Post Depreciation Trends

Peso depreciation is likely to encourage increased FDI in export oriented manufacturing projects; industries with lower import content will be particularly attractive. If the peso's depreciation is maintained in real terms, over time it will encourage greater local content in new and existing operations. New investments could be expected by component manufacturers associated with the major electronics assembly plants now locating in the Philippines, as is occurring in Malaysia and China. Maintaining a substantial real depreciation will also reduce US dollar wage costs and thus increase the Philippines' attractiveness for FDI in unskilled labour intensive exportables like garments and footwear.

If the Government can restore confidence among the international mining community by resuming the reform process, export oriented mining FDI would also benefit. Within the infrastructure sector, the critical factors affecting FDI growth will be maintaining stable policy regimes that minimise investor risk and maintaining public support by protecting consumer interests (See Chapter 6 - *Infrastructure*.)

Agricultural and agri-business FDI also could increase with the peso's depreciation if agricultural trade reform is accelerated, underpinning the viability of labour intensive activities like livestock raising and agri-processing and land reform issues are resolved, particularly in plantation agriculture. (See Chapter 8 - *Agriculture*.)

PHILIPPINE AND ASEAN FDI COMPARED

While Philippine FDI grew rapidly from a low base in the 1990s, its share of the total FDI of developing member countries⁴ of the Asian Development Bank continues to be the smallest of the ASEAN-4⁵ (Figure 4.3). The Philippines also has the smallest per capita FDI among the ASEAN-4 (Table 4.2).

Table 4.2

Philippine FDI Inflows Growing Rapidly, from a Low Base Per Capita FDI, ASEAN-4, China 1985-95 (US\$ million)

Country	1985	1990	1995
Philippines	0.2	8.5	21.0
Indonesia	1.9	6.1	22.3
Malaysia	44.3	131.4	288.6
Thailand	3.2	43.8	34.8
China	1.6	3.1	31.5

Source: Asian Development Bank, 1997; East Asia Analytical Unit, 1997a.

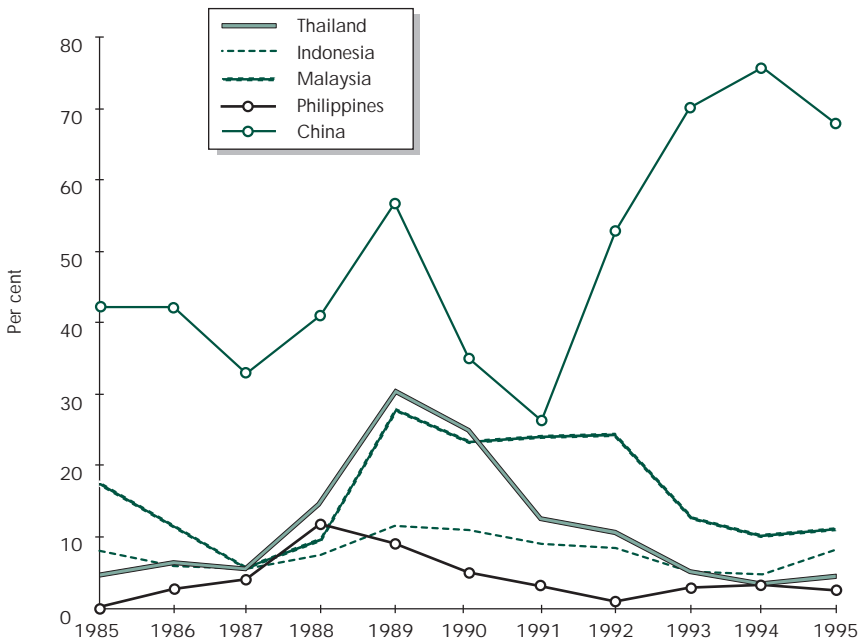
⁴ Developing member countries of the Asian Development Bank include those with per capita GNP in 1995 ranging from US\$695 to US\$2 017.

⁵ The ASEAN-4 comprises Indonesia, Malaysia, Philippines and Thailand.

Figure 4.3

Philippine FDI Share Still the Lowest

Share in Total FDI to Developing Member Countries of ADB, 1985-95
(Per cent)



Source: Asian Development Bank, 1997.

Much of the increase in the FDI share of Thailand, Malaysia and Indonesia in the late 1980s resulted from rapidly growing Japanese FDI after the yen appreciated following the Plaza Accord of 1985. The Philippines largely missed out on this growth because of continued political uncertainty with the 'people's power' revolution in 1986 and a series of coups during the Aquino administration and the high cost of unskilled labour. Having missed this opportunity, in the 1990s the Philippines (and other nations) have faced much greater competition from China (Figure 4.3).

With economic reforms in the 1990s, the Philippines attracted increased FDI to its electrical and electronic product sectors as wages increased in Singapore, Malaysia and Thailand. In these three economies the electrical and electronic product sector's share in total manufacturing FDI fell from the late 1980s (Table 4.3). Other industries where the higher income ASEAN economies of Singapore, Thailand and Malaysia have lost competitiveness and where their FDI flows have fallen in relative terms include food and beverages and textiles (Table 4.3). While the 1997-98 depreciation of the Thai baht, Malaysian ringgit and Singapore dollar will slow the loss of competitiveness in these economies, the peso's depreciation should maintain the Philippines' relative advantage against these economies, and increase it against those of China, Hong Kong, Taiwan and Latin America.

Table 4.3

Share of FDI in Electronics Falls in Singapore, Thailand and Malaysia

Share of Manufacturing FDI by Industry in Singapore, Indonesia, Thailand and Malaysia

	Singapore		Indonesia		Thailand		Malaysia	
	1987-90	1991-93	1987-90	1991-93	1987-90	1991-93	1987-90	1991-93
Food and beverages	4.9	2.0	4.2	5.6	7.4	6.5	5.5	2.5
Textiles	0.3	0.3	13.8	11.8	6.3	4.1	5.1	6.3
Paper and paper products	3.3	2.8	17.5	13.1	na	na	2.4	1.1
Petroleum	9.9	6.2	na	na	7.0	9.6	12.1	27.9
Chemical products	8.7	21.7	43.0	34.0	13.3	16.9	4.0	13.4
Electric and electronic products	45.7	37.4	6.4	21.7	36.7	30.8	28.8	13.7
Transport equipment	4.1	6.1	na	na	na	na	1.3	1.8
Others	23.1	23.5	15.1	13.8	29.3	32.1	40.8	33.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: na means not available.

Source: Takeuchi, 1995.

Furthermore, Thailand's financial sector problems and Indonesia's political uncertainty and extremely large currency depreciation may increase the Philippines' relative attractiveness as an FDI destination within ASEAN. If the Philippines can maintain the depreciation induced boost to its competitiveness, it probably can increase its share of FDI flows relative to these other ASEAN nations.

SOURCES OF FOREIGN DIRECT INVESTMENT

While the USA dominated Philippine FDI inflows in the second half of the 1980s, its share fell substantially in the 1990s.⁶ Since the mid 1980s, FDI from Japan has grown dramatically, replacing the USA as the major investor (Table 4.4).

Between 1993 and 1996, average FDI inflows from Hong Kong, the Netherlands, the UK and Taiwan all increased dramatically compared to 1990-92, although this strength did not continue into 1997 (Table 4.4).⁷ FDI by the Republic of Korea

⁶ The absolute value of US FDI inflows actually declined over the second half of the 1980s.

⁷ Between 1993 and 1996, average FDI inflows were US\$161 million from the Netherlands, US\$96 million from Hong Kong and US\$76 million from the UK. Between 1990 and 1992 the equivalent figures were US\$4.0 million, US\$28.0 million and US\$8.6 million.

actually fell between 1993 and 1996 relative to 1990-92. While the Republic of Korea increased its FDI in 1997, over the next year or two this is likely to lessen due to the sharply depreciated won and financial difficulties being experienced by Korean companies.

One factor causing US FDI to decline in the 1990s was the US-Caribbean and North American Free Trade Area, NAFTA, trade agreements that diverted investments from the Philippines to the Caribbean and Latin America (Austria, 1996). This particularly affected the garments industry as the USA is the Philippines' major export market.

Also causing the decline in the US investment share was the peso's appreciation in the 1990s. Historically, a real appreciation reduces US FDI to the Philippines, while a real depreciation attracts it (Aldaba, 1994, p. 59). However, the potential to increase US FDI after the recent peso depreciation depends on how much the NAFTA and US-Caribbean trade agreements divert investment from the Philippines.

Increased Japanese FDI stems primarily from the rapidly appreciating yen up to mid 1995, labour shortages, surging wage rates and continued high cost structures which pushed Japanese firms to operate overseas (Urata and Tullao, 1995; East Asia Analytical Unit, 1997b). The ongoing financial difficulties in Japan and the yen's depreciation against the US dollar may weaken Japanese FDI over the next few years but over the medium to long term, underlying optimism about business opportunities in the Philippines is likely to drive further increases in Japanese FDI.

Hong Kong's FDI rose between 1993 and 1996, driven by uncertainty regarding the handover to China, while Dutch FDI was strong, largely due to oil industry reform; Shell invested almost US\$550 million in 1994 to purchase privatised assets of the national oil company.

Table 4.4
Japan Replaces the USA as Dominant Investor
FDI by Source, 1985-97

	Average annual values (US\$ million)				Average share (per cent)			
	1985-89	1990-92	1993-96	1997 ^a	1985-89	1990-92	1993-96	1997 ^a
USA	82.4	61.3	115.0	36.2	57.4	19.6	13.7	5.0
Japan	23.2	132.5	208.0	274.3	16.1	42.3	24.8	37.8
Hong Kong	9.4	28.6	95.6	22.8	6.5	9.1	11.4	3.1
Netherlands	7.9	4.1	161.0	21.9	5.5	1.3	19.2	3.0
UK	4.6	8.6	75.8	14.6	3.2	2.8	9.0	2.1
Republic of Korea	0.4	18.8	11.8	17.0	0.3	6.0	1.4	2.3
Taiwan	3.2	5.5	15.3	19.6	2.2	1.8	1.8	2.7
Australia	3.1	4.1	7.1	12.3	2.1	1.3	0.8	1.7
Other	9.5	49.6	149.6	306.4	6.7	15.8	17.9	42.3

Note: ^a January to September only.

Source: Bangko Sentral ng Pilipinas, 1997.

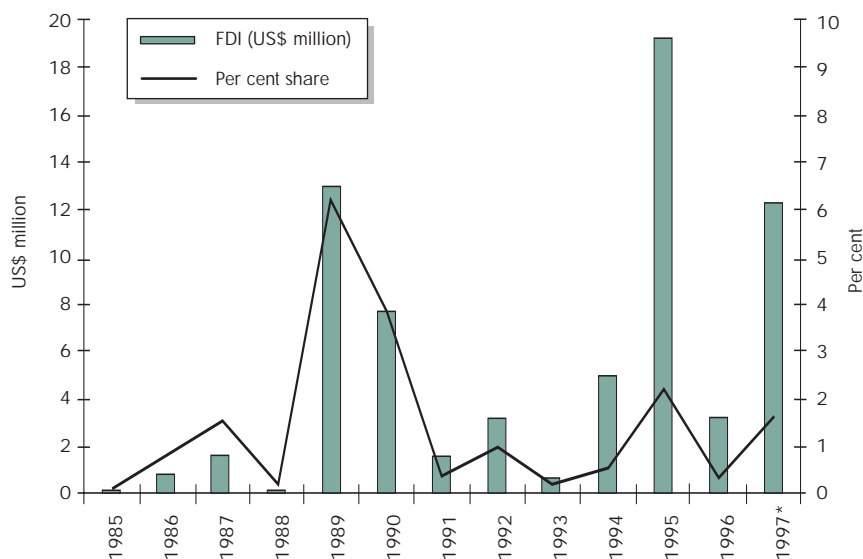
AUSTRALIA'S DIRECT INVESTMENT IN THE PHILIPPINES

Australia's FDI flows to the Philippines are relatively small and volatile. Portfolio flows, while still volatile, are much larger. On 30 June 1996 the total stock of Australian portfolio investment in the Philippines was \$A265 million (Australian Bureau of Statistics, 1997).⁸ Both Bangko Sentral ng Pilipinas and Board of Investments data show relatively strong Australian FDI in the late 1980s and in 1994 and 1995. Investment levels in 1997 were well above those in 1996 (Figure 4.4 and Figure 4.5). The Bangko Sentral ng Pilipinas registered Australia's share of total FDI inflows peaking at over 6 per cent in 1989 but dropping rapidly to 0.4 per cent in 1991. Since then its share has fluctuated between 0.2 per cent and 2.4 per cent.

Between 1985 and September 1997, the Bangko Sentral ng Pilipinas recorded US\$68.0 million in cumulative net FDI inflows from Australia. From 1986 to 1997, the Board of Investments registered US\$89.5 million worth of Australian FDI approvals.⁹

Figure 4.4

FDI Flows from Australia Volatile Central Bank Registered FDI from Australia, 1985-97



Note: * January to September 1997 only.

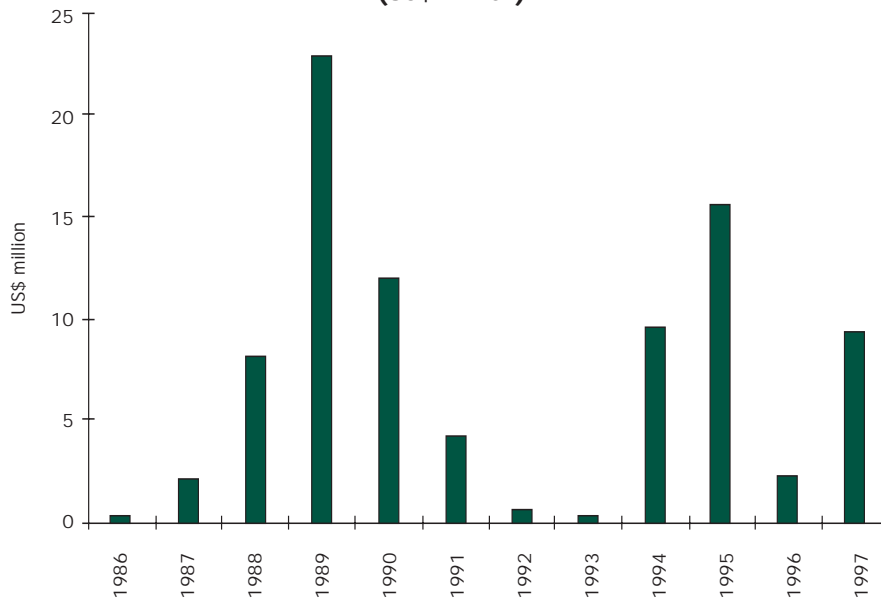
Source: Bangko Sentral ng Pilipinas, 1997.

⁸ While the Philippines has little direct investment in Australia, its investment portfolio was worth \$A406 million on 30 June 1996 (Australian Bureau of Statistics, 1997). Most of this portfolio investment is in finance and insurance.

⁹ These two figures will overlap to some extent. Moreover, the Board of Investments figures do not account for disinvestment and assume all approved projects are implemented. The figures cannot be added to give any meaningful figure for total FDI inflows from Australia.

Figure 4.5

FDI Strong in 1994 and 1995
BOI Registered FDI from Australia, 1986-97
 (US\$ million)



Source: Board of Investments, 1998a.

Table 4.5

Most Australian FDI Still in Manufacturing
Cumulative FDI from Australia, 1985-97

Sector	Value (US\$ million)	Percentage distribution
Mining	7.9	8.8
Manufacturing	38.3	42.7
Public utilities	10.8	12.1
Infrastructure and industrial services	16.8	18.8
Agriculture and fisheries	0.3	0.3
Energy-related projects	3.6	4.0
Commerce	0.4	0.4
Service exporter	0.6	0.7
Service (others)	10.0	11.2
Real estate and regional headquarters	0.5	0.6
Tourism-oriented projects	0.4	0.4
Total	89.6	100.0

Source: Board of Investments, 1998a.

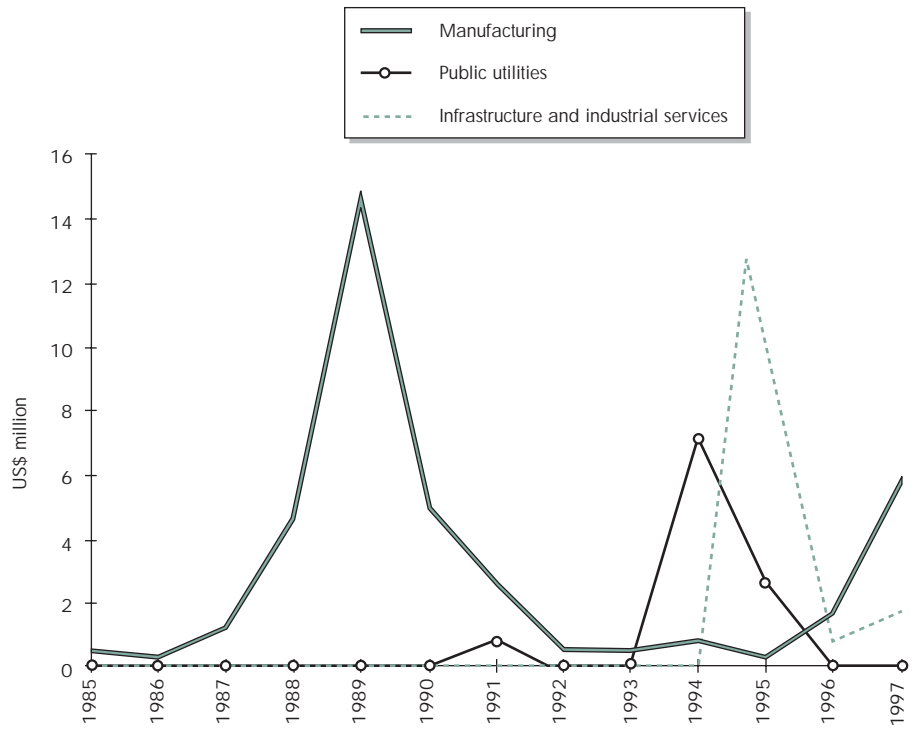
Around 75 per cent of Australian FDI registered with the Board of Investments between 1985 and 1997 went to manufacturing, public utilities, infrastructure and industrial services (Table 4.5). In 1994 and 1995 there was a marked shift to public utilities, infrastructure and industrial services; these received virtually no investment before 1994 but US\$23 million in 1994 and 1995 (Figure 4.6).

Australian manufacturing FDI registrations rose strongly in the late 1980s, fell to virtually nothing in the early 1990s but recovered in 1996 and 1997; in 1997 the Board of Investments registered US\$5.8 million worth of Australian manufacturing FDI (Figure 4.6).

Two major Australian players in infrastructure and public utilities are John Holland Asia and Leighton Asia (Philippines).

Figure 4.6

Manufacturing and Infrastructure FDI Rising in 1997
Registrations of Australian FDI by Major Sectors (1985-97)



Source: Board of Investments, 1998a.

MAJOR AUSTRALIAN PLAYERS

John Holland Asia

John Holland Asia, a 50:50 joint venture with Humes Industries of Malaysia, was one of the first major Australian construction companies to begin operating in the Philippines in the early 1990s.¹⁰ Its initial Philippine market strategy focused on Australian and foreign funded aid and soft loan projects, particularly in infrastructure development. As the Philippine market stabilised and expanded, more opportunities arose from locally funded and financed building projects. The Philippines is now John Holland Asia's biggest business centre - with more than 1 500 personnel, including 50 expatriates.

Its first project, undertaken in 1992 with Japanese trading house Itochu, was to rehabilitate the main commuter rail line from San Pedro to Naga City in Southern Luzon. The project was funded with Japanese Official Development Assistance funds.

Since then, John Holland Asia projects have included constructing hotels for the Shangrila and Waterfront chains in Cebu, rehabilitating 39 lighthouses over 400 nautical miles between Manila and Cebu, and building the Malitbog power plant in Leyte province.

The overall contract for building the Malitbog power plant, the world's biggest geothermal power station, was awarded by the Philippine National Oil Company/Energy Development Corporation to Sumitomo Corporation which subcontracted all civil engineering and building works to John Holland Asia. Despite mountainous terrain and nine metres of rain during the construction period, the project was completed on time.

John Holland Asia believes its success has been achieved by establishing a strong reputation, which has brought considerable repeat business, and by demonstrating a long term commitment to the Philippines. It believes the need for infrastructure development will remain strong despite recent financial market problems.

Leighton Asia

Leighton Asia has mining, construction and engineering divisions in the Philippines. Leighton's history in the Philippines and its mining operations are examined in Chapter 7 - *Mining*. One major non-mining project was to construct a coal loading jetty as part of the Sual power station project.

Source: Bryant, 1997a.

¹⁰ John Holland Asia also has operations in Malaysia and Indonesia.

A survey of Australian investment in the Philippines undertaken for this report and for the Australia-Philippines Joint Commission Meeting indicates that Australian companies investing in the Philippines generally are pleased with their investments.¹¹ Fourteen of the 26 companies (54 per cent) responding to the survey saw the rewards of operating in the Philippines as outweighing the risks, although many noted the importance of being aware of the risks before starting operations. A further nine companies (35 per cent) saw the risks and rewards as evenly balanced (Bryant 1997b).

The major factors respondent companies gave for their initial decision to invest in the Philippines were political stability, access to low labour costs and a large domestic consumer market, and expected economic growth (Table 4.6).

The recent peso depreciation has made Philippine assets substantially cheaper for non-ASEAN investors. (See Chapter 2 - *Macroeconomic Environment*.) One company with substantial Australian equity that increased its presence in the Philippines in late 1997 is Asian Terminals Inc, which is 40 per cent owned by P&O Australia. The Board of Investments approved a P 716 million (US\$18 million)

Table 4.6

Political Stability Attracts Australian Companies

Top Ten Factors Encouraging Australian Companies to Invest in the Philippines

Factors determining initial decision to invest	Major reason		Minor reason		Not relevant	
	No. of firms	Per cent	No. of firms	Per cent	No. of firms	Per cent
Political stability	20	80	5	20	0	0
Access to low labour costs	19	76	5	20	1	4
Large market for consumption of production	13	54	3	13	8	33
Expected economic growth in Philippines	13	52	9	36	3	12
Extending business network	11	46	6	25	7	29
Incentives offered by the Philippine Government.	9	37	6	25	9	37
Access to relatively skilled English speaking labour	8	33	11	47	5	20
Lower unit costs of production	5	21	12	50	7	29
Service/supply Australian company in the Philippines	5	20	7	28	13	52
Easier regulatory environment	4	18	9	39	10	43

Note: No single factor was identified by all 26 companies. The percentages quoted for each factor are based on the number of companies who identified this factor as being either a 'major reason', a 'minor reason' or 'not relevant'.

Source: Bryant, 1997b.

¹¹ The genesis of the survey lies in the April 1997 Joint Commission Meeting when Australia offered to undertake the survey as part of a more strategic approach to bilateral trade and investment issues.

expansion of Asian Terminals' port infrastructure in November 1997.¹² (See box in Chapter 6 - *Infrastructure*.) James Hardie also bought out its Philippine joint venture partner in late 1997. (See box in Chapter 5 - *Business Environment*.)

FACTORS INHIBITING FOREIGN DIRECT INVESTMENT

Peso depreciation, intra-ASEAN resource reallocation, political stability and the Philippines' relatively sound financial system should drive continued FDI into the Philippines. However, some important constraints remain. Five of the most important are:

- the relatively high cost of unskilled labour (this is less serious since depreciation)
- lack of infrastructure
- lack of support industries
- concern about commitment to reform
- slow government decision making and review processes.

The quality and quantity of both skilled and unskilled labour in the Philippines is generally good. A particular advantage is the widespread use of English (World Bank, 1997, p. 9). However, wage levels for unskilled labour are well above those of Vietnam, China and Indonesia (Table 3.7). Depreciation has reduced the wage gap with China and Vietnam but not Indonesia. This restrains FDI in labour intensive industries such as textiles, garments and footwear. In general, wage levels compare with Thailand's, where per capita income is more than double that of the Philippines.¹³ Relatively high wage rates for unskilled labour are compounded by low productivity. Unlike other ASEAN economies, Philippine labour productivity has not kept pace with wage increases (Table 1.9) (Golub, 1995; Takeuchi, 1995).

Poor infrastructure also handicaps the Philippines. Ongoing globalisation of the economy makes improving infrastructure increasingly important as the Philippines is now part of a global production chain and high infrastructure costs and delays can quickly erode profitability and competitiveness.¹⁴ While much has been achieved, considerable further progress is needed to provide adequate supplies of competitively priced transport, water, electricity services and serviced industrial land. (See Chapter 6 - *Infrastructure* and Chapter 5 - *Business Environment*.)

Competitive support industries are few, reducing the extent of local components procured by multinationals in the Philippines. Japanese firms procure fewer inputs locally in the Philippines than in any other ASEAN country where they operate

¹² The conversion into US dollars was undertaken using an exchange rate of P 40:US\$1. Asian Terminals Inc runs the sole container terminal and multicargo facility in Manila's South Harbour. It has also moved into handling, storing and distributing bulk grain cargoes at Bataan (the entry point of Manila Bay) and has an inland clearance depot and systemised terminal for multimodal interchange servicing the Calabarzon industrial corridor (Bryant, 1997a).

¹³ While wage rates for skilled labour are also relatively high, this is less of a constraint in industries such as electronics, which are relatively intensive users of skilled labour. In these industries efficient capital use rather than labour costs has the most important impact on the cost of production.

¹⁴ In integrated circuits, for example, only about 15 to 30 per cent of the value of gross output (including labour costs) is accounted for by the local industry (World Bank, 1997, p. 9).

(Tecson, 1995). This lack of competitive support industries forces direct investors to source intermediate inputs from abroad, making them more vulnerable to import price rises induced by exchange rate depreciation. It also reduces the scope for raising productivity through the proximity of support industries to final goods industries. As discussed previously, if gains in real competitiveness flowing from the peso depreciation are preserved, this should encourage the growth of support industries.

Concerns about commitment to the reform process also may constrain FDI in the Philippines. Until the new administration is firmly in place and demonstrates its commitment to continuing the reform process, some FDI may be withheld.

The slowness of government decision making and review processes emerges as the major impediment to investment in the Survey of Australian Investment in the Philippines (Table 4.7). In the mining sector, where potential for Australian investment is great and government decisions are continually reviewed, 100 per cent of respondents (5 companies) nominated slow government decision making as a major impediment to investment. (See Chapter 7 - *Mining*.) Not surprisingly, since the survey was conducted in September 1997, foreign exchange risk emerged as a major impediment (Table 4.7). Australian companies also identified lack of infrastructure, personal safety and corruption as important impediments. (See Table 4.7 and Chapter 5 - *Business Environment*.)

THE INVESTMENT INCENTIVE SYSTEM

The Philippine Government offers a range of incentives to both foreign and domestic investors. Incentives are only available to investors establishing in regional areas outside Manila. The principal policy instruments to attract investors include:

- incentives under the 1987 Omnibus Investment Code
- development of export processing zones, industrial estates, regional agri-industrial growth centres and special free port zones
- incentives under the Export Development Act
- use of build, operate and transfer, BOT, as an incentive to encourage infrastructure development.

Build, operate and transfer incentives are detailed in Chapter 6 - *Infrastructure*. This section outlines other available incentives and examines some aspects of their effectiveness.

Nine Australian companies (37 per cent of respondents in the Survey of Australian Investment in the Philippines) listed incentives as a major factor in their initial decision to invest (Bryant 1997b).

1987 Omnibus Investment Code

An enterprise can apply for incentives under the 1987 Omnibus Investment Code if it invests in preferred sectors specified in the annual Investment Priorities Plan, or it exports at least 70 per cent of its production and is majority foreign owned (or 50 per cent if it is Filipino owned).

Table 4.7

Slow Government Decision Making Slows Investment

Top Ten Impediments to Australian Investment in the Philippines

Impediments	Major reason		Minor reason		Not relevant	
	No. of firms	Per cent	No. of firms	Per cent	No. of firms	Per cent
Concern about slow government decision making/review	21	81	5	19	0	0
Foreign exchange risk (such as depreciation)	17	65	8	31	1	4
Restrictions on foreign ownership	15	58	8	30	3	12
Lack of infrastructure, such as telephones	15	58	10	38	1	4
Personal safety	15	58	9	35	2	7
Corruption	14	54	12	46	0	0
High company and personal taxes	13	50	10	38	3	12
Concern about long term stability of the Philippine Government	13	50	11	42	2	8
Regulatory controls	11	46	10	42	3	12
Concern about slow pace of economic/ financial reform	11	42	15	58	0	0

Note: Not all factors were identified by all 26 companies participating in the survey. The percentages for each factor are based on the number of companies who identified this factor as being either a 'major reason', a 'minor reason' or 'not relevant'.

Source: Bryant, 1997b.

The 1997 Investment Priorities Plan lists 32 areas and activities classified into five major categories (see Appendix 4.1 for details):

- export oriented industries
- catalytic industries such as shipbuilding, food processing, pulp and paper making, and cement manufacturing
- industries undergoing adjustment such as textiles, organic and inorganic chemical manufacturing, sugar milling, and machinery and equipment manufacturing
- support activities such as manufacturing motor vehicle parts and components, developing industrial estates and generating power
- six mandatory inclusions such as mining, and iron and steel producing.

While the Investment Priorities Plan is revised every year, the six mandatory inclusions are constant. Industries undergoing structural adjustment are also unlikely to change much from year to year because such processes inevitably take a long time.

For qualifying firms, incentives available under the 1987 Omnibus Investment Code include:

- an income tax holiday of 6 years for pioneer¹⁵ projects and 4 years for non-pioneer¹⁶ projects, which can be extended annually for up to 8 years if the enterprise meets the Board of Investments criteria relating to capital/labour ratios, use of indigenous materials and net foreign exchange earnings¹⁷
- tax and duty exemptions on imported capital equipment and accompanying spare parts (as detailed in Chapter 5 - *Business Environment* - these concessions ended on 31 December 1997 but an extension is proposed)
- tax credits on domestic capital equipment
- non-fiscal incentives which include allowing foreign nationals to work in supervisory, technical or advisory positions for 5 years; simplifying customs procedures; and allowing access to bonded manufacturing/trading warehouses.

The above incentives are uniform for exporters and non-exporters, unlike the 1983 code which favoured exporters to mitigate the bias of the former protectionist regime. (See Chapter 3 - *Trade*.)

The share of export oriented industries in Board of Investments approved projects has declined steadily and since 1989 has been smaller than the share of domestic oriented industries (Figure 4.7). At the aggregate level, a major factor contributing to this fall is surging infrastructure related projects (captured in the 'other' category in Figure 4.7). However, within manufacturing, the share of export producers also has fallen since the late 1980s (Figure 4.8), in part because of the overvalued peso prior to mid 1997. If sustained over the next year or two, the peso's depreciation is likely to reverse this decline by making investment in traded goods (exports and import substitutes) more attractive.

.....

¹⁵ Pioneer projects are those which introduce a new product or technique to the Philippines; engage in the pursuit of agricultural, forestry and mining activities considered essential to attaining a national goal; or produce non-conventional fuels or manufacture equipment which use non-conventional sources of energy (Board of Investments, 1997).

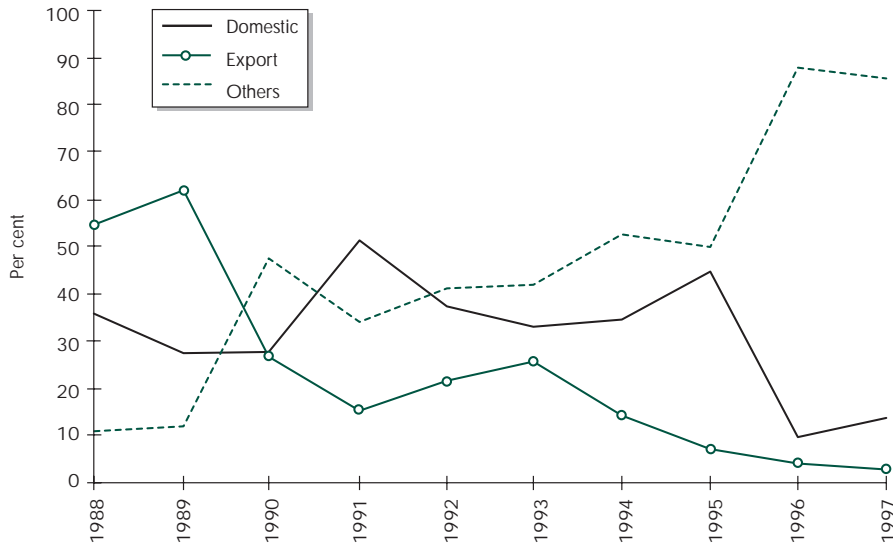
¹⁶ Non-pioneer projects include projects that are common activities in the Philippines and do not make use of new technology (Board of Investments, 1997).

¹⁷ The capital labour ratio should not exceed US\$10 000 per worker; use of indigenous materials should not be lower than 50 per cent of total raw material costs; and net foreign exchange earnings or savings should be at least US\$500 000 per year for the first three years of operation (Board of Investments, 1997).

Figure 4.7

Fewer Exporters Obtain BOI Incentives

Share in Total Project Cost of BOI Approved Projects,
by Type of Producer, 1988-97
(Per cent)



Note: 'Others' include energy-related projects, public utilities, infrastructure/industrial services, export traders, service exporters, tourism-oriented projects, environmental protection projects, research and development activities, power generators and auxiliary projects.

Source: Board of Investments, 1998b.

Incentives for Firms in Export Processing and Other Special Economic Zones

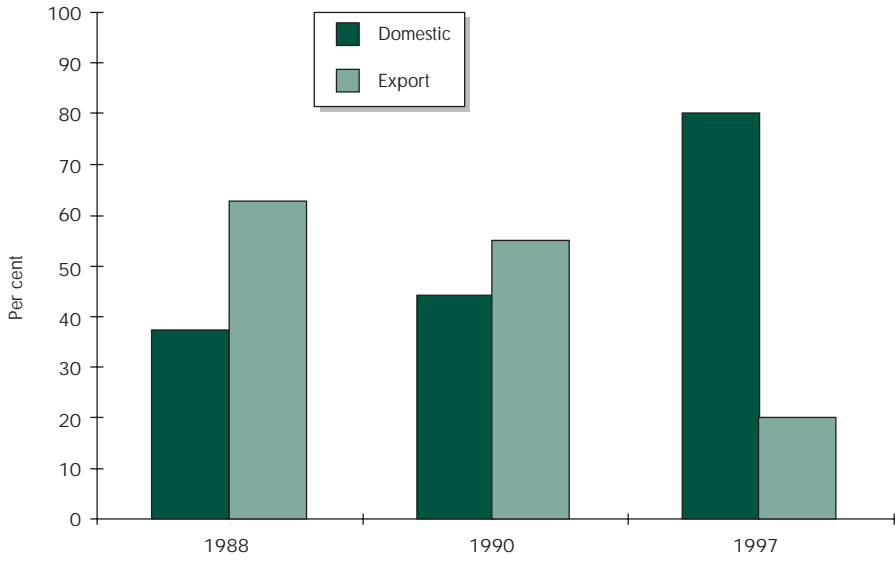
Overall, the Philippine economic zone incentives are easily the most generous and flexible in East Asia (World Bank, 1997, p. 79 and p. 87).¹⁸ Philippine Export processing zones, EPZs, evolved from the pure EPZ concept of industrial zones solely for exporting manufacturers into many hybrid EPZs. Economic zones and industrial estates are very popular with investors as generally they provide tenants with reliable infrastructure services, good transport links to ports or airports, generous fiscal incentives and streamlined government procedures.

¹⁸ The World Bank did note a number of areas where the Philippines' economic zone program is less competitive than similar programs in the region, especially in Thailand and Malaysia. These areas include: the uncompetitive impact of the gross income taxation approach, unclear policies governing sales to the local market and cumbersome approval procedures for new ecozone projects and ecozone expansions.

Figure 4.8

Manufacturing Projects Becoming Less Export Oriented

Share in BOI Approved Manufacturing Project Cost, 1988, 1990, 1997
(Per cent)



Source: Board of Investments, 1998b.

Philippine economic zones, also called ecozones, fall into three broad categories:

- government owned and operated EPZs, where production is solely for export
- privately owned EPZs and industrial estates, where production can be either for export or domestic consumption
- special free port zones, SFPZs established under separate laws, which include the former US military bases.

The Philippines Economic Zone Authority, PEZA, administers the first two categories. PEZA provides incentives for and facilitates private sector participation in constructing and operating public utilities and infrastructure in the zones. PEZA incentives¹⁹ include all the benefits of the Board of Investments scheme without the Investment Priority Plan's restrictions on industry destination or the prohibition on locating in the national capital region. Also offered are duty-free import privileges, generous local taxation arrangements and liberal laws on foreign ownership of land

¹⁹ Incentives for firms operating in the regular export processing zones and special economic zones are the same.

(World Bank, 1997, p. 87).²⁰ Subic and Clarke special free port zones are not administered by PEZA, but offer similar advantages to investors.

Currently the Philippines has four government owned EPZs and 63 other special economic zones (Figure 4.9).²¹ Of the privately operated zones, 11 industrial estates are authorised to operate as export processing zones, and several more are being developed for this purpose. Most are in Luzon (Figure 4.9).

Aside from the EPZs and industrial estates, several special regional agri-industrial growth centres, RAIGCs, receive high development priority. Among these are the Cavite-Laguna-Batangas-Rizal-Quezon (Calabarzon) Special Development Zone in Southern Luzon, the Northwestern Luzon Quadrangle (North Quad), Cebu in Central Visayas and the South Cotabato-Sarangani General Santos City (Socsargen) area in southern Mindanao (Figure 4.9).

The Government also created special free port zones, SFPZs; Subic Bay Free Port and Clark Air Base, both former US military bases, are the most notable. Only purely export oriented firms can locate in the SFPZs.

Incentives under the Export Development Act 1994

Under the Export Development Act, Philippine enterprises earning at least 50 per cent of total revenue from export (70 per cent if foreign) are entitled to Board of Investments, PEZA, or special economic zone incentives as well as the following other privileges:

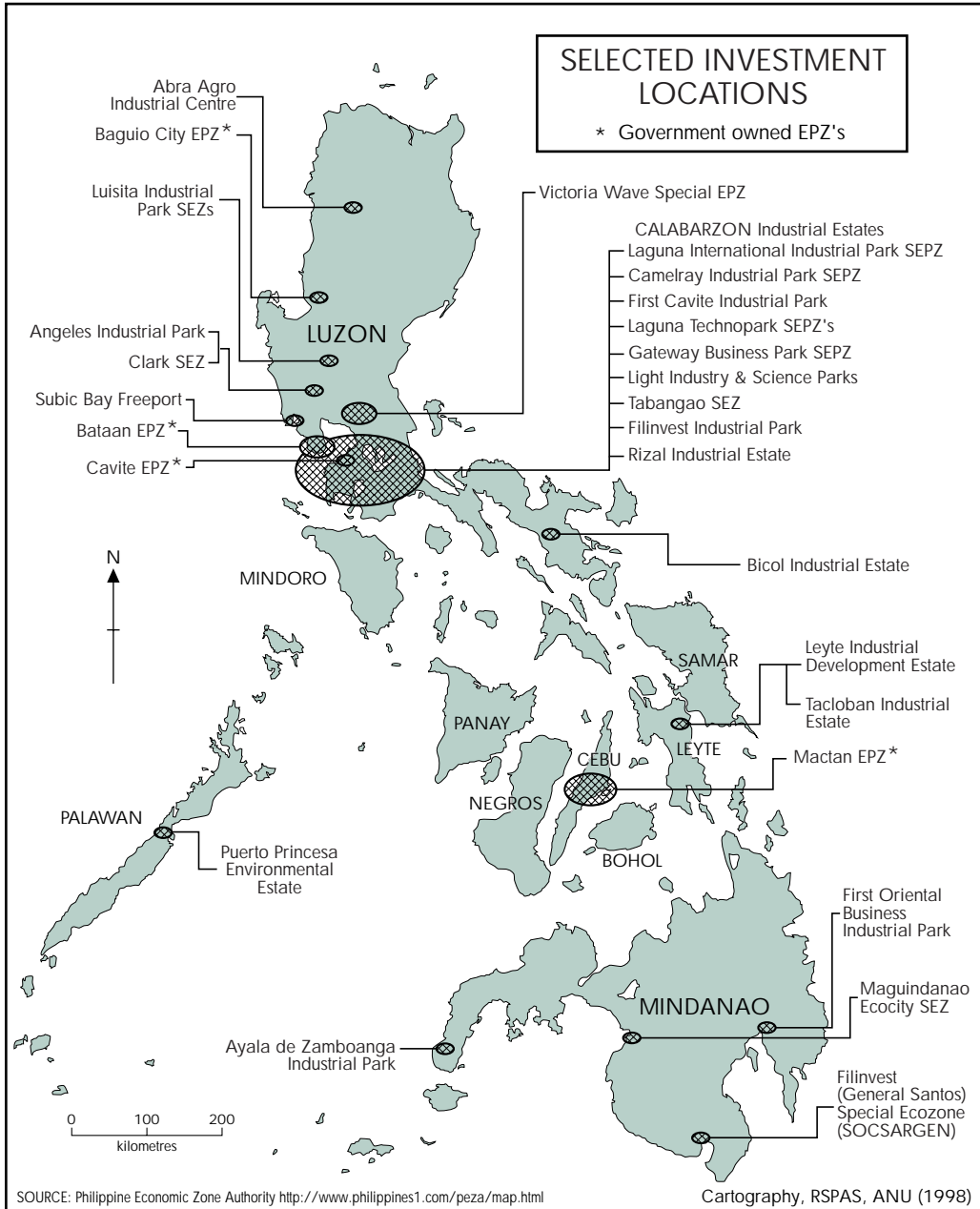
- exemption from advance payment of duties
- zero duty on imported machinery and spare parts
- tax credits on imported raw materials for five years
- tax credit of 25 per cent of duties on local raw materials, capital equipment and spare parts
- tax credit for an increase in the current year's export revenue (with a maximum 10 per cent tax credit for a 15 per cent yearly increase in exports).

²⁰ For more details on PEZA incentives see Chapter 5 - *Business Environment*.

²¹ The four government owned EPZs are at Bagio City in North Luzon, Bataan in Central Luzon, Cavite in Southern Luzon and Mactan in the Visayas.

Figure 4.9

Economic Zones Widely Distributed
Selected PEZA Economic Zones (as of June 1997)



SUBIC BAY: FREE PORT OF THE FUTURE

The Subic Bay free port in Olongapo city in central Luzon, a former US naval base, is 80 kilometres northwest of Manila in Zambales province. Subic became an economic and free port zone after the US withdrew in 1992. Its commercial and industrial operations began in 1993 and now it is about 95 per cent occupied. More than 260 domestic and foreign firms operate in Subic; at the end of 1996 investment totaled nearly US\$2 billion. The biggest investors include Taiwanese computer maker Acer, US firm Federal Express and Enron Subic Power Corporation.

In the Subic Bay Industrial Park, 50 Taiwanese firms operate and a Japanese Technopark caters for 50 medium sized Japanese firms. A second Taiwanese park is being constructed.

Australian investment at Subic to August 1997 was US\$11 million, or 0.5 per cent of the total investment, making it the tenth biggest investor.²² Australian companies include Electruck Pacific (Australia), manufacturer of industrial lifts and cranes and Ocean Pacifico Services Inc, which manufactures power boats. Electruck is among the top three export earners at Subic.

Subic's attractions include:

- US\$1 billion of infrastructure left by the US Navy
- a safe and strategic location, by air only 1.5 hours from Taiwan and Hong Kong; 3.5 hours from Singapore; 4 hours from Japan, Indonesia and Malaysia; and 0.3 hours from Manila (3 hours by car)
- state-of-the art telecommunications and airport
- abundant water and power supplies
- excellent shipping support and facilities
- free port status
- ample housing for foreign executives.

Target Industries

Major existing industries include electronics, light manufacturing and assembly, shipbuilding and repair services, air freight distribution and engineering services. Prospects include financial services, recreation and tourism, information services, (software development and data processing), transport, warehousing and distribution.

Source: Board of Investments, 1996; Bases Conversion Development Authority, 1996; Bryant, 1997a.

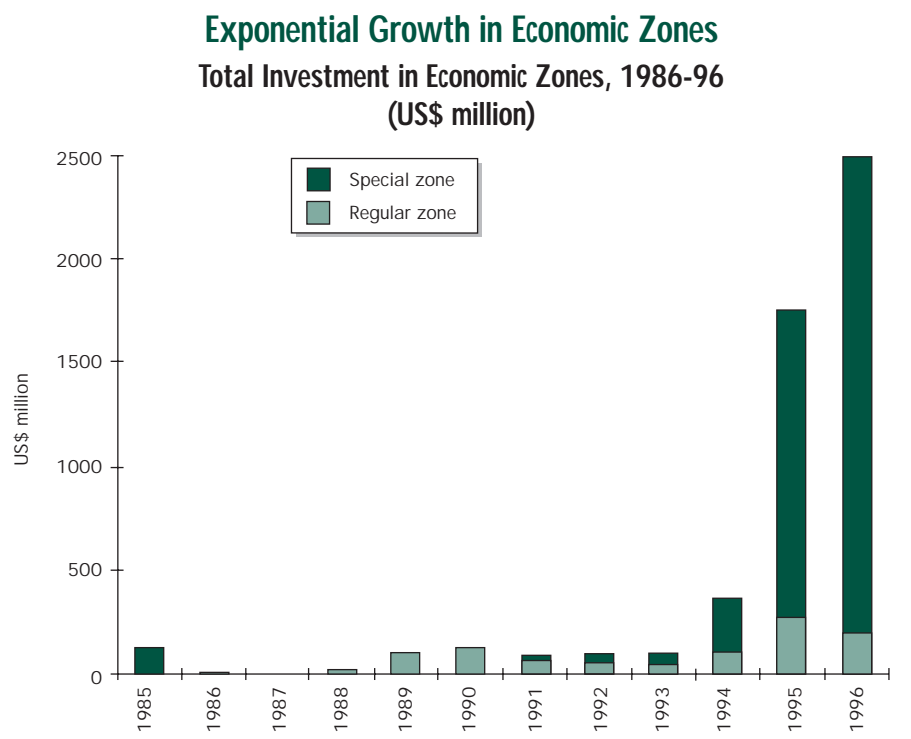
²² As at August 1997, the nine biggest investors at Subic were Philippines, USA, Taiwan, Malaysia, Hong Kong, France, China, UK and Japan with investments ranging from \$US744 million to US\$52 million.

Economic Impact of the Zones

The economic zones make a major contribution to Philippine exports and attract a high proportion of FDI. Registered foreign and domestic firms operating in the zones increased from 57 in 1986 to 553 in 1996 and zone investment dramatically increased from 1994 to 1996 (Figure 4.10). Investment in the privately owned special economic zones is particularly strong, rising from US\$48.6 million in 1993 to US\$2.3 billion in 1996.²³ Total Australian investment in these privately owned economic zones remains small; it rose from US\$406 000 in 1995 to US\$2.7 million in 1996 before falling to US\$1.7 million in the first nine months of 1997.

Exports from the economic zones rose from US\$278 million in 1986 to nearly US\$11 billion in 1997, representing 6 per cent and 42 per cent of total Philippine merchandise exports, respectively (Figure 4.11). Zone imports increased from US\$148 million in 1986 to US\$7 billion in 1997, or from 3 per cent to 19 per cent of total Philippine imports. The net trade balance in the zones has always been positive (Figure 4.11) in contrast to the overall trade balance. (See Chapter 3 - Trade.)

Figure 4.10



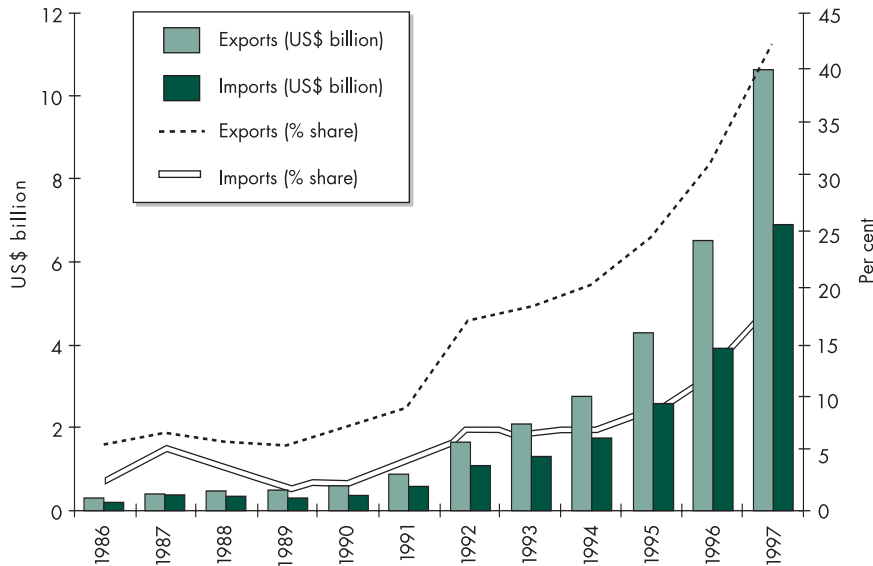
Source: Philippine Economic Zone Authority, 1997.

²³ These figures are for both domestic and foreign investment.

Figure 4.11

Rapid Export Growth in Zones

Exports and Imports in Economic Zones, 1986-97



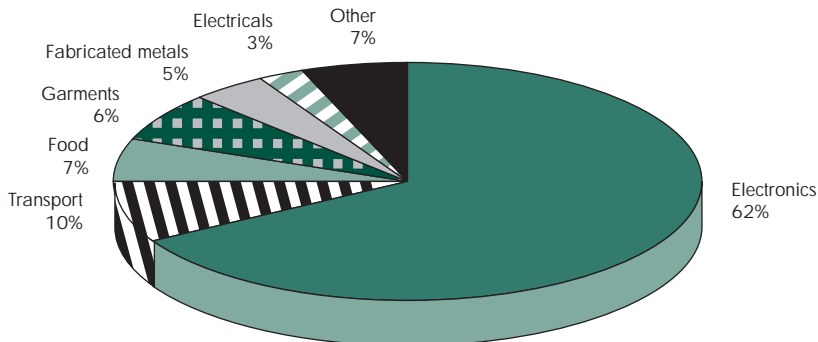
Source: Philippine Economic Zone Authority, 1997.

Figure 4.12

Electronics Investment Dominates

Cumulative Economic Zone Investment by Sector to 1996

US\$ million



Source: World Bank, 1997.

By far the most important single sector in the economic zones is electronics. Electronics firms account for 62 per cent of cumulative investment in the zones (Figure 4.12). The next most important sectors are transport (10 per cent) and food (7 per cent).

Direct employment in the zones grew by an average of over 20 per cent per year between 1991 and 1996; zones provided work for 152 250 people by 1996. While this remains less than 1 per cent of total employment in the Philippines, the rate of job creation over the five years to 1996 compares favourably with employment created in similar zones in the region and Latin America. Around 20 000 new jobs were created each year in the Philippine zones compared to about 5 000 in Malaysia, 12 000 in Indonesia, 10 000 in Vietnam and 8 000 in the Dominican Republic (World Bank, 1997, p. 72).

CLARK SPECIAL ECONOMIC ZONE: SET FOR TAKE OFF?

Clark Air Force Base in Angeles, Pampanga in Central Luzon, became a special economic zone after the USA withdrew in 1992. The zone is divided into two areas: the 4 400 hectare main zone comprising the former air base and the sub-zone comprising surrounding land with a total area of 23 601 hectares. Some 170 domestic and foreign firms operate in Clark. Total investment was US\$0.9 billion at the end of 1996.

By September 1997, two Australian companies operated in Clark, Australian Plumbing Services and Clark International Handling Agents.

Clark's attractions include:

- a safe and strategic location with similar flying times to key Asian capitals as Subic Bay
- excellent infrastructure left by the US air force, including telecommunication facilities, power, water and sewerage systems, fuel and lubricant depots, housing and educational facilities
- availability of existing facilities and land on long term leases.

Target Industries

Zone authorities are developing the main zone for modern industrial estates, tourism and trade and as the site for the Philippines' future premier international airport. Key industries sought include electronics, semiconductors and microchips, export oriented high employment industries, airport-related industries and tourism projects.

The sub-zone, adjacent to the main zone, is earmarked for agricultural projects, corporate farming, contract farming and agri-industries as well as tourism and ecological/environmental projects.

Source: Board of Investments, 1996; Bryant, 1997a.

The net economic impact of the current system of economic zones in the Philippines is likely to be positive (World Bank, 1997, p. 77).²⁴ This is primarily because most zone development costs are now borne by private operators, who also efficiently administer zones. Nevertheless, some aspects of the zones' performance cause concern, in particular:

- a large percentage of investment in the zones is for zone infrastructure development. In 1996, around 66 per cent of total zone investment was by zone developers. This could result in an oversupply of space in the next few years
- the high concentration of investment in the electronics industry could make the zones vulnerable to an industry downturn
- value added in the economic zones is low. Local value added in Philippine zones reportedly ranges from 25 to 30 per cent compared to figures of 45 per cent in Malaysia and 75 per cent in Taiwan (World Bank, 1997). This suggests the zones have considerable potential to increase their integration into the domestic economy.

CALABARZON: GATEWAY TO THE ASIA-PACIFIC REGION

Calabarzon, south of Metro Manila, is one of the Philippines' most progressive regional growth areas. Its 13 major private industrial estates, fully equipped with industrial and commercial support facilities include Laguna Technopark, Light Industry and Science Park, Carmelray Industrial Park, Gateway Business Park, Laguna International Industrial Park, First Cavite Industrial Park and Cavite Export Processing Zone.

Calabarzon's attractions include:

- a safe and strategic location with similar flying times to key Asian capitals as Subic and Clark
- a major international port in Batangas and two commercial ports in Quezon
- abundant water and power supplies
- support industries outside the zone.

Target Industries

These include electronic and electrical products, wood and metal furniture, chemicals, machinery and components, construction materials, shipbuilding, consumer durables, fresh and processed fruits and food products, metal manufactures, garments, computer software, cut flowers and ornamental plants, textiles, footwear and leather goods.

Source: Board of Investments, 1996.

²⁴ This contrasts to the situation in the late 1980s when one analysis estimated the EPZ program had a negative net present value of US\$225 million in constant 1982 dollars (Warr, 1989). This was largely because employment and foreign exchange benefits were offset by high government incurred infrastructure costs, low usage rates, subsidised access to the local capital market and electricity subsidies.

SOUTHERN MINDANAO - LINKING INTO INTERNATIONAL OPPORTUNITIES

This developing trade and investment region covers 31 000 square kilometres and includes 4.6 million people, living in the key cities of Davao, Cagayan de Oro and General Santos. Davao is now seen as the Philippines' second most important city. The creation of the Brunei-Indonesia-Malaysia-Philippines East Asian Growth Area (BIMP-EAGA) gives southern Mindanao a good opportunity to develop as a key centre in this East Asian sub-region.

South of Davao, the South Cotobato-Sarangani General Santos City (SOCSARGEN) area is set to become an important growth centre, with abundant agricultural and natural resources.

Target Industries

Target industries include agri-business, food processing, tourism, mining, construction and property development.

Source: Board of Investments, 1996.

Desirable Reforms of the Investment Incentive Program

The major reform required is to design a universal set of incentives and investment policies to be applied inside and outside zones. This would discourage firms moving from one jurisdiction to another just to maintain access to benefits such as income tax holidays. Such a reform would also eliminate the discrimination against firms not in economic zones, thus encouraging firms to choose locations based on their true merits, such as infrastructure availability and the presence of suppliers or customers, rather than available fiscal incentives.

Another desirable reform would be to change the type of incentives from 'front loaded incentives', such as income tax holidays, performance based incentives. Income tax holidays and other front loaded incentives provided at the beginning of the investment cycle are less effective than performance based measures that use tax deductions to reward firms that actually meet performance targets or make qualifying expenditures (World Bank, 1997, p. 100). Such a move would eliminate the need for an upfront screening process and the ponderous Investment Priorities Plan List that defines and restricts access to Board of Investments incentives.

THE INVESTMENT OUTLOOK

The Philippines has liberalised substantially its foreign investment regime and FDI has increased substantially across a range of industries. However, in several areas such as mining, inflows have failed to increase due to stalled reforms and poor policy formulation and implementation. (See Chapter 7 - *Mining*.)

The Philippines has fared relatively well in the currency crisis. Sustaining a substantial real depreciation of the peso should help maintain strong overall FDI in the Philippines and encourage greater domestic value adding and stronger export orientation by manufacturing FDI. However, authorities urgently need to address

constraints to increased FDI, including inadequate infrastructure, lack of efficient support industries, slow government decision making and (at least prior to depreciation) the relatively high cost of unskilled labour. After the May election, investors also will seek evidence of the new administration's commitment to reform. (See section on political developments in Chapter 1 - *Development Policies*.)

Special economic zones have promoted growth and regional development in recent years. The comprehensive system of incentives offered in the economic zones has attracted foreign investors and stimulated manufacturing exports. However, the lack of a universal set of incentives for firms inside and outside zones and performance based incentives would reduce distortions in investment decisions and improve resource allocation.

APPENDIX 4.1

1997 INVESTMENT PRIORITIES PLAN

Under the investment priorities plan, these activities are eligible for incentives:

- export oriented industries
- manufacturing
 - composite board
 - drugs and medicines
 - shipbuilding, ship repairing and shipbreaking
 - processed food
 - cement
- agriculture, food and forestry
 - production of planting materials, breeders, genetic materials and fish fingerlings
 - pulp and paper
- industries undergoing industrial adjustment
 - textiles
 - chemical products
 - sugar cane plantations and sugar mills/refineries
 - product packaging
 - machinery and equipment and/or their parts
 - coconut plantation and coconut oil mills/refineries
 - fishery production
 - animal feed production
- support activities
 - infrastructure
 - transport services
 - agricultural services
 - environmental support facilities
- support to other government priority programs
 - rice and corn production
 - livestock/poultry production and processing
 - housing components for low cost housing
 - motor vehicle parts and components
 - social services
 - tourism
- mandatory inclusions
 - mining
 - iron and steel
 - commercial tree plantations
 - book publishing
 - build, operate and transfer projects
 - projects under the ASEAN Industrial Cooperation Scheme.

Source: Wallace, 1997.

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Chapter 5

THE BUSINESS ENVIRONMENT

In the past, many Australian companies neglected the Philippine market. For much of the post war period and even as recently as the early 1990s, the Philippines had negligible economic growth, high inflation and few foreign investors. Power shortages crippled economic activity in 1992-93 and infrastructure needed dramatic improvement. Today, the Philippines is much changed. Following President Ramos' visit to Australia in August 1995, Australian attitudes towards doing business in the Philippines also have altered; increasingly Australian companies recognise the many good opportunities for trading and investing in the country.¹ The Philippines, located centrally in the Asia Pacific region, offers Australian business some advantages other East Asian economies cannot match. Many Filipinos are familiar with western business practices and English is widely spoken in business. The Philippines is a vigorous democracy which has achieved considerable political stability during the Ramos administration.

The overall business environment in the Philippines remains positive, with policies geared to maintaining macroeconomic stability and a more liberal economic environment. However, some problems remain for Australian and other foreign companies entering the market. This chapter examines the Philippine business and investment environment, highlighting challenges and opportunities for Australian business. The chapter also highlights the cultural background to business in the Philippines and analyses the overall operating and regulatory environment, focusing on problem areas. It concludes by examining important strategic issues for Australian companies doing business in the Philippines during and beyond the uncertainty created by the Asian currency crisis.

THE CULTURAL BACKGROUND TO BUSINESS

Spain colonised the Philippines from 1551 to 1898, when it was ceded to the USA after the Spanish-American war. The USA remained in control until independence in 1956.

Filipinos are of Malay stock, with some Islamic, Hindu, Chinese, Spanish and American influences. The Chinese, as elsewhere in Asia, constitute a powerful but quiet economic bloc.² Because of this mixed cultural background, Filipinos are tolerant of race; despite some mild envy at the success of Chinese Filipinos, they are well accepted, as are foreigners generally.

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¹ This chapter is closely based on a contribution by Peter Wallace, head of the Economist Intelligence Unit, EIU, Philippines. He is an Australian who has lived and worked in the Philippines for over 20 years.

² The ethnic Chinese community of around 1.2 million (or about 2 per cent of the population) controls between 50 and 60 per cent of the share capital by market capitalisation (East Asia Analytical Unit, 1995, p. 65).

The Philippines often is compared with Latin America rather than Asia, mostly because of its history of Roman Catholicism and Spanish colonisation. However, it could also be compared to the USA or even Australia because of the strong influence of 42 years of US colonisation. Neither comparison would do it justice, nor allow for a proper understanding. The Philippines is a unique mix of cultures and cultural and business mores.

Business Mores and Relationships

The Philippines embraces western concepts, yet retains its own culture, which foreigners must understand and be sensitive to if they are to succeed.³ As elsewhere in Asia, personal relationships play a much larger role than they do in Australia. Filipino society is fiercely family oriented and this leads to multiple relationships. Filipino extended families include blood relations and others, such as godparents and wedding sponsors.

Smooth interpersonal relationships are fundamental to good business. Great effort is taken to avoid offence or embarrassment. This can make workplace discipline difficult as criticising job performance is seen as criticising the person. Consequently managers often will not impose the necessary discipline, for fear of offending someone.

It is sometimes claimed that Australians often act more objectively and rationally than Filipinos who are more emotional and intuitive. Although this is simplistic, it can help understanding when developments go awry. Australian straight forward decision making and frankness need tempering to maintain smooth interpersonal relationships and communication needs couching with restraint so as not to offend.

Time is unimportant and meeting deadlines can be frustrating. However, Filipinos are willing workers and will work extremely well if they are proud of what they are doing. Almost always the job does get done.

Filipinos will take time to get to the point, building the relationship up through small talk. Australian directness is not appreciated; a slower, more careful approach will be. 'In Asia you take time.' Some foreign companies mistakenly send young, inexperienced 'hot-shots' who do not blend in or succeed; instead, a more mature, patient person will adapt more easily and be more successful.

Filipinos defer to authority; the hierarchy of status is important and should be respected. Australia's egalitarian approach is known but not well understood. Factory workers will defer to the manager, the manager to the boss, and so on. This deference also brings with it a reluctance to tell bad news; a subliminal fear is 'they'll shoot the messenger'. In one company a broken machine was not fixed until the manager visited the shop floor and saw it lying idle - the workers were too scared to report it. This is extreme but makes the point.

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³ Department of Foreign Affairs and Trade, 1996, *Cross Cultural Program: Australia-Philippines*, Canberra, is a good source for insights into cross-cultural issues and business practices for Australian officials, business people and others preparing to visit, live or work in the Philippines. The kit contains audio cassettes and a booklet.

Considerable gender equality in the Philippines means many women are in senior positions in business, politics, government and law, and many more are in technical and middle management positions.

Overall, the key to successful business is to build relationships. Sincerity and sensitivity to others is important and appreciated. In Asia, building firm foundations leads to success. Investments will not produce instant returns but will over time. The experience of the Japanese auto industry shows this. During the turbulent last years of President Marcos, when US auto makers pulled out, the Japanese stayed. Now the Japanese have virtually all the business, and the US firms are seeking to re-enter the market.

Filipino-Australian Links

The Philippines is a significant source of migrants for Australia, with the Filipino-Australian community numbering around 140 000. Over the ten years ending June 1997 approximately 56 000 Filipinos settled in Australia, 27 per cent of all settler arrivals from South East Asia. The Filipino-Australian community offers Australian companies wanting to do business in the Philippines useful cultural skills and contacts to market Australian produce in the Philippines and facilitate cross investment. Products Filipino-Australians export to the Philippines include packaging materials, advertising materials and frozen beef. Products they import include handicrafts and foodstuffs.

Bilateral business associations are a good starting point for those wishing to establish contacts.

Australian-Philippine Business Organisations

The Australia-Philippines Business Council in Melbourne actively promotes trade and investment links between the two countries. It now has over 160 members and is expanding rapidly, reflecting Australia's growing trade and investment links with the Philippines. Its counterpart organisation, the Philippines-Australia Business Council in Manila has 56 members, mainly Philippine firms doing business in Australia. The Manila based Australian New Zealand Chamber of Commerce, representing Australian businesses with representative offices in the Philippines, is also growing very rapidly. All three organisations are focal points in facilitating the exchange of business information, networking and enhancing contacts and partnerships among Australian and Philippine entrepreneurs. Contact details for these and other organisations are provided at the end of this report.

NUBLA AND COMPANY

Nubla and Company, based in West Ryde in Sydney, is the Australian representative for San Miguel's beer and packaging businesses. It also imports floor tiles and will soon import furniture and giftware ceramics. The company exports packaging materials and printed advertising materials to the Philippines. Its Managing Director, Ricardo Nubla, is a Filipino-Australian.

Source: Nubla and Company.

HOW BUSINESS RATES THE PHILIPPINES

Improvements in the Philippine business environment, evident over the past five years, should continue. The Economist Intelligence Unit's (1998) latest comparative survey of expected business environments in regional economies over 1998 to 2002, increased the Philippines' global and regional rankings; the Philippines' global position rose from thirty fourth (out of 58 countries) to thirtieth (out of 60), while its regional ranking improved from tenth (out of 16 countries) to ninth. This survey reflects the main criteria companies use to formulate their global business strategies. The EIU's assessment of the macroeconomic environment over the next five years has improved significantly. The Philippines is now ranked fifth on a regional basis for this variable compared with eleventh in the EIU's December 1997 Country Report. The Philippines is expected to emerge from the currency crisis with less trauma than some of its neighbours because its economy is much more resilient following a sustained period of restructuring. While the Philippines is placed behind Malaysia (ranked fifth), it is ahead of Thailand, Indonesia, India, Sri Lanka, China, Vietnam and Pakistan.

Table 5.1

The Philippines - a Good Place to Do Business Ranking by EIU

	Value of index out of 10, 1998-2002	Global rank out of 60 countries, 1998-2002	Regional rank out of 16 countries, 1998-2002
Overall position	6.9	30	9
Political environment	5.5	39	11
Political stability	6.4	33	8
Political effectiveness	4.8	44	12
Macroeconomic environment	8.0	24	5
Market opportunities	6.4	29	12
Policy towards private enterprise and competition	6.6	32	7
Policy towards foreign investment	7.8	25	4
Foreign trade and exchange controls	8.9	10	5
Taxes	7.4	12	6
Financing	6.6	35	9
Labour market	7.1	17	6
Infrastructure	4.6	44	10

Note: Surveyed regional economies comprise Australia, China, Hong Kong, India, Indonesia, Japan, Malaysia, New Zealand, Pakistan, Philippines, Singapore, Republic of Korea, Sri Lanka, Taiwan, Thailand and Vietnam.

Source: Economist Intelligence Unit, 1998.

'On the Ground' Assessments of Doing Business in the Philippines

This EIU business rankings survey does not necessarily canvass business people with a direct involvement in the Philippines. However, in a mid 1997 survey of multinational companies operating in the Philippines, 93 per cent believed the Philippines was as good as or better than anywhere in Asia as an investment location (Wallace, 1997). All believed the operating environment had improved or was as good as a year earlier and expressed confidence in the country's long term prospects.

These results were echoed in a recent survey of Australian investment in the Philippines (Bryant, 1997). Fifty four per cent of responding companies said the rewards of operating in the Philippines outweighed the risks; a further 35 per cent said the rewards and risks were evenly balanced.

OPERATING ENVIRONMENT

The Philippine economy is generally open; foreign investment is welcome and restrictions and complexities do not overly hamper business, despite the convoluted bureaucracy. The key is to take the time to understand the country, talk to people 'on the ground' and seek sound advice.

Choosing a Partner

As most sectors of business except infrastructure now are open to 100 per cent foreign investment, partners are not necessary. However, a partner may provide local market knowledge or bring specific advantages such as:

- better market access, through an established distribution network
- important local relationships that could enhance business
- relationships into government that could smooth bureaucratic complexities
- protection against policy changes detrimental to the company's interests
- raw material inputs.

A partner's attitude needs to be compatible with corporate philosophy and choosing a partner in the Philippines deserves extra time and effort. Australians may take people at 'face value' and enter partnerships after only superficial assessments. It is important to know why a partner is needed and what the partner is expected to provide. Furthermore, both considerations must apply to the long term. Common goals or an understanding and acceptance of the differences are vital. A family owned company, for example, often has different goals to a publicly listed company.

Finally, as with other aspects of establishing a business presence in the Philippines, seeking local expertise is important when undertaking the indepth research necessary to select a partner.

JAMES HARDIE

In early 1997, James Hardie formed a joint venture with Jardine Davies Inc to build a \$A50 million fibre cement manufacturing plant south of Manila. Jardine Davies assisted in establishing sales and marketing networks during this startup phase. The plant, to be completed in mid 1998, will have fibre cement production equivalent to half the total Australian market. While the factory was being built, James Hardie exported large volumes of fibre cement to the Philippines to establish a market presence.

A major consumer advertising campaign, training for local carpenters and assistance for customers in retail outlets supported these exports. Consequently, exports are penetrating the market at twice the expected rate. James Hardie recently took over its partner.

Local Representation

The importance of relationships means having a local presence in the Philippines is essential. Ideally this should be a company office but a local agent or distributor is viable at least in the early stages of market entry. The decision greatly depends on the nature of the business.

In establishing a company office, whether to choose expatriates or local staff is a difficult issue. An expatriate generally intimately knows the business but costs more than local staff. Starting with an expatriate and later employing a Filipino is common, although it is more common to retain a foreigner to head the company. Seventy per cent of chief executives of multinationals in the Philippines are foreigners.

If starting with a local agent or distributor, it is important to establish a long term strategy and ensure that any move to a full representative office fits into that strategy. Many businesses suffer unnecessarily trying to separate from an agent, distributor or partner whom the business no longer requires.

Choosing a Plant or Office Site

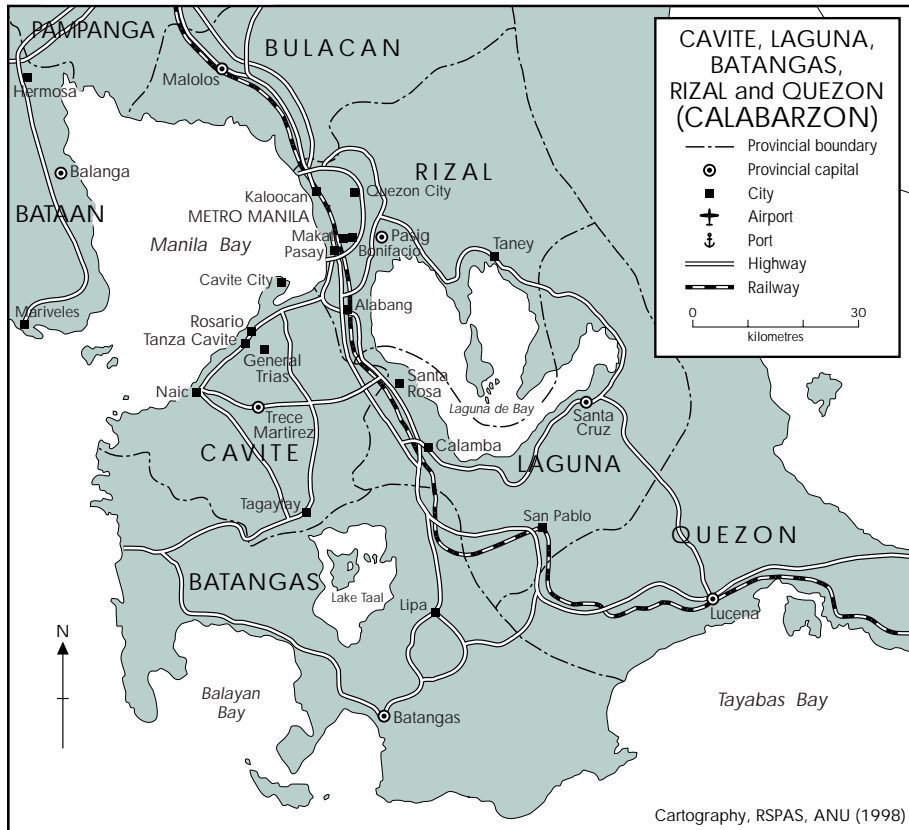
Offices invariably are in Makati, the main central business district of Manila or nearby Ortigas. Very few are in the old city of Manila. Some companies are moving to Alabang in the south, closer to the newly constructed factories (Figure 5.1). This shift is likely to accelerate in coming years.

Two new cities are being built at Bonifacio and Filinvest. Bonifacio is close to Makati and may become the new premier district in about a decade. Filinvest is beside Alabang and once established, will be a desirable business address. Substantial construction in recent years has provided reasonable quality office space, so leasing or buying should not be a problem. Increasingly the trend is to establish factories in Calabarzon, the industrial corridor south of Metro Manila, or in Subic and Clark freeports. Cebu is also a very attractive investment site, well regarded by those operating there.

Figure 5.1

Manila and Surrounding Cities

Metro Manila, Cavite, Laguna, Batangas, Rizal and Quezon



Calabarzon is favoured by most new businesses as it has many developed industrial estates and an export zone. These zones are either privately or government run and provide all basic services, plus a developed environment within which to work. Labour is readily available.

The freeports offer low taxes (only 5 per cent of gross income) and no customs procedures providing the business is principally for export. Freeports are relatively autonomous, and less subject to government bureaucracy. (See Chapter 4 - *Investment*.)

Infrastructure and Utilities

Both the Marcos and Aquino regimes did little to expand infrastructure or utilities; consequently, the shortfall was huge when the Ramos administration took office in 1992. Ramos moved swiftly and decisively to install power, encouraged private provision of transport, electricity and water services and increased competition in the telecommunications, shipping and air travel sectors. (See Chapter 6 - *Infrastructure*.)

Considerable roadwork and railway construction is currently underway. Within two to three years, this should help to relieve Manila's serious traffic problems. Meanwhile traffic jams can result in extensive travel delays. On the personal level, traffic problems require careful scheduling of meetings and trips. For transporting goods, the traffic problems necessitate organising night delivery (outside the daytime truck ban) or using smaller vehicles with more frequent trips. The location of warehouses becomes critical. Overall the difficulty of moving between places dictates, in part, where you live and work.

Investment Incentives

The Philippines Board of Investments, BOI, publishes annually a list of industry sectors the Government wishes to encourage and offers incentives to attract investors to these sectors. (See Chapter 4 - *Investment* and Appendix 4.1.) Principal fiscal incentives include income tax exemption for 3 to 6 years, a 3 per cent tariff on imported capital equipment (ended on 31 December 1997 but an extension is proposed⁴), tax and duty exemption on imported spare parts and tax credits for purchases of locally produced capital equipment and parts.

Another government agency, the Philippine Economic Zone Authority, PEZA, administers incentives to export oriented industries in government owned export processing zones and special economic zones (ecozones) located in privately developed industrial estates. Incentives to PEZA registered firms include:

- tax and duty-free exemption of capital equipment, raw materials, spare parts and supplies
- income tax holidays of 4 to 8 years
- a 5 per cent tax on gross income in lieu of all national and local taxes (including the regular 34 per cent corporate income tax rate)
- exemption from wharfage dues, export tax and import fees.

Land Ownership Rights of Foreigners

Only Filipinos or corporations at least 60 per cent Filipino owned can own land. However, foreign investors can lease commercial land on which they operate for 50 years, renewable for a further 25 years if sought. Land lease contracts have to conform with the Comprehensive Agrarian Reform Law and the Local Government Code. Leases are granted for the establishment of industrial estates, factories, processing plants, agribusiness and agri-industrial enterprises, land development for industrial and commercial use, tourism and other priority investments (Citibank, 1996).

With the proliferation of economic zones, a dynamic industrial market in land leases has emerged, offering companies a wide range of options for expanding operations or establishing a presence in the Philippines (World Bank, 1997).

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⁴ The BOI has proposed adopting a system which would allow BOI registered firms to post surety bonds (equivalent to 6 per cent of the value of the imported capital equipment) instead of paying the full tariff (between 20 and 30 per cent). The scheme is intended as a stop-gap measure pending Congressional approval of a new law which would extend the tariff incentive on capital equipment for BOI registered firms for another year.

Foreigners can wholly own office space under the condominium concept whereby they receive a strata title for their office, providing no more than 40 per cent of the total building is foreign owned (Wallace, 1997).

Restrictions on Foreign Ownership of Small Business

Generally, ownership of small and medium sized companies which are not export oriented is reserved for Filipino nationals. The Foreign Investments Act sets a minimum paid-in capital requirement of US\$200 000 for foreign owned companies which export less than 60 per cent of their total output. However, the requirement may be reduced to US\$150 000 for companies which use advanced technology or directly employ at least 50 workers.

Australians in small businesses find perseverance is essential; managers cannot give up at the first sign of adversity. Australians successful in Manila have all faced setbacks and reversals. They survive because of their persistence. These small successful Australian businesses include brass bed and plush toy manufacturing, resort hotels, precious metal recycling, specialised pool equipment supply and service, and management consulting. In all these, the owner's expertise counted. The key is to be in a niche business that others would find difficult to enter.

The Labour Force

STABLE LABOUR SITUATION

The transition to democracy saw a rash of strikes and widespread labour unrest in 1986. Leftist trade unions used their new democratic freedoms to lead organised labour to a record 581 strikes. However, since then the number of strikes has declined dramatically with 95 strikes, and only 7 involving major multinational companies in the first 11 months of 1997. Most strikes were over disagreements during wage negotiations; 3 year collective bargaining agreements normally are negotiated where unions exist.

Filipino workers generally are the most skilled in Asia and speak English, making doing business much easier than in many other Asian countries. Filipinos represent a productive workforce when correctly managed. Most required skills are readily available, although some shortages are appearing in the faster growing industries (mainly electronics).

Many companies do not encourage union membership, although the law mandates it must be permitted if workers request it.

Foreigners can hold senior management positions and work where specific skills are required. Generally they are supposed to train a Filipino replacement, although this is not strictly enforced. Working visas are rarely denied, although bureaucratic delays can be significant.

RESOLVING LABOUR UNREST

A major European food manufacturer plagued by continual strikes resolved the problem by changing the English president to a Filipino president who managed through consensus rather than confrontation. He understood the sensitivities of his workers, and adapted his style to suit. That he was Filipino was not the issue. What mattered was that he listened to workers and their requests, gave them a sense of involvement, and generated a corporate pride which Filipinos value highly. He broke down the 'them and us' barriers without sacrificing the hierarchical structure of the company.

Dealing with the Banks

The banking system is well established and almost all normally expected services are available. Fourteen banks are wholly foreign owned, including ANZ, and six are in partnership with local companies. Overall, there are 52 commercial banks, 47 investment houses plus a number of offshore banking units, which are foreign bank offices engaging in limited foreign currency denominated banking transactions. (See Chapter 2 - *Macroeconomic Environment*.)

Deposits can be in pesos or foreign currency. However, high intermediation costs mean that borrowing rates are uncompetitively high compared to elsewhere in Asia. (See Chapter 2 - *Macroeconomic Environment*.) Because of the exchange rate risk, dollar loans are not encouraged unless borrowing firms are earning dollars or can afford to hedge. Banks generally require loans to be backed by collateral, which can include a head office revolving guarantee, with loan terms generally for a maximum of three to five years.

Automatic teller machine services are plentiful in the large cities and normal trade transactions are readily accommodated.

Foreign versus Local: the Domestic Market

Traditionally Filipinos preferred imported products when they could afford them because of the perceived better quality and status. However many Filipino products have improved and the peso's recent large depreciation makes local products more attractive. In a price conscious market like the Philippines, potentially lower local product prices could result in a significant market shift over the next 12 months.

Competitively priced, locally made or assembled foreign products generally sell well. Two examples are refrigerators and air-conditioners, where compressors and coils were imported; the rest was fabricated locally. This worked well, and eventually led to full local manufacture. The peso's depreciation will increase the advantage of producing locally, particularly for products with low import content such as some processed foods, furniture and decorative household items.

ASEAN's rapidly reducing inter-country tariff rates make production in the Philippines for export to other ASEANs a viable option, given the possible economies of scale. If sustained, the large real currency depreciations of all ASEAN countries will naturally protect this unified market.

The domestic market is influenced by US habits and much of what is practised in the USA applies to the Philippines. Western-style advertising and point-of-sale marketing are successful, so localising promotion is often unnecessary. Most advertisements of liquor and cigarette products, for instance, use Caucasian models and western settings, as do advertisements of imported brand clothes. Localised promotion may be needed for new products not normally used or consumed in the Philippines. For example, in promoting fibre cement boards, James Hardie emphasised how fibre boards suited local conditions. For McDonald's, promotion was localised apparently because its competitor was a homegrown fast food chain. Many good local and international advertising companies can provide the requisite expertise and advice.

Filipino consumers can be separated into three groups: a market with discretionary funds; a market able to afford purchases that are more than basic but not yet luxurious, like TV sets, bottles of Scotch or electric rice cookers; and a market restricted to simple basics.

The first market can be further subdivided into those earning over P 600 000 (US\$15 000) per year and comprising 0.8 per cent of households, who tend to buy signature brand products and status symbol items, and those earning P 300 000 to P 600 000 (US\$7 500 to US\$15 000) per year and comprising 3.3 per cent of households (Figure 5.2).⁵ Status is a key element in upper market sales, much more so than in Australia.

The middle group earns about P 125 000 to P 300 000 (US\$3 125 to US\$7 500) per year and comprises 20 per cent of households (Figure 5.2). Those in the bottom market earn below P 125 000 and comprise the remaining 76 per cent; around 39 per cent of these live below the poverty line of P 80 000 (US\$2 000) per year.

UNDERSTANDING THE MARKET

One Australian company failed because it did not understand the market. It joined a local steel company to produce stainless steel tubing, but the quality of the product was too high. The market was not ready for a higher priced, better quality product, so imported Taiwanese tubing forced it out of business.

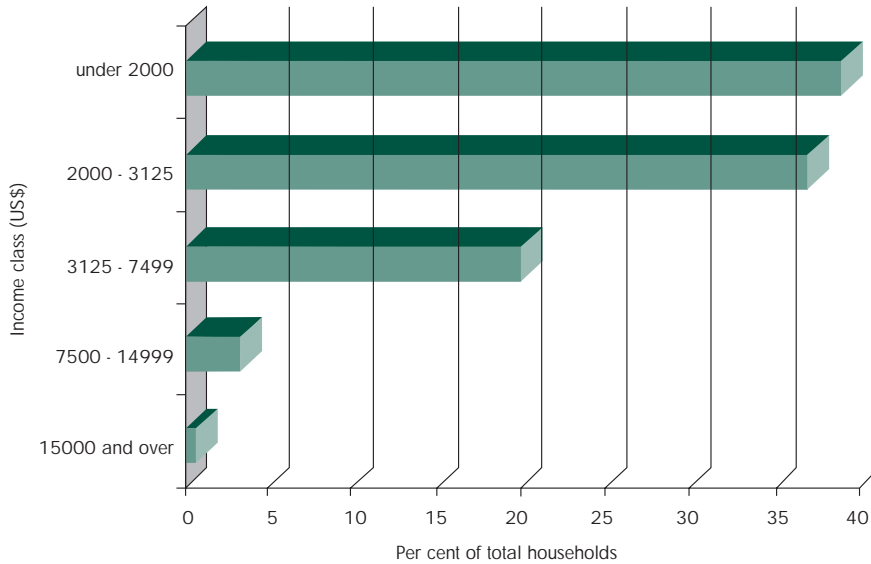
Similarly, Jollibee, a Filipino company, emulated McDonald's and beat it. After competing neck and neck in the 1980s, the race for the fast food market's top spot is now over. Jollibee posted sales in 1996 of P 5.8 billion versus sales of P 2 billion for McDonald's. Jollibee understood the market well and produced sweeter hamburgers more suited to Filipino tastes, spaghetti and a native noodle dish. Meanwhile McDonald's basically stayed with its burger and fries menu. McDonald's took a long time to adapt and follow Jollibee's path.

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Converted at the exchange rate of P 40:US\$1.

Figure 5.2

Basics Market Biggest

Breakdown of Household Income by Class, 1996^a



Note: ^a These figures are projections by the Economic Intelligence Unit, Manila based on existing official data for 1994.
 Source: Wallace, 1997.

Distribution

With 7 100 islands, distribution in the Philippines can be very difficult. Many companies do not distribute nationally, relying solely on the major cities (Manila, Cebu, Davao, Cagayan de Oro) for the bulk of their business.

Sales elsewhere in the country generally are handled in one of three ways:

- by the company itself, where mass market, low cost products justify the massive infrastructure and logistics needed (for example Coca Cola, Pepsi Cola, Procter and Gamble, Shell and Caltex)
- through specialist national distributors (for example in the pharmaceutical industry), with major distributors including Metro Drug, Zuellig, Philusa, Marsman and Macondray
- through the Chinese network, with sales to Filipino-Chinese dealers in Manila who then use their own systems for distribution.

Goods are transported by truck (owned or contracted) on the main islands and by ship or plane between islands. Pilferage at ports is small, but nevertheless poses a problem. Shipment costs are comparatively high and in many cases, prices apply nationally with Manila sales subsidising the cost of distribution.

At present the law restricts retail selling to Filipinos. A bill in Congress to allow foreign involvement in retail trade has not progressed and is unlikely to pass in the Ramos administration. Direct inputs sales to manufacturers is not considered retail trade, so maintenance products and tools can be sold directly.

Personal Security

Crime in the Philippines has received high, possibly excessive publicity in recent years. Manila, like most large cities, has a relatively high level of crime. However, crimes against foreigners are few, partly because they often live in secured villages and work in the central business district. Across the country, reported crimes against foreigners are also few. Reasonable precautions and commonsense should prevail, like not displaying large sums of money or wearing expensive jewellery in crowded places.

Kidnapping is almost entirely restricted to wealthy Filipino-Chinese families and wealthy Filipinos. Recent kidnappings of foreigners involved foreign missionaries who were abducted by Muslim rebels in the southern island of Mindanao. The last case of kidnapping a foreigner in Metro Manila was in January 1992; then the American was rescued and all the kidnappers were killed.

Expatriates living in Manila do not consider crime a significant problem and generally take no more precautions than they would at home.

Media Relations

Few foreign firms bother to maintain ongoing relationships with the media. Generally, as issues occur they are handled through direct contact. In some sensitive industries, however, developing a good working relationship with the media is critical. These industries include mining, energy and oil, and telecommunications. Having a public relations firm on retainer, or an internal public relations officer, can be a wise precaution.

Monitoring for adverse developments in your industry is important. Twice the soft drink industry was threatened with an industry surtax, and only swift reaction using outside consultants helped prevent its imposition.

THE REGULATORY ENVIRONMENT

Dealing with the Bureaucracy

The Philippine bureaucracy has two very distinct levels, the top and the remainder. The top echelons are generally excellent, professional and helpful. Standards deteriorate below that level and getting approvals and processing documents can be tedious and laborious. Patience is needed.

Investors can seek advice and briefing from the Board of Investments' One-Stop Action Centre, BOI-OSAC, the Bureau of Trade Regulation and Consumer Protection, BTRCP, the Philippine Economic Zone Authority, PEZA, and the

Securities Exchange Commission, SEC.⁶ A Businessman's Ombudsman's office in the Board of Investments is tasked with assisting business with specific problems. This new agency's capability is still to be tested, but the agency is well staffed with personnel keen to demonstrate their ability.

Fortunately, very little of the approval and documentation process needs to be done personally. The key to success is having either in house staff or agents who build close, personal relationships with the relevant government employees and meet them frequently. Small *pasalubong* gifts, for example a pack of cigarettes, some pastries or a meal, can help build relationships.

ONE-STOP ACTION CENTRES FOR FRONTLINE ASSISTANCE

Designated one-stop action centres, OSAC provide investors with facilities and services for obtaining information and documentation in one location. These OSACs are:

- one-stop action centre for investments - at the Board of Investments
- one-stop export documentation centre - at the International Trade Centre Complex
- one-stop import processing centre - at the Bureau of Import Services
- one-stop tax credit centre - at the Department of Finance
- one-stop garments exports assistance centre - at the Garments and Textile Board.

New Taxes

In late 1997, Congress passed the last component of its comprehensive tax reform package that modifies individual and corporate tax rates. Unfortunately, because individuals have high exemption levels, the changes for corporations are less favourable than planned.

The corporate income tax rate is being reduced from its current rate of 35 per cent to 34 per cent in 1998, 33 per cent in 1999 and 32 per cent in 2000. (Originally the rate was to drop to 30 per cent by 2000.) The Government has introduced a 3 year net operating loss carryover, and a 2 per cent minimum tax on gross income, even if a loss is incurred. Fringe benefits now are quantified and included in employees' gross income, unless the benefits are specifically of corporate benefit. Representation and entertainment expenses will be limited on an industry basis. The administration has yet to finalise some details of the new tax changes, but companies will need to re-examine their accounting systems to determine how to best fit into the new structure.

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⁶ Philippine Board of Investments, 1998, *Doing Business in the Philippines: A Checklist*, Internet site, www.sequel.net/~dtboi/dpb.htm. This site contains a checklist for investors preparing to do business in the Philippines, including a list of general registration and operational requirements and special permits, clearances and registrations. It also lists facilities and agencies that can assist investors in fulfilling the necessary requirements.

The Bureau of Internal Revenue is being gradually computerised and its ability to enforce proper payment and limit tax evasion enhanced. Senior management is working to reduce corruption in the bureau, but this is still a serious concern.

Most multinationals strictly abide by the tax laws and reject any 'compromise' deals suggested by examiners. Consequently multinationals now generally are not targeted. Dealings with the Bureau of Internal Revenue are, or can be transparent and above board, but some smaller firms still may be approached for inducements to expedite tax assessments or forstall detailed tax audits.

Export/Import Restrictions

Due to the far reaching trade liberalisation program started in 1985, very few items now are covered by export and import restrictions. On imports, the main restrictions are on sensitive agricultural products such as rice, corn and pork where licences are required. Other restricted imports include weapons, drugs, pornographic materials and gambling equipment.

Export prohibitions cover mostly plant and animal exports. Government agencies regulate only a few remaining export products including pesticides, grains, sugar, tobacco and tobacco products, timber, cement and clinker, copper concentrates and gold. Everything else is freely tradeable. (See Chapter 3 - *Trade*.)

Foreign Exchange

The exchange rate policy is essentially market dictated, with the central bank intervening only to avoid excessive volatility. Since the Asian currency crisis began, the central bank has intervened even less in the foreign exchange market. (See Chapter 2 - *Macroeconomic Environment*.)

Foreign exchange transactions were liberalised in 1992. Dollar recipients - exporters, overseas Filipino workers and their relatives, tourist related businesses and brokerage houses - are allowed to keep and spend their dollars. If banks cannot fully accommodate dollar payments, parallel sources, for example legal foreign exchange dealers, can provide foreign exchange. Nationals and foreigners alike can open foreign currency deposits with banks through the foreign currency deposit unit mechanism. (See Chapter 2 - *Macroeconomic Environment*.) Banks do not need to know the source of the foreign currency and the funds can be freely converted.

Full and immediate repatriation of profits is guaranteed and foreign investment may be made without inward remittance approvals. It is wise, however, to register the foreign investment with the central bank as remittance is then legally guaranteed.

Stricter Environmental Laws

The Government is now beginning to take environmental protection more seriously, with companies being forced to limit polluting practices. The change has largely to do with the presence of environmental activist groups which, with the help of a sympathetic media, have grown increasingly vocal about environmental issues. Pressure tactics from these groups have hampered the implementation of some infrastructure projects, particularly power plants, and business ventures such as cement plants and mining.

The law requires that 'environmentally critical' projects secure an environmental compliance certificate from the Environment Management Bureau of the Department of Environment and Natural Resources. Environmentally critical projects include heavy industries, resource extractive industries, infrastructure projects and projects located in environmentally critical areas. A key element of the environmental compliance certificate approval process is social acceptability, which requires project proponents to secure approval from local communities affected by projects.

Complaints about red tape in approving environmental compliance certificates prompted the Board of Investments to set up an environmental support unit, responsible for assisting the business community in securing these certificates.

Dealing with the Legal System

FREQUENT RESORT TO COURTS

Nuisance and harassment cases are common. For example a 1996 survey of 74 multinational companies showed they had a total of 1 200 cases pending, an average of 16 cases per company, with 50 per cent initiated by third parties, 35 per cent by the company and 15 per cent by their employees. Almost half the respondents had cases which had been pending for more than five years, with most in the eight to 12 year range.

The Philippines is a highly litigious society, and minor slights or offences can lead to a court case. The court system is based on the US system, even quoting US law for precedents, but it does not have a jury system. The judge decides.

Most companies only get involved in relatively minor cases that aggravate, but do little more. However, some cases have been very detrimental to the foreign investors involved and the court's decision quite controversial. The final arbiter is the Supreme Court. No case can be considered final until the Supreme Court has ruled on it, and even relatively minor cases can be heard in the Supreme Court.

THE MANILA HOTEL DECISION

In September 1995, the Government sought tenders for 51 per cent of the shares of the Manila Hotel, a 73 year old, five-star hotel owned by a state owned pension fund for government employees. The bidding was won openly and fairly by Renong Berhad of Malaysia in partnership with ITT Sheraton. The Malaysian firm bid P 44 per share; a Filipino firm bid P 41 per share. The losing Filipino firm subsequently took the matter to the Supreme Court and after five months, won a decision based on a concept never raised before - that the hotel, because of its historical significance, should be considered part of 'national patrimony'. The court ruled that according to the constitution's Filipino first policy, the Government should give preference to the Filipino firm. The ruling was made despite the absence of a law defining 'national patrimony' and despite the issue not being raised in the pre-bidding conference, when such questions presumably should have been asked - and clarified.

THE PETROCHEMICAL DECISION

In 1988, Taiwan's USI Far East applied for and obtained approval for a major petrochemical complex in the Philippines. Initially it considered Bataan, at the entrance to Manila Bay, for the plant site, but later decided to shift closer to two major oil refineries in Batangas, south of Manila. The congressman from Bataan opposed the shift and petitioned the Supreme Court to force USI Far East to remain in Bataan. In a highly controversial decision, the Court agreed and even defined what raw material USI Far East could use.

USI Far East relocated its venture to Malaysia.

There is no simple solution to the problems raised by the litigious nature of Philippine society, except to choose a good business oriented solicitor to handle cases. Personal involvement or attendance is rarely required.

Graft and Corruption

The nature of corruption makes it almost impossible to determine its level and extent. However, anecdotal evidence suggests that bribery does occur, principally to obtain major government projects. Pressure to contribute to political campaigns can be strong but foreign companies can politely reject these requests by citing the constitutional prohibition on foreigners becoming involved in Philippine politics.

Commissions frequently are paid to purchasing managers; corporations should monitor this. Within the building industry, these and inducements to government inspectors add an estimated 10 per cent to the cost of an average commercial building. In other sectors 'facilitation fees' are also commonly paid. The amounts are small and dramatically speed processing, mainly in the bureaucracy. Corruption within the Bureau of Internal Revenue and Customs is a more serious obstacle for business.

The significant underground economy also may mean that the domestic market is substantially larger than statistics indicate.

STRATEGIC CONSIDERATIONS

Australian companies should seriously consider investments in the Philippines, despite recent economic turmoil in Asia. Investments made during a downturn often result in spectacular growth later. With domestic spending predicted to grow at around 3 per cent in 1998 and faster after that, demand should remain relatively strong. For investors wishing to set up export oriented operations, the Philippines will be a competitive choice.

A CRISIS INVESTMENT

In the mid 1980s, at the height of the political turmoil in the Philippines after Senator Aquino was assassinated, and when uncertainty was high, the Kuok group invested in three five-star hotels.

All have run at over 80 per cent occupancy ever since, and often have been at full occupancy. Furthermore, two have just had new wings added; the other has no land on which to extend.

Opportunities are likely to include moving into existing operations at relatively low cost and avoiding the otherwise slow build up most new entrants experience. Analysts recommend considering acquisition or merger now, researching the market and seeking in principle approval from company boards to enable rapid decision making should an opportunity arise. Hiring a consultancy firm to monitor specific opportunities could be a cost effective strategy. With the peso's recent large depreciation, plant construction costs should be significantly lower, although this may be offset by higher than normal interest rates for locally financed investments.

SEIZING AN OPPORTUNITY

The Monte de Piedad and Savings Bank, majority owned by the Roman Catholic church, went into bankruptcy in May 1997. The central bank ordered its closure after it failed to service heavy withdrawals by depositors. The bank run was triggered by news reports about the bank's financial difficulties which arose from its failure to collect some P 1.8 billion in loans.

Within two weeks, the Keppel Group of Singapore had negotiated a deal to acquire 60 per cent of the stock and assume control of the bank. Keppel had acquired an existing bank with about 30 branches and within days was in business. The long route of finding a local joint venture partner, the only way foreign banks can establish new local operations, securing a licence from the central bank and putting up branches would have taken at least a year.

An Australian bank missed out because it could not get an executive into Manila quickly enough, let alone go through the myriad corporate approval requirements in time to match Keppel. Had conditional approval from the company board been agreed, a faster response may have been possible.

With the present currency uncertainty and high interest rates, companies with existing operations in the Philippines will need to:

- keep receivables under control
- minimise inventories
- introduce new products, packaging or services to stimulate growth momentum
- increase efficiency and productivity, and reduce costs
- raise prices without losing critical market share
- strengthen treasury functions to take advantage of possible volatility of the peso
- reconsider input sourcing to control production costs.

JAMES HARDIE EXPANDS PHILIPPINE INVOLVEMENT AS THE PESO DEPRECIATES

An Australian company, James Hardie, has increased its exposure to the Philippine market in the midst of the Asian financial market turmoil. In December 1997, it bought out the 33 per cent share of Jardine Davies in their fibre cement plant, gaining 100 per cent control of the operation.

Jardine was looking to consolidate its businesses after the turmoil in regional financial markets; James Hardie was looking to consolidate its position in the fibre cement industry. The peso's sharp depreciation in the second half of 1997 made a deal more attractive for James Hardie.

James Hardie remains very optimistic about its prospects in the Philippines. Its product suits the Philippine market and the construction sector is set for further growth, particularly in residential construction.

At present a defensive strategy is needed to survive the short term crisis, but an offensive strategy should be put in place for the expected upturn in growth as the country enters the next century.

CONCLUSION AND IMPLICATIONS FOR BUSINESS

Philippine economic fundamentals are sound, underpinned by a period of reform during the Ramos presidency. Financial sector liberalisation, central bank reform, tariff reductions and liberalisation of the foreign investment regime coupled with political stability have improved significantly the country's business image internationally. To sustain economic recovery and business confidence during ongoing financial crisis in East Asia, the Government needs to remain committed to stability, liberalisation, privatisation and deregulation.

The business environment over the medium term remains promising. The market still presents good opportunities for Australian firms, particularly those willing to make a longer term commitment, providing they exercise commercial prudence. Australian companies might usefully follow a number of guidelines for doing business in the Philippines:

- study the market carefully, including the experience of others in the sector, plan thoroughly and be prepared to invest in consultants
- put time into managing and assessing the risks associated with credit, sales and exchange rate fluctuations
- do not rush into joint ventures, explore all options, including the pros and cons of establishing a representative office, appointing an agent and setting up a joint venture or a wholly foreign owned company
- be aware of Philippine culture despite its western appearance
- ensure Philippine contacts are valid and legitimate
- do not underestimate the importance of relationships; they are a key element of Philippine business practice, and be patient and persevere

- be prepared to spend time on what you are doing as things take longer than planned
- acquire local support and contacts, work with a Filipino who can navigate the cumbersome Philippine bureaucracy
- take time to investigate hidden costs, including taxes and government charges
- put in place marketing and promotion programs at least two years before setting up a manufacturing operation
- develop good strategies and take a medium to long term view.

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Chapter 6

INFRASTRUCTURE

The Philippines has moved from a crisis in infrastructure – notably in electricity and water in the first half of the 1990s to innovative forms of private sector participation in infrastructure.¹ Formerly the under-performer in terms of infrastructure, the Philippines now has taken the lead in East Asia in many appropriate and efficient forms of private sector participation. While the links are complex, improved availability of infrastructure services has undoubtedly contributed to the higher economic growth rates the Philippines has experienced since 1993.

The proposed restructuring of electricity embraced by the National Power Corporation, Napacor, seems likely to break up generation into a significant number of generating companies which compete across an independent grid, very much like the Victorian model of the 1990s. In water supply, in 1997 the Philippines implemented a concession model for Manila which brought lower tariffs and reduced the national government's fiscal burden. While the road transport situation is near crisis with frequent traffic gridlocks in Manila, a number of toll road, light rail and other Build Operate Transfer, BOT, initiatives are underway. The overall picture at the start of 1998 is of innovation and competition in infrastructure, albeit in an environment of uncertain political and economic change.

The hope in the Philippines is that its financial shakeout may be less severe than in those Asian countries which have devoted less care to infrastructure restructuring and privatisation, and the liberalisation of other key sectors like finance.

OVERVIEW OF INFRASTRUCTURE POLICY

The Philippines' recent experience with private sector infrastructure development also confirms that competitive and customer focused reforms, such as seeking competitive tenders for well structured contracts and implementing competitive models for privatisation which minimise tariffs, bring community benefits. The Philippines' experience confirms that a clear regulatory structure is required if a community is to accept private sector participation in owning and managing essential and often monopoly services. Furthermore, the private sector will invest in sensitive infrastructure assets only if it can predict the value of the customer base, and that requires clear contracts, enforcement of contractual obligations and faith that the government will adhere to the spirit and letter of the contractual arrangements.

Experience in Latin America, the UK, New Zealand and Victoria in Australia demonstrates that improving the efficiency of infrastructure service provision through competition and privatisation requires a broad based government

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¹ Professor Michael Porter of Tasman Asia Pacific, Melbourne, undertook the consultancy that formed the basis of this chapter.

commitment to reform and sectoral restructuring. Experience also indicates that the political capacity to implement what are often perceived as difficult reforms is greatly assisted if countries are facing a crisis. Chile, New Zealand, Victoria and others pioneering beneficial infrastructure reforms each faced a real sense of economic crisis, pre-reform. So too the Philippines in 1992, when the brownout problems and looming water crisis preceded profound reforms, including the path-breaking BOT law implemented in 1993.

Basic Principles

To communicate and promote its economic development objectives, the Philippine Government identified five high level policy principles: devolution, decentralisation, democratisation, deregulation and privatisation.

By applying these principles in key infrastructure sectors, the Government has committed itself to a competitive environment that will enhance efficiency and reduce costs, while maintaining service standards and environmental quality. This chapter examines the effectiveness of this new policy in promoting service efficiency and new investment in the Philippines' infrastructure sectors. The chapter discusses in general terms:

- the extent of existing serious infrastructure constraints and whether continued bottlenecks are likely to limit growth rates
- the success of infrastructure and regulatory reforms in encouraging private sector participation in the vital infrastructure sector
- the likely future path of reforms in infrastructure sectors in the Philippines.

Foreign Participation in Providing Infrastructure

The Philippine Constitution restricts foreign participation in most infrastructure sectors to 40 per cent partnerships with local companies. In the power industry, emergency legislation waived this restriction, enabling 100 per cent ownership of BOT schemes to generate power. (See fuller discussion of constitutional issues in a later section.)

One fundamental characteristic of infrastructure services is they are sold on the local market for local currency. They are classic non-traded goods in terms of the international market. However, with privatisation and substantial foreign investment in infrastructure, capital costs may be substantially in foreign currency. This immediately complicates the foreign financing of infrastructure projects. Typically, investors try to manage this by seeking Department of Finance guarantees that local profits can be converted into foreign exchange and repatriated, or as in some early electricity BOTs, require rates of return in foreign exchange. Foreign investors also seek guarantees of domestic tariff settings or revenue flows under take or pay contracts.

In principle, monopoly services in essential areas such as electricity, water and transport should generate secure income not requiring guarantees. With indexed tariffs, including against foreign exchange costs, guarantees should not be needed in these expanding and secure markets. However, with large low income communities in the major cities, tariff increases will always meet substantial political opposition.

As a result, negotiations regarding tariff and regulatory regimes for infrastructure services are usually quite complex.

Experience with private sector participation in electricity since 1992 has led the Philippine Government to seek to reduce the extent of government guarantees offered to lower costs and risks to taxpayers. Recent private participation in electricity and water sectors involve softer guarantee arrangements than earlier power purchasing agreements.

In tandem with higher economic growth rates and opening the infrastructure sectors to private funding, foreign investment in infrastructure in the Philippines increased rapidly from US\$23 million in 1990 to US\$1 072 million in 1996. The Philippines was the third largest recipient of foreign infrastructure funds in East Asia in 1996, after Thailand and Indonesia (Kohli et al, 1997). However, the 1997 currency crisis in East Asian economies has raised questions about the quality and efficacy of some investments. Substantial currency depreciation, while less than in Indonesia, Thailand and the Republic of Korea, is testing the contractual and regulatory framework within which private infrastructure investments were developed.

The Philippines appears to be better prepared for weathering the currency crises than some East Asian neighbours. In attracting private and foreign investment to infrastructure, the Philippines accepted World Bank and Asian Development Bank advice favouring open tendering processes for carefully specified projects. Comparing infrastructure reforms and implementation in the Philippines and elsewhere may improve credit assessments relative to the pre-reform situation.

A BRIEF HISTORY OF INFRASTRUCTURE PERFORMANCE

In 1992-93, the Philippines faced an infrastructure crisis. Public investment in economic infrastructure in the Philippines declined by around 50 per cent from 1979 to 1990 (World Bank, 1992). Between 1979 and 1983, investment was relatively strong, averaging 4.7 per cent of GDP. However, coinciding with the mid 1980s political turmoil, public investment in economic infrastructure fell dramatically, to around 3 per cent of GDP in 1984. Fiscal constraints and the poor performance of public utilities reduced the scope to publicly fund substantial new infrastructure. Private sector investment in infrastructure became very limited and political upheaval undermined both investment and asset maintenance. This was reflected, for example, in the poor state of energy infrastructure and the dramatic decline in investment by the private telecommunications monopoly Philippines Long Distance Telephone Company, PLDT. In 1985, the stated waiting time to connect a typical consumer was the longest in East Asia – over 3 years; this deteriorated to almost 9 years by 1993 (International Telecommunication Union, 1995; Serefacia, 1997).

By 1992-93, the country was subject to sustained brownouts in the power sector, inadequate telephone lines and quality of service, traffic gridlock and poor access to ports and paved roads. Almost 60 per cent of Filipinos had no ready access to piped household water.

Decline in Infrastructure Services Relative to Other Regional Economies

In terms of service availability, the Philippines suffered a general decline in its competitive position relative to its neighbours. While the level of services, in some instances, compared to East Asian countries, the growth of services was typically below that of neighbours (Table 6.1). In all sectors large discrepancies existed between demand for and supply of infrastructure services. Supplies therefore were rationed - for example, by long waiting times for telephone connections, and by quotas and publicity campaigns relating to available times for electricity consumption.

During the Marcos and Aquino administrations, Philippine infrastructure investment, as a percentage of GDP, fell far behind that of its regional neighbours (Table 6.2).

INFRASTRUCTURE POLICY INNOVATION - BOT PROJECTS

Infrastructure policy development and reforms under the Ramos administration sought to alleviate these serious problems. The main innovation was to tap private sector funds through BOT infrastructure projects concessions and other new private-public sector arrangements.² Most BOTs were initially in electricity generation but key new projects include major transport infrastructure in Metro Manila, and highway inter-connections in Leyte, Cebu and Davao. One strategic project subject to substantial delays owing to heavy daytime traffic, is the Metro Manila Skyway. Other projects vary from supplying rural water to developing General Santos fishing port and building basic telephone infrastructure.

Table 6.1

The Philippines Lags Behind Region in Infrastructure Growth Growth in Infrastructure Stock and Services, 1980-90 (Growth Rates over Period, Per cent)

Country	Paved road	Electricity generation capacity	Electricity production	Phone main lines	Rail tracks	Access to safe water	Access to sanitation ^a
Philippines	-20 ^b	48	46	45	-55	36	-2
China	na	105	107	64	na	na	na
Indonesia	106	312	534	184	5	11	22
Republic of Korea	120	134	197	299	38	18	na
Malaysia	36	107	143	301	7	15	24
Thailand	69	142	206	262	6	14	na

Note: a Percentage change in coverage; b according to the Department of Public Works and Highways' Bureau of Maintenance, the decreased length of road network was due to correction and/or revision in measuring the length.

Source: Kohli, 1995, p. 22; Serefacia, 1997.

² Contractual structures now include: build-transfer, BT; build-lease-transfer, BLT; build-operate-transfer, BOT; build-transfer-operate, BTO; contract, add and operate, CAO; develop-operate-transfer, DOT; rehabilitate-operate-transfer, ROT; rehabilitate-own-operate, ROO, and others that may be approved by the President.

Table 6.2

**Philippine Infrastructure Share of GDP Almost Half
Regional Average
Infrastructure Investment, 1990-92
(Per cent of GDP)**

Year	Philippines ^a	China	Indonesia	Republic of Korea	Malaysia	Thailand	Other ^b	East Asia ^c
1990	2.3	4.1	4.9	4.5	4.4	4.1	4.1	4.2
1991	3.0	4.5	4.3	4.7	6.9	4.4	4.0	4.5
1992	2.5	5.1	3.8	4.7	6.0	4.3	4.0	4.7

Note: a In alternate estimates composed of investments by the national government, government owned corporations and local government units, the share of infrastructure of GDP is 3.6 per cent for 1990, 3.8 per cent for 1991 and 4.0 per cent for 1992 (Kohli, 1995); b others includes Cambodia, Fiji, Lao PDR, Maldives, Mongolia; c East Asia includes China, Indonesia, the Republic of Korea, Malaysia, Philippines, Thailand and others as defined above.

Source: Kohli, 1995, p. 23.

Table 6.3

**Electricity BOTs Dominate Total
Philippine BOT Program: Summary List of National Projects, 1997**

Sector	Value (US\$ million)			Number of BOT projects (including variants of BOT)				
	C and O	Pipeline	Total	Per cent share	C and O	Pipeline	Total	Per cent share
Energy	4 084.5	5 909.7	9 994.2	70	48	5	53	65
Transport	1 117.7	2 043.1	3 160.7	22	3	7	10	12
Water	481.0	204.6	685.6	5	1	2	3	4
Telecoms	0.0	0.0	0.0	0	0	0	0	0
Others	411.0	73.6	484.5	3	8	8	16	19
Total	12 004.2	2 329.0	14 325.0	100	60	22	82	100

Note: Total value does not cover all projects due to incomplete data. C and O refers to completed and operating projects. Pipeline refers to projects under negotiation or construction.

Source: National Economic Development Authority Public Investment Staff, 1997.

BOT projects as at 31 March 1997 are listed and classified according to 'completed and ongoing' or 'in the pipeline' (Table 6.3). At the end of 1997, roughly P 485 billion of projects had flagship project status. Of these 102 projects, 22 were BOTs (P 157 billion), 3 were purely private enterprise (P 229 billion) and 76 were official development assistance, ODA, assisted (P 98.3 billion).

BOT Project Coordination

The body coordinating infrastructure investments is the National Economic Development Authority, NEDA. It presently operates under Philippine Development Plan 1993-98 which outlines strategies and investment priorities. Projects costing over P 300 million are submitted to the full Board of NEDA, which makes recommendations to the President, after first being considered by the Inter-Agency Coordination Committee, chaired jointly by NEDA and the Department of Finance. The Inter-Agency Coordination Committee represents all major relevant government departments and the BOT Centre.

Government agencies implementing projects under the BOT law require approval from NEDA or the Inter-Agency Coordination Committee. Local governments wishing to develop a BOT project must obtain approval from local development councils.

All projects go to the Inter-Agency Coordination Committee, except telecommunications and power projects which the telecoms and power authorities deal with themselves. The Inter-Agency Coordination Committee uses foreign consultants and World Bank assistance when necessary.

The Manila light rail project provides an example of how the BOT approvals process works. To develop the scope of project and assess bids, the Inter-Agency Coordination Committee drew on World Bank funded consultants from the Philippines Department of Finance, a US legal firm recommended by the World Bank, and a foreign engineering consulting firm. In addition, the Department of Transportation advised on appropriate toll fares, the Department of Justice on legal issues, the Department of Natural Resources and Environment on environmental issues, and the Department of Finance on fiscal issues. The Inter-Agency Coordination Committee examined how to raise finance, whether to ask the World Bank for guarantees, and whether partial aid funding was needed.

For major BOT projects, the process of developing a project framework, assessing bids and selecting project sponsors takes 9 to 12 months, but most issues are worked through properly. The first project in a sector is always hardest, as all issues - industry structure, competition and consumer welfare - must be resolved. However, once a successful approach is developed, it can be used as a model and subsequently refined. By then the process becomes routine, as with BOT power schemes (Reyes, 1997).

Projects implemented under the BOT law are administered by the BOT Center in the Coordinating Council of the Philippine Assistance Program, attached to the Office of the President. In 1993, the BOT Centre was set up, initially focusing on promoting the BOT program (also called the Philippine Infrastructure Privatisation Program) and on training implementing agencies and local governments. In 1995, the BOT Centre's role was extended to coordinating and monitoring the implementation of projects; now it maintains core staff who provide technical assistance and training at all stages of the project cycle.

FEATURES OF THE BOT SYSTEM

The legal and policy framework for infrastructure development under the BOT law provides an increasingly coherent framework for government policy on private involvement in infrastructure. As the policy framework has developed, it has become

more generalised and, to some extent, has transcended single infrastructure sectors or single government bodies. This in turn provides private investors with the basis for a clearer understanding of which areas the government broadly supports for investment. A focused legal and regulatory structure to govern the development of infrastructure projects also reduces the burden in some perennial areas of complaint for private investors, such as long waiting periods for government approvals.

The Constitution

In common with a number of countries, the Philippine Constitution limits the extent to which the private sector and foreign parties can own and operate infrastructure services. Article 12 of Section 11 in the 1987 Constitution restricts public utilities operation to nationals or corporations and associations with 60 per cent domestic ownership. All executive and management personnel must be Philippine citizens and the use of 'front-men' or corporations is prohibited by the 'anti-dummy' law, Act No. 108 (Guislain, 1997, p. 249).

Recent legal decisions have highlighted contradictions between the Philippine Government's desire to promote greater competition and attract foreign and private investment in industry and infrastructure sectors. For example, in late 1997 a Supreme Court ruling blocked proposed oil industry deregulation measures as unconstitutional. Similarly a 1996 court ruling blocked the sale of the Manila Hotel to a Malaysian company. (See Chapter 5 - *Business Environment*.) Moves to amend the constitution to make it more consistent with the Philippines' changing economic circumstances and the Ramos administration's economic reform program also have been stalled by an alliance of business and political interests unhappy with the trend towards greater private sector participation in sectors traditionally controlled by the public sector (Jackson, 1997). Recent laws on environmental protection and indigenous peoples' rights also may affect some infrastructure projects. (See Chapter 7 - *Mining*.)

In the past, either executive orders (for example, Executive Order 215 allowing 100 per cent foreign ownership of independent power generators) or concessions that retain public sector ownership rights (for example, the recently awarded Manila water concessions) circumvented constitutional restrictions on ownership and operations in priority infrastructure sectors. However, constitutional restrictions and the Supreme Court's interpretation of them, as in the Manila Hotel and oil industry rulings, could jeopardise government plans to progress privatisation in sectors such as power and ports. (See Chapter 5 - *Business Environment*.)

The BOT Law

The Philippines was the first Asian country to pass specific legislation to promote private infrastructure investment and circumvent restrictions on private and foreign ownership and operations. This legislation is embodied in Republic Act 6 957, authorising the financing, construction, operation and maintenance of infrastructure projects by the private sector. The original version of the act was approved in July 1990 and its implementing regulations were signed in April 1991. Initially only BOT and Build Transfer, BT contracts were legal. Hence it is often known as the BOT law. However, in 1995 an amending act (Republic Act 7 718) expanded the range of contractual arrangements the government could enter into with the private sector.

The BOT law is intended to act as a catalyst for private sector participation in infrastructure projects in most key sectors. Eligible projects include ports, roads, airports, telecommunications and water supply.

Under Republic Act 6 957, a relevant infrastructure project includes a contractual arrangement whereby the sponsor is responsible for financing, constructing, operating and maintaining an infrastructure facility. The BOT law recognises the sponsor's right to operate the facility for up to 50 years; to impose tolls, fees or rentals to recover construction, operating and maintenance costs; and to earn a return on investment. The BOT law restricts the standard requirement of 60 per cent Filipino ownership to specified public utilities; consequently, it allows 100 per cent foreign ownership of BOT companies in a wide range of projects that do not fall within the ambit of specified utilities.

The BOT law also reduces local participation in construction. Normally, all private sector construction contracts undertaken in the Philippines must be awarded to companies with at least 60 per cent Filipino owned capital. However, the BOT law allows either a foreign and/or Filipino construction contractor.

Under the BOT law, private investors must meet a range of eligibility requirements, including certain pre-qualification requirements about financial capacity and previous development and construction experience.

The 1995 amendments to the BOT law provide investors with additional financial and non-financial incentives, including allowing foreign aid money to be used as a source of funds for up to 25 per cent of costs, streamlining approval processes and offering projects in excess of P 1 billion an entitlement to incentives under the Omnibus Investments Code of 1987. (See Chapter 4 - *Investment*.)

Solicited versus Unsolicited Bids

The 1995 BOT law amendments also allow government agencies to consider unsolicited projects and engage in direct negotiations. Unsolicited bids and projects can create problems in assessing the cost effectiveness of a proposal; consequently, they can take longer to negotiate and implement than well defined solicited bids open to competitive tenders. Unsolicited bids may lead to higher costs for users or the government purchaser of infrastructure services.

The BOT law, in response to these considerations, limits the types of projects that can be directly negotiated and legislates controls on what types of unsolicited proposals may be accepted. Direct negotiations with a single project proponent can occur if only one qualifying or complying bidder exists. Unsolicited proposals may be accepted on a negotiated basis if the project:

- involves a new concept or technology and is not a part of the Government's priority list of projects
- does not require any government guarantee, subsidy or equity
- is put out for alternative bids but none is received within 60 days.

If another bidder submits a lower price, the original bidder has the right to match it. Under all other circumstances, projects must be put out to competitive bidding.

ELIGIBLE PROJECTS UNDER THE BOT LAW

The BOT law and implementing rules and regulations indicate that appropriate agencies may authorise the construction, rehabilitation, improvement, betterment, expansion, modernisation, operation, financing and maintenance of:

- highways, including expressways, roads, bridges, interchanges, tunnels and related facilities
- railways or rail-based projects packaged with commercial development opportunities
- non-rail based mass transit facilities, navigable inland waterways and related facilities
- port infrastructure like piers, wharves, quays, storage handling areas, ferry services and related facilities
- airports, air navigation, and related facilities
- power generation, transmission, distribution and related facilities
- telecommunications, backbone networks, terrestrial and satellite facilities, and related service facilities
- information technology and data base infrastructure
- irrigation and related facilities
- water supply, sewerage, drainage and related facilities
- education and health infrastructure
- land reclamation, dredging and other related development facilities
- industrial and tourist estates or townships, including related infrastructure facilities and utilities
- government buildings, housing projects
- markets, slaughterhouses and related facilities
- warehouses and post-harvest facilities
- public fishing ports and fish ponds, including storage and processing facilities
- environmental and solid waste management related facilities such as collection equipment, composting plants, incinerators, landfill and tidal barriers.

Source: Republic Act 6 957 (the BOT law) and its implementing rules and regulations.

The Philippine privatisation process is increasingly transparent and encourages competitive project preparation, tendering and implementation. The Government is moving towards the 'solicited bid' model rather than the wide variety of unsolicited proposals which characterise infrastructure proposals elsewhere. While the Philippines' BOT law does not preclude unsolicited proposals, it does not strongly encourage them. It recognises an asymmetric information problem - government

knows less than the private player. In many cases, an unsolicited bid may be the only way forward because a firm may have information and technology that those in government who define the scope of works may not fully understand.

Philippine law deals with this dilemma by defining a process so that those making unsolicited bids genuinely face competitive tenders for projects they bring forward. The originator can then match the cheapest bid. While this process frustrates some potential or actual originators because, for example they may lose intellectual property when their concept is put out to tender, compared to alternatives, the Philippines' approach seems to have considerable merit.

Many in the private sector originally preferred the unsolicited bid approach, seeking to put proposals to government which they could then advance on a preferred basis. They argued this brought advantages of more rapid implementation and finance. However, considerable experience in the Philippines and elsewhere indicates that the negotiation process following unsolicited bids can drag out substantially, not least because the government fails to properly define the scope of works, market boundaries and other matters which should be defined clearly at the start of a solicited bid project.

The rapid progress from concept to execution of two private water concessions in Metro Manila shows the gains from competitive solicited bids; the two concessions were implemented in 1997 following a two year gestation. Some other Asian cities started seeking private sector water concessions before the Manila process started, but in most cases they remain to be fully implemented, despite the supposedly faster results of direct negotiation.

Competitive tendering appears to save substantial costs. The Manila water example, like the Victorian electricity restructure and privatisation, has generated considerably lower tariffs to customers as a consequence of the tendering process.

Bidding and Evaluation Requirements

The BOT law lays out procedures for bidding, evaluating and implementing contracts. Notices to pre-qualify and bid must be published, and potential bidders can attend a pre-bid conference. To pre-qualify, bidders must meet requirements on Filipino participation, previous track record and financial capability. Tender documents are prepared along with a draft contract. Bids are evaluated first on the basis of their technical, operational, environmental and financial viability. Financial proposals then are evaluated and the best bid is selected on the following criteria:

- the present value of proposed customer tolls, fees and rents for schemes where private sector operators fund project construction and operating expenses; the bid with the lowest present value of tolls, fees and rents succeeds
- the present value of construction payments and lease back arrangements where the government pays for the facility; the bid with highest payments succeeds.

The implementing agency or local government responsible for the project supervises contracts. These agencies then submit regular information on project status to the BOT Centre in the Coordinating Council of the Philippine Assistance Program.

The BOT law and its implementing arrangements have successfully mobilised private funding for many infrastructure projects, particularly in electricity generation (Table 6.4). In the power sector, 27 projects have been completed. The BOT approach is now being employed in other sectors. A further 20 projects have been awarded or are under construction, including two light rail projects, two highway projects, two water and sanitation projects, and further electricity generation projects. Forty more projects are being evaluated either for bidding or through direct negotiation. The total cost of all projects completed, awarded or under consideration is US\$19.7 billion.

In addition to national projects, a further 19 projects are being developed or have been shortlisted at local government level. These smaller scale projects include commercial shopping centres, public markets, solid waste management and town water supply and sanitation, and will cost about US\$870 million.

Dispute Resolution

Private infrastructure investors in Philippine BOTs and other projects have more dispute resolution options available than in many other East Asian countries. Parties involved in arbitration have significant flexibility and can either draft their own rules of procedure, or operate under the United Nations Commission on International Trade Law or the International Chamber of Commerce Rules of Conciliation and Arbitration. The Philippines has both ratified and implemented the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

Nevertheless, foreign investors in infrastructure projects face some difficulties. While a Philippine court may enforce a foreign judgment, this is not automatic, and a foreign judgment may be set aside because of lack of jurisdiction or lack of notice to affected parties.

FINANCIAL MARKET DEEPENING AND ACCESS

Finance Minister de Ocampo estimates that the Philippines will require US\$38.1 billion in infrastructure finance in the next three to five years (de Ocampo, 1996). While the innovative nature of the BOT program has attracted foreign contractors and banks, difficulties of project sponsors in raising the local peso component of projects indicates the need for further financial market reforms. (See Chapter 2 - *Macroeconomic Environment* and Chapter 4 - *Investment*.)

Domestic Capital Market Developments

The relatively undeveloped nature of the Philippines' capital market causes heavy reliance on foreign exchange to finance infrastructure. The Government is upgrading the capital market, improving the regulatory framework and generally seeking to expand the capacity of capital markets, including the stock market, to fund BOT style investments. Stock exchange depth was enhanced considerably when the Makati and Manila Stock Exchanges merged to form the Philippine Stock Exchange.

Table 6.4

Many Transport BOTs Being Considered
Philippines National Infrastructure Projects:
Summary List of National Projects, 1997

	Electricity generation	Other energy	Light rail	Railways	Highways	Air transport	Water & sanitation	Information technology	Other	All sectors
Completed projects	Cost US\$m Number	510 4	0 0	0 0	0 0	0 0	0 0	0 0	0 0	4 492 27
Projects awarded or under construction	Cost US\$m Number	3 976 11	0 0	961 2	0 0	323 2	0 0	175 2	0 0	885 3
Projects being prepared for public bidding	Cost US\$m Number	0 0	0 0	0 0	110 1	7 2	0 0	90 2	107 4	314 9
Projects under public bidding	Cost US\$m Number	1 085 9	0 0	0 0	0 0	0 0	104 1	115 3	789 1	2 093 14
Unsolicited proposals being evaluated	Cost US\$m Number	700 2	0 0	1 190 2	2 000 1	1 210 2	440 1	852 6	137 3	6 529 17
All projects	Cost US\$m Number	9 743 45	510 4	2 151 4	2 000 1	1 643 5	447 3	1 131 9	1 918 11	19 748 87

Source: BOT Centre, 1997.

The Philippine Stock Exchange has created a special board for infrastructure. Infrastructure projects do not need a track record to list; the decision to allow listing is based solely on the BOT asset. In recent years, ten BOT schemes have listed, with both foreign and local sponsors (Yulo, 1997).

Consortia of local branches of multinational banks such as Citibank, local and foreign banks have financed several infrastructure projects (Montes, 1997). For example, Citibank, ING Baring, Bank of Nova Scotia and Metrobank financed Manila light rail. In this project, private bank lenders adopted an approach the Department of Finance developed, involving an inverted financing mechanism. Under this approach principal repayments were delayed, increasing from 3 per cent to 12 per cent of the loan as the project's cash flow built up, while initial interest payments were also capitalised into the loan. The World Bank gave a partial guarantee, and attempted to provide guarantees on the latter part of the loan to stretch amortisation, from 12 to 18 years, but this did not eventuate. However, this concept is being explored elsewhere.

Citibank is prominent in syndicating loans with local banks and export credit agencies for projects. For power projects, the national Government guaranteed power purchase agreements, enabling risk to be unbundled and priced, and facilitating private financing (Montes, 1997).

Local bond markets are very thin; recently a German power company raised funds for a BOT power project through the local bond market but took all available local liquidity (Montes, 1997). An alternative is to develop mutual funds. The expected growth of the domestic life insurance sector with the recent entry of foreign companies should expand the market for long term infrastructure bonds.

A key to developing the corporate bond market, which would expand infrastructure financing options, is to develop the government bond market. Typically, the government bond market has been thin at the long term end relevant to infrastructure, but recent success in issuing longer term bonds should contribute to developing a long term corporate bond. However, with low income levels and savings, for some years the Philippines will only provide a relatively shallow bond and equity market, able to finance only a modest proportion of the country's massive infrastructure needs. By de Ocampo's estimate, over the next three to five years, infrastructure requirements will be from US\$8 billion to US\$13 billion per year; total Philippine savings in 1996 were only US\$12 billion.

As with all capital market developments, taxation is central to infrastructure project funding, not least because open ended funds have a capital gains tax of 10 per cent to 35 per cent. Additionally, some fund holders may be subject to double taxation in the Philippines (Asian Development Bank, 1997).

Municipal Bonds

Another development being considered relates to expanding the capacity of local governments to issue bonds to finance infrastructure. The 1991 local government code gave local government units at the provincial, city and municipal level increased responsibility for providing basic infrastructure services and installing facilities. Local governments also were given increased revenue raising powers through taxes, fees and other charges, and the right to issue bonds and other longer

term securities to finance projects. As well, local governments use allocations from the national budget to fund projects.

However, most local governments have limited ability to implement infrastructure projects, and are inexperienced in attracting cost effective and appropriate private sector funding for infrastructure projects. Instead mayors often focus on their three year election cycle. However, some areas like Northern Mindanao are more advanced and have organised a list of revenue and non-revenue earning projects for Japanese OECF assistance and for funding with municipal bonds; Bureau of Internal Revenue agency commitments will provide an income stream to repay loans (Osmond, 1997).

In early 1998, the Government and multilateral development banks are considering schemes for a municipal bond market, based on a US municipal bond concept. The Land Bank of the Philippines and a local security firm (Dharmala) are expected to launch a municipal bond market in 1998, initially selling P 500 million of local bonds. Revenue from bond sales will target large cities in Northern Mindanao to fund local government infrastructure projects, including ports, roads and bridges. The 5 to 7 year bonds will be peso denominated, guaranteed by municipal government, listed on the Philippine Stock Exchange and traded on their own secondary market. They are aimed at local and foreign institutional investors (Ortiz, 1997).

Local governments would repay bond holders from revenue the national government allocates through the budget to them but pays into escrow-style accounts. This would reassure borrowers that they would be paid before other calls were made on local government funds. The same successful USAID financial market development project which promoted unifying the country's two stock exchanges is facilitating the development of the municipal bond market.

Credit Enhancement and Infrastructure Development Funds

In 1995 the Philippine Government considered setting up a US\$1 billion Private Sector Infrastructure Development Fund. Such funds can reduce the transaction costs of evaluating and processing projects and seeking finance (Bond and Carter, 1994). The World Bank proposed multilateral agencies contribute foreign currency to a venture capital fund that would fund Philippine infrastructure projects. The fund also would have assisted in undertaking due diligence assessments of private sector project sponsors and provided technical assistance in developing the regulatory framework for infrastructure projects. Foreign and local funds raised would have been invested in local infrastructure projects that provided commercial rates of return. The fund would have given developers access to long term financing for infrastructure projects the Government identified as high priority under the BOT scheme.

However, the World Bank proposal did not receive unanimous support. The Government deemed the proposal redundant as private sector equity and venture capital funds developed in the market place in the late 1990s. The proposal is being revised, as are initiatives aimed at broadening and deepening private sector bond markets.

Foreign Bond Issues and Export Credits

As a result of shallow local markets, most firms look overseas for long term infrastructure finance, even though this creates a foreign exchange risk that

borrowing locally does not. When local subsidiary of the US company Enron Power wanted to raise finance for its recent power plant, it used Eurobonds. Enron used the 144A private placements market in the US bond market for non-recourse financing of its project. The high yield market in the USA also was used for very expensive finance for two tollways in China, at 300 to 400 basis points above the London Interbank Borrowing Rate, LIBOR. Philippines Long Distance Telephone Company is raising funds on the Eurobond market to finance its expansion. However, if the recent peso depreciation is sustained, all pre-depreciation projects will face serious problems repaying foreign currency loans with peso receipts, unless they can raise peso tariffs steeply.

Market participants indicated that export insurance agencies like the US Overseas Private Sector Investments Company provides US exporters with strong support. Even though US exporters of private infrastructure projects may not be as competitive as European or Australian competitors, such funds confer a considerable advantage in winning projects (Montes, 1997).

Multilateral Bank Guarantees

The World Bank and Asian Development Bank both provide guarantees for funds borrowed for some private sector funded infrastructure projects in the Philippines, increasing the 'bankability' of such projects.

RISK MITIGATION STRATEGIES

A key feature of Philippine infrastructure laws and regulations that supports private sector participation is the development of a consistent set of legal rules and regulatory procedures, promoting a reasonable degree of predictability and consistency in the treatment of projects. Minimising risk is a core issue in structuring successful infrastructure projects and many projects only reach fruition if a long term income stream is assured.

In such circumstances, potential investors seek a legal and policy framework that reduces the risk of policy changes which adversely affect cost or revenue flows during project life. The Philippine BOT law formally recognises the rights of developers to operate facilities on a long term basis and obtain a reasonable return on investments. The Government clearly accepts the need for a stable policy environment, as the conditions of the dual water supply concession arrangement for Manila implemented in 1997 show.

Guarantees

The lack of a Philippine track record in private sector infrastructure investment in the early 1990s meant that private investors perceived risks as high. Consequently, the Government provided extensive credit guarantees to infrastructure project investors particularly in the power sector. For example, lenders to electricity BOTs received credit guarantees against all contractual obligations of the National Power Corporation. The downside of such guarantees was the Government bore commercial project risks that would have been better allocated to the private sector.

Now it has established a track record of honouring payments, the Government can reduce its guarantee obligations. Under a 1995 policy initiative, the Government aims to:

- unbundle commercial from sovereign risk
- reduce guarantee obligations to 75-80 per cent of contractual payments
- have guarantee products that fall away under specified conditions, such as achieving an improved credit rating
- more carefully review guarantee pricing and budgeting (Kohli et al, 1997, p. 6).

These initiatives have had some success; for example foreign exchange risk guarantees provided under previous BOT agreements now fall away if the Philippines achieves investment grade (Baa and higher) from an international credit agency such as Moody's, and project specific guarantees fall away if corporations themselves reach investment grade.

Risk Management and Allocation

Another significant development in identifying and managing risk was delineating risk bearing responsibilities in circumstances where a sponsor is responsible for overall project implementation, a contractor for construction and equipment supply, and an operator for operation and maintenance functions.

With recent major infrastructure projects, the Department of Finance has invited project sponsors to identify significant risks which, if carried by the sponsor alone, would adversely affect project viability and 'bankability'. For sovereign risk or factors over which the Government has significant control, the Department of Finance may recommend that the Government be paid to carry this risk and sponsors can include in their overall project bid what they are willing to pay to have this risk covered for them (Reyes, 1997). Previously, guarantees were negotiated after bids were won; this potentially distorted the outcome of the bidding process, as other bidders may have improved their bids if they had realised guarantees were available.

TARIFFS, SUBSIDIES AND FISCAL REFORMS

A major problem in obtaining private sector participation in infrastructure projects in the Philippines and other East Asian economies is the prevalence of subsidised tariffs and/or unprofitable utilities. Water, electricity and even phone tariffs often are set below the actual cost of providing services. Governments are reluctant to support sharp tariff increases because of political resistance, strikes and other difficulties which higher tariffs can create. In addition, governments are loath to raise tariffs which often are high by international standards because of artificially high losses from distribution systems (like electricity and water), non-payment or non-collection of fees, theft and general mismanagement, because this will affect the competitiveness of local industries.

While higher tariffs cover the losses on infrastructure service provision, a better approach is to get the right operating structure first to facilitate competitive and low cost provision. Introducing competitive provision may not be feasible (for example in operating a natural monopoly network like electricity transmission), so

introducing a regulatory regime which indexes tariffs from an acceptable base to a basket of costs indicative of efficient practice is an alternative. For water and electricity, the Philippines is moving towards regulating tariffs. These reforms should consequently reduce subsidies to infrastructure providers and users, thereby assisting in achieving fiscal objectives.

Direct subsidies are the best way to support customers with very low incomes. Water, electricity and other charges which are set artificially low so low income households can afford them, generally benefit middle and higher income groups disproportionately, as they use such services more intensively per capita. Furthermore, artificially low tariffs reduce the commercial viability of the utility and encourage wasteful overuse of the service.

The Philippines accepts these arguments and the need for the Department of Finance rather than the utility concerned to be responsible for subsidies to low income groups.

TRAINING AND ODA SUPPORT FOR INFRASTRUCTURE REFORM

One reason many East Asian economies fail to adopt best practice infrastructure reforms is the shortage of expertise and inadequate budgets for training personnel. In the Philippines, however, key government agencies such as the Department of Finance, the Bank Sentral ng Pilipas and NEDA have invested substantially in developing expertise. The BOT Center is a specialised institution which multilateral agencies strongly support to train local institutions and spread best practice regarding the use of BOTs.

The pioneering work in infrastructure reform in New Zealand and most recently in Victoria in Australia in electricity, transport and water provides Australia with an opportunity to further assist the Philippines through technology transfer and training. (See Chapter 9 - *Implications*.) This focus on knowledge transfer, emphasising providing 'concepts not concrete' is a major theme of new approaches to ODA by a number of bilateral donors and multilateral banks.

In the Philippines, support could be extended not just to organisations, such as the BOT Centre, but also to specialised reform units focused on electricity, water, transport and other key infrastructure. In a country as geographically decentralised as the Philippines, a broad base of support and training is needed if complex infrastructure reforms are to be understood and implemented in an efficient, transparent and sustainable manner at both central and local government levels.

SECTORAL STUDIES

In addition to developing generic laws and regulations to promote private sector infrastructure development, the Philippine Government has adopted sector specific reforms in water, telecommunications, electricity and transport. These reforms include unbundling integrated monopolies into competitive services and natural monopoly network facilities; separating regulation, ownership, policy and utility management; and developing innovative contractual arrangements allowing firms to compete for the market in sectors where direct competition in the market is not feasible. However, the pace of reform in these key infrastructure sectors varies depending on political, institutional and technical constraints.

Table 6.5

Philippines Leads Independent Power Production, IPP Structure and Ownership of Electricity Supply in Selected East Asian Countries

Country	Generation (G)	Transmission (T)	Distribution (D)	Ownership	IPP share of power generated (per cent)	Planned IPPs
Philippines	1 (National Power Corporation)	1 (National Power Corporation)	146	state (G+T) mixed (D)	19	39 signed July 1996
Indonesia	PLN + some RECs	1 (PLN)	PLN + RECS	state (PLN) mixed (others)	0	first IPP started operating in 1997, signed July 1996 15 more signed, now on hold
Thailand	1 (EGAT)	1 (EGAT)	2 (MEA, PEA)	state	0	0 signed 1996
China	1 new NPC holder of all state power assets	1 National Power Grid Company (Subsidiary to NPC)	over 1500 state owned local distribution companies	state	many IPP joint ventures with state owned enterprises	2-3 signed by early 1998, several being negotiated
Vietnam	1 (EVN)	1 (EVN)	1 (EVN)	state	0 in 1996	a number being negotiated
Japan	12 (+small others)	10	10	private	0	limited cogeneration recently permitted

Note: PLN is Perusahaan Umum Listrik Negara
 NPC is National Power Company, China
 PEA is Provincial Electricity Authority
 EGAT is Electricity Generating Authority of Thailand
 RECs is Regional electricity cooperatives
 EGCO is Electricity Generating Company Limited
 MEA is Metropolitan Electricity Authority

Source: International Energy Agency, 1997; Shiwei et al, 1997; Kinhill and Tasman, 1996.

POWER SECTOR

Like China, Vietnam, Indonesia and Thailand, the Philippines' power sector was mainly state owned and operated (Table 6.5). However, while in some countries state ownership may have lowered subsidised tariffs, in the Philippines, the National Power Corporation had few incentives to operate efficiently and competitively, so power generation growth lagged seriously behind regional neighbours (Table 6.1). As a result, major shortages developed in the early 1990s. By allowing waste and

inefficiency, public ownership also created a drain on government budgets. For example, the National Power Corporation had grid losses of 14 per cent and power sales per employee of 2 100 megawatt hour. This compared to grid losses of 9.7 per in Thailand (Table 6.6).

In the 1992-93 power crises, 12 hour blackouts occurred regularly, forcing a major rethink of infrastructure development and precipitating a staged process of reform and restructuring in the electricity sector.

The first stage of the electricity reforms focused on rapidly expanding generation capacity through private sector BOT projects by independent power producers while centralising control in the National Power Corporation. Three main laws were passed enabling private sector participation in generation to proceed. The BOT law authorised private sector participation in government infrastructure projects. The Foreign Investment Act of 1991 permitted 100 per cent foreign ownership of generation projects.³ Thirdly, during the power crisis of 1992-93, Republic Act 7 648 of 1993 fast tracked generation project approvals by allowing the President, through the National Power Corporation, to enter into negotiated contracts and raising the National Power Corporation's allowed rate of return to 12 per cent, thus facilitating increased tariffs.

Table 6.6

Lagging Philippine Technical Efficiency

Technical Performance Indicators of Selected Utilities in Selected Countries (1994-95)

Country	Grid losses		Average thermal efficiency (per cent)	Power sales (MWh per employee)	System load factor (per cent)
	Transmission (per cent)	Total (per cent)			
Indonesia	2.8	13.4	34.0 (gas+oil) 30.0 (coal)	1 019 (PLN)	68.0
Philippines	3.0	14.0		2 100 (NPC)	40.0
Thailand	na	9.7	35.6	2 099 (EGAT) 1 963 (MEA) 1 032 (PEA)	75.8
Australia (NSW)	2.8 (PE)	4.8 (PE)	35.7	34 100 (PP) 4 500 (PE)	63.2
Japan	na	5.8	38.8	4 725	56.8

Note: PE is Pacific Energy, PP is Pacific Power (NSW), others as for Table 6.5.

Source: International Energy Agency, 1997.

³ Foreign investment and electricity sector legislation was first modified in 1987 to allow private investment in generation with Executive Order No. 215. Implementing legislation allowing independent power producers was introduced in Republic Act 6 957 of 1991. These legislative changes enabled independent generating companies to sell to the 'single buyer' state owned utility.

Following these legislative changes, a number of BOT schemes were approved and implemented very quickly. New independent power producers netted relatively high returns (World Bank, 1994, p. 67) and received tax and import duty incentives; for example, electricity investors were offered a 6 year tax holiday.

While such deals attract private investors, their cost may be buried in the total system costs and they are not necessarily attractive for customers. The extent of the power crisis in 1992-93 and the limited credibility at that time of the Philippines with international investors probably precluded any other approach to overcoming power shortages.

Initially, this approach required the least change to existing institutional structures. Independent power producers with foreign equity funding continue to supply wholesale power direct to the single buyer, the National Power Corporation, which then sells to distributors. Private generators simply provide power to the state monopoly and have little effect on the utility's structure or mode of operation. Independent power producers generally do not take substantial risks in estimating future demand, as the Government backs 'take or pay' contracts, usually in foreign currency, for the power they supply to the grid.

While many independent power producers are negotiating in East Asia, only a few have signed power purchasing agreements (International Energy Agency, 1997, p. 28). However, the Philippines' record is much better than elsewhere (Table 6.5). The negotiations for the first power purchasing agreements in the Philippines were lengthy and complicated, but subsequent processes became streamlined and have mobilised private sector capital to meet immediate needs.

While these initiatives successfully met immediate capacity shortages, they have not yet moved to world best practice in electricity industry reform. The National Power Corporation and the Government increasingly recognise the need for more comprehensive industry reform based on the multiple buyer/seller model, involving customers trading across an independent grid. Here independent power producers would compete freely to sell power, rather than being given a guaranteed market at a set tariff, which may be high in international terms.

The potential cost savings to end users of the multiple buyer/seller model are substantial, as the Victorian experience shows. The electricity sector review lays the foundation for more comprehensive industry restructuring and greater private participation in distribution and generation (National Power Corporation, 1996).

The Omnibus Electric Power Industry Act, that remains before Congress, outlines the power industry's future organisation and roles for government, private agencies and companies. The proposed restructuring, to start in 1998, would proceed in three stages, leading to eventual privatisation of selected National Power Corporation generation and service subsidiaries.

- Phase 1 should take two years, once Congress approves the bill. During that time the National Power Corporation's generation and transmission functions would be unbundled and its operation streamlined. The unbundled generation and transmission businesses would operate as subsidiaries, but be corporatised, turning them into profit-making entities in preparation for privatisation.
- Phase 2 also should take two years, during which the National Power Corporation would progressively divest all its thermal generation assets. The

government, either through the National Power Corporation or its successors (for example a hydro power authority) would retain control of hydro and geothermal resources. Existing BOT contracts with independent power producers would be renegotiated as Build Own Operate contracts, or sold. Selected service subsidiaries also would be privatised and the sub-transmission system relinquished to regional and local electricity utilities.

- Phase 3 would involve full restructuring of the industry, with the National Power Corporation becoming an independent national transmission company. The Electricity Regulation Board would regulate wheeling arrangements and prices, aiming at fair and transparent outcomes. Independent power producers and electricity utilities owning power stations would undertake generation and sell into the independent grid through a competitive wholesale market. Distribution would remain the responsibility of local power utilities. However, private investors would be encouraged to distribute and retail electricity, and utilities would be allowed to consolidate and merge. Distributors also would be able to enter into direct contracts with generators (National Power Corporation, 1996; International Energy Agency, 1997).

Proposed ownership and structural changes in the Philippine electricity sector are more radical than many the International Energy Agency indicates are taking place, or planned in other East Asian economies (Table 6.7). They significantly depart from previous practice and go further in introducing private sector participation and competition than many more developed International Energy Agency countries are proposing. Indonesia's plans are still under review and they also consider the multiple buyer/seller model implemented in Victoria. Thailand's reforms are also significant.

Table 6.7

The Philippines and Thailand Plan Radical Reforms Proposed Ownership and Industry Structure by Country

Country	Assets to be privatised	Planned structure
Indonesia	<p><i>Generation:</i> Maximum of 40 per cent of PLN's (or its successor's) generating assets. One model advanced involves two generating groups - Genco 1 (Java-Bali 1) Genco 2 (Java-Bali 2) after 1998. An alternative model advocates substantially more generators competing across an independent grid.</p> <p><i>Transmission:</i> Grid extension. Timing not determined.</p>	<p>One model being advanced suggests PLN as single buyer. Independent power producers and privatised generators compete to provide new capacity and power to PLN. A separate transmission subsidiary may be created along with four horizontally separated distribution subsidiaries.</p> <p>A separate model proposed is for multiple buyers/sellers along Victorian lines.</p>
Philippines	<p><i>Generation:</i> National Power Corporation privatisation through thermal generation divestiture. Geothermal and hydro power remain under government control.</p> <p><i>Transmission:</i> Possible.</p> <p><i>Distribution:</i> New private entity. Starting date not fixed, awaiting enabling legislation.</p>	<p>Bidding for new capacity centralised to Gridco/Department of Energy. Partial divestiture of generation. Grid to be retained by Gridco or National Power Corporation.</p>
Thailand	<p><i>Generation:</i> EGAT successor EGCO already under majority private ownership. Further privatisation progressed in 1997.</p> <p><i>Transmission:</i> Strategic partners to be admitted after 2000.</p>	<p>Possible generation split up before 2000.</p> <p>Separate transmission and distribution after 2000.</p>
China	<p>All existing power assets to remain state owned; however, effective control vested in National Power Corporation. Control may be devolved, with national corporations being only passive owners. Provincial corporations have considerable autonomy.</p>	<p>World Bank recommends single buyer model, pool trading between regional blocks, sale of regional generation assets to non-affiliated companies.</p>
Vietnam	<p>No proposals to divest assets. Private sector involvement only as independent power producers in new generation capacity.</p>	<p>All assets recently vested in single national state owned power company, EVN. Greater separation of state ownership from EVN management is being reviewed.</p>

Source: International Energy Agency, 1997.

WATER SECTOR

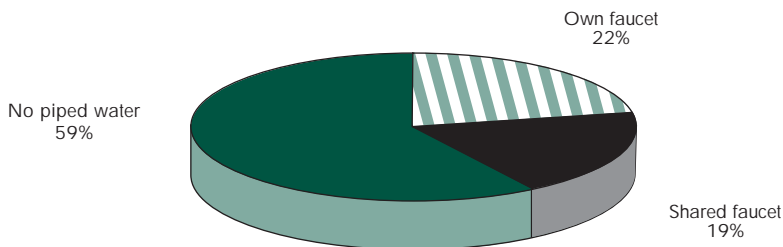
The major problem related to water infrastructure is a dearth of household piped water connections as the *potential* water supply for domestic and industrial consumption appears plentiful. Water consumers in the Philippines, like consumers elsewhere value the time and energy savings and health benefits of safe, reticulated water supplies delivered to their premises. However, data on water connections clearly demonstrate the inadequacy of water supply coverage to Philippine households.⁴

Nearly 60 per cent of Philippine households do not have ready access to water faucets and must rely on other sources (Figure 6.1). Only 22 per cent of households have their own faucet, while 19 per cent share faucets (Figure 6.1). Metropolitan Manila has the largest share of water supply infrastructure: 50 per cent of households served by the former supplier, Metropolitan Waterworks and Sewerage System, have individual faucets; and a further 28 per cent share faucets. Of households outside Manila, over 65 per cent have no access to faucets and must rely on other sources for water supplies (Figure 6.2).

High rates of unaccounted for water loss accompany low levels of connection. In 1993, unaccounted for water losses for Manila were almost 60 per cent higher than for any other major Asian city (Table 6.8). However, Manila's operating ratio (operating costs to revenue) was relatively low (37 per cent), indicating a better performance on cost recovery than most Asian cities.

Figure 6.1

Most Households Have No Access to Faucets Rural and Urban Households with Household Taps



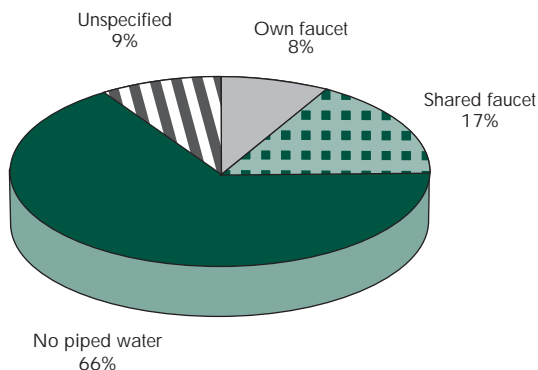
Source: Tasman Asia Pacific, 1993.

⁴ While specific data for water supply to firms were not obtained, sizable deficiencies in availability probably exist.

Figure 6.2

Over Half the Population outside Manila Has No Access to Piped Water

Distribution of Household Water Supply Outside Manila



Source: Tasman Asia Pacific, 1993.

Table 6.8

Highest Water Losses in Manila

Water Tariff Method and Revenue Recovery in East Asian Cities, 1993

Country	City surveyed	Method of household payment for water	Operating ratio (operating costs/revenue)	Unaccounted for water (per cent)
Philippines	Cebu	Metered use	0.63	38
	Metro Manila	Metered use	0.37	58
China	Beijing	Metered use	1.47	28
	Guangzhou	Metered use	0.49	na
	Shanghai	Metered use	1.92	25
	Tianjin	Metered use	1.25	12
	Hong Kong	Metered use	1.15	26
Indonesia	Bandung	Metered use	0.43	42
	Jakarta	Metered use	0.42	57
	Medan	Metered use	1.02	34
Thailand	Bangkok	Metered use	0.43	31
	Chiang Mai	Metered use	0.74	39
Vietnam	Hanoi	Combination	0.79	53
	Ho Chi Minh City	Combination	0.59	41

Source: Asian Development Bank, 1993.

To address the entrenched problems of low coverage and high unaccounted for water losses in metropolitan Manila, the Government initiated a process of contractual negotiations with private enterprises to operate, maintain, upgrade and augment Manila's water supply and sanitation system. In January 1997, a competitive bidding process led to the selection of two private water concessionaires to supply east and west Manila (Veroy, 1997).

The bids for the concession were decided on the lowest water tariff offered to consumers. The winning bidder with the lowest proposed tariff for both zones was a consortium comprising the Ayala Corporation (local partner) and Bechtel and Northwest Water (foreign partners). However, bidding rules specified that a single consortium could only win one zone. Consequently, the Ayala consortium was awarded the east zone and the second placed Benpres and Lyonnaise des Eaux consortium was awarded the west zone. The winning bidders now offer an average water supply tariff in the west Manila concession that is 57 per cent below previous Metro Manila tariffs, and in the east Manila concession 27 per cent below previous Manila Waterworks and Sewerage System tariffs (Table 6.9).

SUMMARY OF THE PRIVATISATION STRUCTURE FOR MANILA WATER SUPPLY AND SANITATION

- Two 25 year concessions were granted for water supply and sanitation, for east and west Manila.
- Metropolitan Manila Waterworks and Sewerage System prepared a rigorous concession agreement to define rights, responsibilities and relationships.
- Metropolitan Manila Waterworks and Sewerage System owns the fixed assets but transfers operations and investment responsibility to private operators.
- Concessions are geographically separated but vertically integrated, incorporating water and sewage, headworks, distribution and retailing.
- Concessions must establish project companies that are at least 60 per cent Filipino owned.
- Concessions have rights to the local water source (Angat River) but must supply all additional bulk water needs.
- Concessions will improve service and expand coverage according to standards and targets stipulated in the concession agreement.
- A small unit in the Metropolitan Manila Waterworks and Sewerage System will regulate, monitor and enforce the agreement.
- An arbitration panel of three members was established outside the Metropolitan Manila Waterworks and Sewerage System to resolve disputes between the regulator and concessionaires.

Source: Veroy, 1997.

Table 6.9

Ayala, Bechtel, Northwest Water Bid Slashes Existing Tariff
Bid Rates for Manila Water Concessions
(Peso/Cubic Meter and Per cent of Existing Rate Structure)

Bidder	East zone	West zone
Aboitiz Equity Ventures (local), Generale Compagnie des Eaux (foreign)	P 5.52 (63 per cent)	P 4.99 (56 per cent)
Ayala Inc (local), Bechtel and Northwest Water (foreign)	P 2.32 (26 per cent)	P 2.51 (29 per cent)
Benpres (local), Lyonnaise des Eaux (foreign)	P 6.13 (70 per cent)	P 4.97 (57 per cent)
Metro Pacific (local), Anglian Water (foreign)	P 5.66 (65 per cent)	P 5.87 (67 per cent)

Source: BOT Centre, 1997.

Private concessionaires have compliance targets which will directly benefit water users. These benefits include almost universal water service for the Manila water supply and sanitation service area within ten years, and almost no increase in real water tariffs over the first ten years. Over the concession period, an additional US\$7 billion also will help improve and expand the system. The proposed extensions address the needs of the 30 per cent of the population, who are mostly poor, unconnected to the current supply and typically paying water vendors over ten times the price of tariffs connected customers pay. Within three years, concessionaires must provide to all existing connections an uninterrupted, 24 hour supply that meets WHO quality standards. The agreement requires non revenue water to drop from 56 per cent to 32 per cent over the first ten years and a waste water program with 80 per cent coverage to be implemented within 25 years. Other benefits include providing the Philippine Government with tax revenues of about US\$4 billion over the concession period.

The strength of these contractual obligations remains to be tested. The current exchange rate volatility in East Asia will place pressure on consortia and contracts. However, initial assessments indicate this concession approach potentially can deliver major real cost savings to customers and expand supply capacity. Manila customers have noted the lower tariffs since the concessionaires took over; this greatly increases public support for private sector participation in infrastructure.

TRANSPORT

Historically, most of the Philippine transport system was publicly owned, operated and regulated. Until recently, the public sector provided transport investment and services in every sector and subsector, except ocean and waterway carriers. Where private operators existed, for example in inter-island shipping services, small private airports and seaports, and a limited number of road projects, extensive systems of public regulation and control and in some cases guaranteed private monopolies also existed. The Public Service Act of 1936 and the Civil Aeronautics Act of 1952 embody these controls and, despite amendments, continue to constrain the deregulation process. Legislative change is needed to promote greater competition and efficiency.

Innovations in Transport Policy

The system of public ownership, operation and regulation is slowly being replaced by a more market-based approach to providing transport services. The Department of Transportation and Communications oversees a process of institutional and regulatory change in the transport sector and is responsible for developing, operating and regulating most transport sectors except national highways. The Department of Public Works and Highways is responsible for these.

The Department of Transportation and Communications Order of March 1992 set up a revised regulatory framework for transport services by instructing its regulatory bodies to facilitate the entry of new transport service suppliers, liberalise tariffs and reduce subsidies (APEC Transportation Working Group, 1997, p. RP-9). The following principles promote competition and the scope for privatisation:

- ensuring a minimum of two franchise holders on any route
- progressively freeing freight rates from government control
- deregulating most passenger fares
- putting unserved routes out to private tender.

As these initiatives and existing laws are inconsistent, a bill has been drafted to amend the relevant bodies of legislation.

Government agencies involved in transport will be privatised. For example, the Department of Transportation and Communications approved in principle the privatisation of its corporations, including the Light Rail Transit Authority and Philippines National Rail.

Role of Local Government Units

Local Government Code 1991 and the 1993-98 Philippine Development Plan gave local governments increased autonomy in developing, operating and maintaining local transport facilities. Local governments are now responsible for local roads, bridges, traffic signals, public transport terminals and ports in their areas, including those the national Government funds (APEC Transportation Working Group, 1994, p. RP-6). However, local government officials often have minimal understanding of private sector participation in transport infrastructure and the required regulatory structures, and need considerable training and assistance. (See Chapter 9 - *Implications*.)

Transport BOTs

Transport investment and operations traditionally were financed through general and specific taxes, loans, credits and other forms of government debt, and user fees and charges. User fees include facility and equipment leases, port charges and vehicle registration. The principle source of finance for major capital works was government borrowing from bilateral and multilateral lenders supplemented by suppliers' credit and local counterpart funds. However, under the BOT law, transport projects now attract private investment, in for example the light rail and expressways in Manila, Cebu and South Luzon (Table 6.10). Recently completed BOT road projects include:

- Circumferential Road No.5 (OECD assisted)
- Calamba–Calauag (Quezon) sections (OECD assisted)

- Quirino highway project
- Kilbar–Liboro section (Camarines Sur)
- Liboro–Sipocot section (Camarines Sur)
- Leyte–Cebu Interconnection (IBRD assisted)
- Davao City–Digos Road (IBRD assisted).

Table 6.10

Expressways Attract Private Investment

Major Expressways Planned in Philippine Infrastructure Privatisation Program

Project	Estimated project cost (1996)
<p>South Luzon Expressway Extension</p> <p>The project is to support the ongoing and planned development in the Cavite-Laguna-Batangas-Rizal-Quezon growth area and the development of Batangas Port to an international port. The project involves constructing an almost 20 kilometre road from Lipa City to Batangas City, the missing link of the South Luzon expressway extension. It will include building a 5 kilometre access road to Batangas port and operating and maintaining a 40 kilometre stretch from St Tomas to Batangas City. The project is currently in the bidding process.</p>	US\$80 million
<p>Metro Manila Expressway</p> <p>Route R-4 is to link the C-3 and C-5 expressways. Pre-feasibility studies were undertaken in 1993.</p>	US\$363 million
<p>Route R-5 is to provide transport services to the eastern towns of Metro Manila and Rizal province. Pre-feasibility studies were undertaken in 1994.</p>	US\$102 million
<p>Route R-7 is to increase the level of transport service by providing access to the fastest urbanising areas in Metro Manila. Pre-feasibility studies were undertaken in 1993.</p>	US\$109 million

Source: BOT Center, 1997.

AIR TRANSPORT

Executive Order 219 permitted the entry of three new private air transport carriers, Grand International Airways, Cebu Pacific Air and Air Philippines Corporation, to the domestic aviation market. Competition has increased services and reduced fares. However, the national flag carrier, Philippine Airlines, which monopolised pre-reform domestic services, remains the dominant industry player and is yet to be privatised.

The national government continues to administer civil aviation regulations, including air space allocation, safety and operations standards. The Air Transportation Office under the Department of Transportation and Communications controls air traffic control and navigation including designing, constructing, operating and maintaining equipment and civil aviation safety. It also administers pilot and crew qualifications and search and rescue operations. Air transport regulations are patterned after ICAO standards and recommended practices.

The Air Transportation Office supervises the 85 national airports and the national government makes all public airport investments. The Department of Transportation and Communications and Air Transportation Office are responsible for planning and developing public airports, except for the Manila and Cebu International Airports. The Manila International Airport Authority and Mactan-Cebu International Airport Authority operate these. Private concessionaires operate commercial activities in the international airports and government owned duty-free shops are to be privatised.

RAIL

The main railway system in the Philippines is on the island of Luzon; most other islands have no rail transport. The national government authority, Philippine National Railways owns and operates 1 000 kilometres of line. A small number of private lines also carry short hauls of sugar and minerals.

Manila is the main area where traffic gridlock demands major reforms, notably in light rail and other mass transit systems. The Light Rail Transit Authority owns, operates and maintains the 15 kilometre north-south light rail transit line in Metro Manila. Private groups handle some commercial operations in stations on the North Line, including advertising. A private lease-develop-operate arrangement also is being implemented for the Philippine National Railways' Tutuban terminal on its land. This arrangement includes constructing commercial and residential buildings on the site.

Delay in implementing the private BOT Manila Light Rail is partly due to traffic congestion but by early next century, Manila should have a much expanded light rail and improved expressway system, due to BOT investments. The key question is whether the total system can be made manageable.

Larger local governments now are taking initiatives to develop their own rail systems; for example, a mass transit project is being prepared for Metro-Cebu. Officials in Mindanao are also promoting the Mindanao Railway system on the basis of minimal government subsidies (APEC Transportation Working Group, 1994, p. RP-6).

ROAD TRANSPORT

Systems to encourage the private development of new roads, including introducing toll roads, were endorsed 25 years ago, for example under Presidential Decree 1 113 in 1973, but became submerged in political obstructions and delays. As a result of the overall lack of action on management systems and a failure to invest in major

expressways and inter-connections, passengers and freight in the Philippines suffer huge time delays from the ineffective use of transport systems.

Unpaved roads still account for 80 per cent of the total road network, and until the late 1990s, the length of paved roads was dropping as existing roads fell into disrepair. This contrasted with the rapid growth in road building in the rest of East Asia (Table 6.1). The poor condition of the national road network was recently identified as the country's major transport problem (Serefacia, 1997, p. 5).

Compared to Indonesia or China, the Philippines was relatively slow to develop private funding of road projects. However, the Department of Transportation and Communications and Department of Public Works and Highways now are processing many BOT projects. Other urban transport reforms include the privatisation of Metro Manila Transit Corporation and Pantranco North Bus Company in 1994. The private sector already provides most urban and inter-urban road transport services.

In an innovative approach to public-private partnerships in road financing, the Philippine Government provided funds to build a section of road in a major highway project, but then allowed the private partner to charge tolls over the full road length. The 'seed capital' reduced risks for the project sponsor and ensured the project proceeded with mostly private finance and with the bulk of commercial risk ultimately resting with the operator.

Major Road Projects Underway

One road development crucial to removing traffic gridlock in Manila is completing the flagship project Southern Tagalog Arterial Road (STAR) BOT. This project supports ongoing sub-projects in the Cavite-Lagina-Batangas-Rizal-Quezon growth area, and includes expanding the Batangas container port to international standards.

A key part of this project is to construct the P 0.2 billion 'missing link', 20 kilometre section of the South Luzon Expressway from Lipa City to Batangas City. These new toll roads should greatly improve traffic flows in the Manila area although population expansion, migration to urban centres, and the resulting rapid increase in vehicle numbers makes it highly likely that traffic chaos will plague Manila for some time.

A similar flagship extension of the Manila system is the P 1.8 billion Pasig Expressway BOT. Another major project is the P 14 billion Manila North tollway project upgrading the North Luzon Expressway, extending to Clark and adding key link roads.

The Manila-Cavite toll expressway is scheduled for completion by 1999. This P 6.5 billion expressway is a joint venture between the Public Estates Authority and the Malaysian firm, Renong Berhad.

The Metro Manila Skyway was about 10 per cent complete in late 1997. This US\$716 million joint venture between the Philippine National Construction Corporation and the Indonesian firm P.I. Citra Lamtoro Gung Persada involves a 6 lane elevated expressway, totaling over 44 kilometres, a key part being along the South Luzon expressway, which is also to be upgraded as part of the project.

Coordination and Regulation of Road Transport

The Department of Public Works and Highways funds construction and maintenance of national roads. Previously, this department also funded and maintained feeder roads, called farm-to-market or 'barangay' roads. However, local governments now are responsible for the development, investment and maintenance of these roads although the Department of Public Works and Highways still provides some funding. Local authorities maintain city and municipal roads.

Larger area development programs run by the Department of Interior and Local Government and Department of Tourism may also include funding road projects. However, local governments carry out construction and maintenance.

Other government agencies are involved in road traffic regulation. District offices of the Department of Public Works and Highways administer inter-urban road traffic control and the Traffic Engineering Centre regulates urban road traffic. The Land Transportation Office under the Department of Transportation and Communications registers motor vehicles and issues drivers' licences. The Land Transportation and Regulatory Board of the Department of Transportation and Communications regulates public land transport services.

MARITIME

The Philippines, like China, Malaysia, Thailand and several other East Asian economies seeks greater private sector involvement in existing ports and new port development (Guislain, 1997, p. 227). Before reform, most ports were in poor condition, with inadequate equipment and storage areas. Many inter-island shipping services were government protected monopolies. Most passenger services, particularly third class ones offered sub-standard comfort and safety: accident rates were (and still are) high due to overloading. Combined passenger and freight services result in long travel times. Several executive orders since 1994 have deregulated domestic shipping routes and rates, accelerated privatisation and competition in ports and opened domestic water transport to new operators and investors.

Port Reforms

Manila International Container Terminal was one of the earliest successful tenders for a private firm to develop, operate and maintain a port facility. The private sector mainly handles cargo and other port services except in some ports where the Philippines Port Authority also competes. However, the Philippines Port Authority is phasing out its competitive operations (APEC Transportation Working Group, 1997). Privatising port administration is being examined (APEC Transportation Working Group, 1994). The need to remove port monopolies is recognised but action is minimal.

ASIAN TERMINALS INCORPORATED

In 1990, a consortium of P&O Australia Ltd and a local interest acquired all the issued and outstanding stock of Marina Port Services Incorporated. Marina Port Services Incorporated was a privately owned firm providing general services operating and managing port terminals in the Philippines. In 1992, the Philippine Ports Authority approved for another 15 years, the renewal and extension of Marina Port Services Incorporated's contract for cargo handling services at the Port of Manila's South Harbour. At the same time, the Board of Directors of the Philippine Ports Authority required that as the sole container terminal and multicargo operator, Marina Port Services integrate storage and stevedoring services at South Harbour. Integrating cargo handling services paved the way for reorganising and upgrading port facilities and equipment there as Marina Port Services handled all international bulk, non containerised cargo passing through the port.

In September 1993 the Securities and Exchange Commission approved the change of name from Marina Port Services to Asian Terminals Incorporated. Asian Terminals was then primarily owned by two major groups of stockholders, P&O Australia Ltd and All Asia Capital Consortium. In 1996 Mitsui took a 7.7 per cent stake in the company.

Asian Terminals' share of the international container market at Port of Manila, South Harbour, grew from 26 per cent in 1991 to 38 per cent in 1997. Asian Terminals Incorporated also handles more than 8 million metric tonnes of bulk, non containerised cargo per year.

Success in expanding its share of container volume at the Port of Manila is due to sustained port growth as well as the company's long and medium term equipment acquisition, leasehold improvements and computerisation programs. As part of its expansion program, in June 1996, Asian Terminals Incorporated moved into handling, storing and distributing bulk grain cargoes at Bataan, the entry point of Manila Bay, with a 10 hectare project, the Mariveles Grain Terminal.

In January 1997, Asian Terminals opened its Inland Clearance Depot and Logistics Centre on 22 hectares in Calamba, Laguna, providing third party logistics services to industries operating in the Calabarzon industrial corridor. The terminal complements the inland clearance depot with a cargo distribution centre and commercial warehousing. Its network of warehouses offer 45 000 square metres of covered space, a few kilometres from the inland clearance depot.

In July 1997, Asian Terminals Incorporated took over the management and operations of an existing cargo handling contractor at the Port of Batangas, the second busiest port on Luzon, after Manila. The company plans to modernise the facility to improve its productivity. Asian Terminals Incorporated plans to develop other Philippine ports by modernising equipment and acquisition programs, computerising and automating, developing infrastructure and improving the leasehold, streamlining port procedures and training personnel.

Source: Asian Terminals Incorporated, 1997.

A telling example of the need for a clear approach was the 38 hectare port at Subic Bay, which was put out for concession tender in 1997. The first round of bidding failed due to inadequately specified concession terms. Tenders for the concession to operate the port bid on the price they would pay the Subic Bay Metropolitan Authority per container handled through the port, but did not indicate what they would charge shippers. It was assumed that bidders' charges to shippers would compete with nearby ports, particularly Manila.

However, Filipino owned group Manila International Container Terminal, which operates Manila port, made the highest bid. This bidder intended to increase tariffs to shippers well above existing levels, and being a major operator at nearby Manila port, it would benefit from shipping diverting to there. Similarly, its Manila operations could have suffered if a competitor offered cheaper wharfage charges at Subic.

The Subic Bay Metropolitan Authority therefore accepted the next highest bid, a joint venture with Hutchison, which indicated it would not increase charges to shippers. Subsequently Manila International Container Terminal challenged this decision in the courts, delaying the whole process considerably. This aborted concession plan shows the importance of properly structuring the bidding process.

Deregulation of Inter-Island Services

Opening inter-island shipping services to competition has increased the number of new shipping companies registered with the Maritime Industry Authority from 25 to 220, and the number of vessels operating services from 66 to 154. Deregulating international shipping movements and accelerating economic growth also tripled the number of international shipping movements in four years in the mid 1990s (Serfacia, 1997).

Shipping and Port Regulation

The national government regulates sea navigation, safety, port operations and security, vessel registration and environment controls. The Philippines Ports Authority is responsible for developing, maintaining and administering national ports and supervising private ports. Port services include traffic movement, loading and unloading of vessels, warehousing and cargo handling.

The Department of Transportation and Communications plans and develops local ports and later transfers these to local authorities to operate. Local governments operate and maintain a number of riverine municipal ports.

The Department of Transportation and Communications funds the maintenance of navigational systems. However, another government agency, the Philippines Coast Guard operates and maintains the navigational system. The Philippines Coast Guard also takes responsibility for inspecting and certifying vessels, clearing departures and providing search and rescue. However, the principle responsibility for maritime safety and security is with the Maritime Industry Authority, MARINA. The Philippines Coast Guard and MARINA now jointly set safety standards. MARINA also regulates domestic and overseas shipping services, for example setting service standards and seaman qualifications.

TELECOMMUNICATIONS

In contrast to most other East Asian economies, and indeed many OECD countries, the Philippine telecommunications sector has been privately owned since the Marcos years. Until recently, a privately owned monopoly, the Philippines Long Distance Telephone Company, PLDT, provided most fixed wire telephony. In 1996, PLDT was the largest fully privately owned telecommunications company in South East Asia (International Telecommunication Union, 1997).

PLDT is a typical example of the monopolies that dominated the Philippine economy during the Marcos era. The company is publicly listed on the stock exchange, but one of the Philippines' wealthiest families holds the controlling interest. For a long time, PLDT enjoyed special treatment and protection from competition. It also operated very inefficiently with long connection waiting times,⁵ high charges and a poor record of new connections (Esfahani, 1994; Tasman Asia Pacific, 1993; Serefacia, 1997).

Until the 1980s, the high fixed costs of fixed line telephone systems and the need to limit line duplication justified monopoly providers. However, the cost structure of the industry is changing rapidly as new technology is introduced (Bond, 1997a; Bond, 1997b).

A single private operator, Piltel introduced cellular services in 1989. As in most countries, mobile telephones initially were seen as a niche market, providing specialised services and not competing with fixed lines. However, this rapidly changed as the cost of cellular systems fell. The low fixed costs of mobile telephones make cellular phones the preferred entry point for many new telecommunications companies, particularly in Asia. Up to a minimum teledensity, cellular phones are more cost effective than fixed phones (Smith, 1995). At the same time, unreliable fixed line systems, such as those operated by PLDT created a much broader demand for cellular services than initially anticipated.

With technological change making competition more feasible, the Philippine Government is promoting competition in the telecommunications sector. During the 1990s, the Government progressively increased the number of operators licensed to provide international and cellular services. To support new private operators entering the market, President Ramos issued the long overdue Executive Order 59 in 1993, obliging existing telecommunications operators to connect new operators to their networks.

The Government requires that telecommunication service providers initially conduct bilateral commercial negotiations to reach a viable interconnection agreement with PLDT. However, the industry regulator, the National Telecommunications Commission, will intervene if asked by a negotiating carrier or if delays or conditions in the agreement are against the public interest. The commission will then provide guidelines to reach an acceptable agreement (International Telecommunication Union, 1997, p. 52).

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⁵ In 1993, the average waiting time for a new service in the Philippines was 8.9 years, compared to 6.3 years in Thailand, 0.4 years in Indonesia, 0.5 years in Malaysia and 0.01 years in Singapore (Serefacia, 1997).

Since 1990, eight companies have entered the telecommunications industry to compete with the incumbent monopolies (Table 6.11). Now nine international gateway operators and five national mobile phone operators compete. Consistent with the constitutional limits on foreign ownership, many new operators are 40:60 per cent joint ventures with foreign companies. The new telecommunications licences generally are controlled by well connected Filipino families in joint ventures with strategic foreign partners. For example, Islacom is owned by the Delgado family in partnership with Thailand's Shinawatra and Germany's Deutsche Telecom. Globes' majority ownership is under the control of the Ayala family in partnership with Singapore Telecom (International Telecommunication Union, 1997, p. 12). While the extent of foreign ownership is limited, at 40 per cent it is still the highest level of foreign ownership allowed in the telecommunications sector in East Asia; it is 20 per cent in Thailand, 35 per cent in Indonesia, and 30 per cent in Malaysia (International Telecommunication Union, 1997, p. 11).

Some analysts believe the adopted structure allows too many small players into the market with none really able to challenge the commercial position of PLDT (Lichauco, 1997). However, the number of cellular licences granted is less than Malaysia (with six carriers) and Hong Kong (with eleven licences). The Philippines also is one of the few developing countries in the Asia Pacific where cellular tariffs are similar to fixed line tariffs (International Telecommunication Union, 1997, p. 31). This clearly shows the benefits of competition from introducing multiple cellular phone systems.

To promote increased access to telephone services in under-serviced areas, new licencees must provide new fixed line connections. Cellular licencees must install 400 000 lines within five years and international licencees must install 300 000 lines within three years. The licence agreements also contain a universal service obligation and include a specified mix of urban and rural lines in 11 new service regions defined by the National Telecommunications Commission. The service regions and licences are designed to eliminate cross-subsidies between regions. If all new connection requirements are met, companies other than PLDT will serve 50 per cent of the local market (Serafica, 1997b).

Some new carriers complain that they cannot meet network deployment and connection commitments because PLDT will not provide enough interconnection points. The guaranteed mandatory interconnection rights under Executive Order 59 are difficult to enforce. PLDT appears to have strongly resisted interconnection, possibly as a strategy to reduce competitors' revenue and maintain market share. The company still has 80 per cent of the market, although this has dropped from 90 per cent.

While PLDT has no economic incentive to facilitate interconnection, new operators have an incentive to lobby government to reduce their contractual obligations. New operators have only completed 20 per cent of required new lines and are behind schedule (International Telecommunication Union, 1997, p. 56). President Ramos ordered the Department of Transportation and Communications to solve this problem by mid 1997, so the department attempted to introduce a bill imposing criminal sanctions if PLDT and other small local companies refused interconnection, but Congress did not pass it.

Table 6.11
Many New Players in Telecoms
Telecommunications Operators in the Philippines, 1997

Company	Ownership	Launch date	Local	National	International	Cellular
PLDT	Public company Cojuangco family	Incumbent	✓	✓	✓	
Piltel	Public company 100 per cent Philippine	1989 launch date	✓			✓
Eastern Telecommunications	Cable and Wireless (UK, 40 per cent) Philippine Government (60 per cent)	1990			✓	
Exitelcom	Millicom (USA, 37 per cent)	September 1991				✓
Philcom	Enriles/Yuchengcos families	February 1992	✓		✓	
ICC Telecoms/Bayantel	Benpres (75 per cent) Nynex (15 per cent) Telecom Holdings (10 per cent) AIF (6 per cent) Chase Manhattan (0.93 per cent)	February 1994, (licence)	✓	✓	✓	
Capwire	Santiagos family (main shareholder) Korea Telecom (20 per cent)	May 1994 (licence)			✓	
Globe Telecom (GCMR)	Ayala family Singapore Telecom (37 per cent)	September 1994	✓	✓	✓	✓
Digitel	JG Summit Holdings (Gokongweis family) Telia (Sweden, 11.8 per cent) Jasmine (Thailand, 3 per cent)	1996	✓		✓	
Islacom	Deigado family Shinawatra (Thailand, 30 per cent) Deutsche Telecom (Germany, 10 per cent)	1996			✓	✓
Smartcom	Metro Pacific First Pacific (Hong Kong, 28 per cent) NIT (Japan, 12 per cent)	1996			✓	✓
PT&T	Telectronic A2 Telecom Korea Telecom (20 per cent)	na	✓	✓		

Source: International Telecommunication Union, 1997.

Despite these difficulties, since 1993 the annual installation of main lines has increased 15 fold (Petrazzini, 1996). The threat of competition in 1993 may have prompted the PLDT to announce its 'zero backlog program' with investment increasing sharply after that (Smith, 1995). Constant US dollar investment rose from about US\$300 million to US\$450 million after relatively stagnant growth in previous years. At same time, from 1995 to 1996, staff levels decreased by 5.8 per cent (International Telecommunication Union, 1997).

Mobile telephones increased the incentive to improve productivity and investment in fixed line telephony. The number of cellular subscribers in the Philippines rose rapidly to 26 per cent of all subscribers in 1996 (International Telecommunication Union, 1997). There were 1.39 subscribers per 100 people in 1996, which is the highest density in low income Asia Pacific economies except for Thailand. Call charges per minute at peak rate are 13 cents compared to a regional average of 28 cents. Monthly subscriptions are \$46 per month compared to an Asia Pacific regional average of \$43 per month. The market share of the original monopoly operator, Piltel, has dropped to less than 50 per cent and is now the size of the recent new entrant Smartcom (Table 6.12).

The capacity of new entrants in fixed wires and international services to deliver sustainable benefits, like those achieved by the mobile telephone sector, will partly depend on the independence and authority of the industry regulator. In contrast to other Asian economies and more in line with the best practice approaches being adopted in countries like Chile (Guislain, 1997) and Australia, the Philippines has set up an independent telecommunications regulator. The National Telecommunications Commission is relatively independent; it rejected planned tariff reductions by incumbent cellular operators because the price changes would cripple smaller competitors. It also initiated the division of the country into eleven service areas, and removed cross-subsidies between areas but allowed them within areas.

Table 6.12

Some New Cellular Providers Growing Rapidly Growth in Cellular Telecommunications Subscribers by Company

	Year began operating	Subscribers		Annual growth (per cent)
		1995	1996	
Piltel	1989	202 358	330 000	63
Smartcom	1994	120 378	308 000	156
Extelcom	1991	100 126	101 000	1
Globe Telecom (GCMR)	1994	41 000	45 581	11
Islacom	1994	30 000	39 074	30
Total		493 862	823 655	67

Source: International Telecommunication Union, 1997.

The commission's ability to act pro-competitively was strengthened when the Philippines signed the WTO agreement on Basic Telecommunications Services in Geneva on 15 February 1997, committing the Government to competition in fixed line voice, data and cellular telephony. The Philippines also partially adopted the reference paper attached to the agreement, outlining key regulatory principles, including interconnection on non-discriminatory terms and transparent licencing. However, the commission's capacity to act on the issue of inter-connection has yet to be proven. Also, while the commission may promote competition, court action can undermine this trend. For example, the Filipino courts have limited operations by international callback service providers.

FURTHER REFORMS

The Philippine Government has progressed considerably in overcoming the infrastructure crisis it inherited after decades of neglect by previous administrations. The innovative involvement of private sector competition has lightened the fiscal burden of providing necessary infrastructure services, increased the efficiency of provision and reduced costs to consumers. However, the huge backlog in infrastructure required and rising demand for infrastructure services as growth accelerates will necessitate continual rapid reform in this sector.

In particular, the reform and privatisation activities of government departments and local governments must be coordinated to ensure sharing of skills acquired and lessons learnt regarding best practice reforms and private sector involvement. This will help in the efficient unbundling, privatisation, deregulation and appropriate government oversight of infrastructure sectors to ensure private provider involvement maximises consumer gains. This will not only provide significant welfare benefits for the Philippine people but also consolidate political support for further reforms, generating future efficiency and welfare gains. Australian ODA may well assist in spreading good infrastructure reform models from the Philippines, Australia and elsewhere. (See Chapter 9 - *Implications*.)

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Chapter 7

MINING

The Philippine mining industry was once the regional leader and a substantial world producer of several commodities. It remains highly prospective. Until the mid 1980s, mining significantly contributed to economic development, particularly exports. However, over the last 15 years, mining declined and stagnated, investment stalled and other emerging mineral producers in the region overtook the Philippines.

Since 1992, the Philippine Investment Priorities Plan has promoted policies to revitalise mining through injection of foreign capital and advanced mining technology. A reform process was initiated to liberalise and modernise the mining code, reduce the high tax burden on the sector and make it more attractive to foreign investment. Restoring overall political stability and improving the law and order situation in the countryside also made mining investment more attractive.

However, the Government's mining sector reforms now have stalled due to various legal, political, constitutional and bureaucratic obstacles. If the sector is to fulfil its vast potential, these obstacles need to be addressed decisively as soon as possible after the 1998 presidential and congressional elections.

This chapter profiles the role of the mining sector within the economy and the sector's prospectivity. It outlines recent developments, mining policy reforms and barriers constraining development. Finally, the chapter analyses the actual and potential contribution to mining development of foreign investment, technology and support services, particularly from Australian firms.

THE MINING SECTOR WITHIN THE ECONOMY

Philippine mining activity occurs in both a largely unmeasured, unregulated informal sector comprising thousands of small scale miners and a formal industry sector, which is generally measured, taxed and regulated.

Small Scale Mining

Small scale mining is a traditional activity for indigenous communities in upland areas, who have been joined increasingly by other Filipinos displaced from farming land. These operations locate surface gold by hand or simple machinery, often involving considerable environmental degradation.¹ In 46 declared small mining areas, the Department of Environment and Natural Resources has issued 300 000 small mining certificates, most since the end of the Marcos era (Ramos and Jasareno, 1996). Many more illegal operators may exist.

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¹ Environmental problems associated with large scale mining are considered later in the chapter.

Competition between the interests of small and large scale miners should be minimal as large scale mining targets deposits that small scale mining technology cannot exploit. Nevertheless, the presence of small scale miners on mining leases issued to large scale miners can cause many logistical and environmental problems. If large scale miners find deposits, the right to exploit them could create a legal challenge.

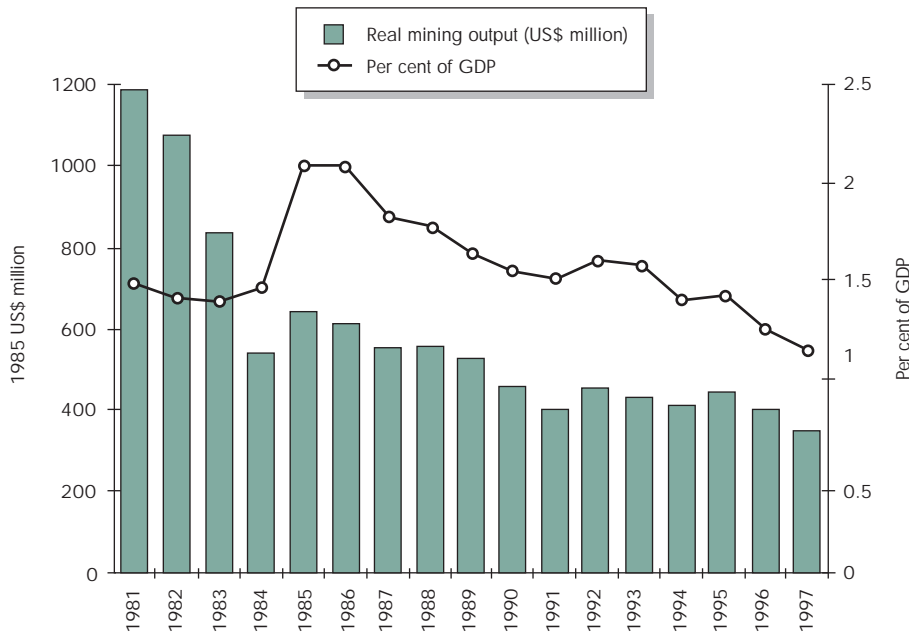
Contribution of Large Scale Mining to Economic Activity

The formal mining and quarrying sector includes metallic mining, extractive industries and quarries producing industrial and construction materials, coal mining, geothermal development, natural gas and petroleum. Most detailed discussion in this chapter focuses on metallic minerals, although salient statistics are included for the total sector.

The real US dollar value of mining and quarrying output declined by 55 per cent between 1981 and 1984,² then continued to decline more slowly (Figure 7.1). The contribution of the mining and quarrying sector to Gross Domestic Product, GDP, peaked at 2 per cent in 1985 but declined steadily to 1.1 per cent in 1997 (Figure 7.1).

Figure 7.1

Mining Output Stagnating Mining Sector Economic Contribution, 1981-97



Source: National Statistical Coordination Board, 1997.

² Most of this decline was due to the depreciation of the peso:US\$ exchange rate from 7.9 in 1981 to 16.7 in 1984, with real output in peso terms only falling by 4.2 per cent.

In 1995 and 1996, metallic mining comprised around 52 per cent of total mining industry output, down from around 80 per cent in the early 1980s (Table 7.1). By 1996, metallic mining's output share was down 25 per cent on its 1990 level. Copper and gold mining are the major metallic mining activities, though their relative ranking has changed; gold is assuming a greater output share and copper's importance is declining. Absolute copper output declined throughout the 1980s and 1990s; gold output rose sharply between 1981 and 1990 but declined again in the 1990s (Table 7.1).

Chrome and nickel mining each accounted for around 5 per cent of mining industry output in the early 1980s but have contributed little for a decade since the main nickel operation ceased production. Other metallic mining, principally iron ore, also dwindled from around 4 per cent of mining output in the early 1980s to less than 1 per cent in the mid 1990s.

Non-metallic mining's contribution to mining output has more than doubled since the early 1980s, reaching 48 per cent in the mid 1990s. Most growth is within the quarrying subsector, where output is not traded internationally (Table 7.1). Coal is another important source of growth in the other non-metallic mining sector.³

Table 7.1

Metals Dominate but Are Declining Output Values and Shares in Mining and Quarrying, Selected Years in Constant 1985 Prices

	Output Value (Million pesos)				Share (Per cent)			
	'81	'90	'95	'96	'81	'90	'95	'96
Type of mining within sector								
Copper	3 718	2 605	1 580	962	40	23	14	9
Gold	2 231	4 800	4 025	4 171	24	43	35	40
Chromium	453	230	106	131	5	2	1	1
Nickel	512	108	150	131	5	2	1	1
Other metallic	376	94	73	50	4	1	1	1
Total metallic mining	7 298	7 837	5 934	5 445	78	70	52	52
Crude oil	0	0	305	95	0	0	3	1
Stone quarrying, clay etc	1 577	1 844	3 323	3 469	17	17	29	33
Other non-metallic mining	483	1 410	1 834	1 513	5	13	16	14
Total non-metallic mining	2 060	3 254	5 462	5 077	22	30	48	48
Total	9 358	11 091	11 396	10 522	100	100	100	100

Note: Other non-metallic mining includes coal, cement raw materials and salt.

Source: National Statistical Coordination Board, 1997.

³ Coal production increased from 220 000 to 300 000 tonnes per year in the early 1980s to 1.2 to 1.6 million tonnes in the early to mid 1990s (National Statistical Coordination Board, 1997).

Balance of Payments Contributions

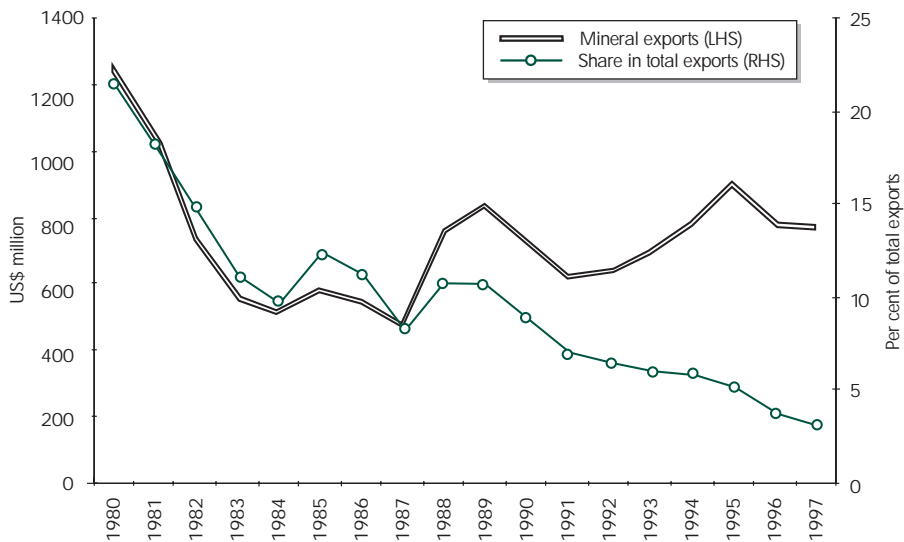
In 1980, the mining industry contributed 20 per cent of the Philippines' total export revenue. Since then its overall contribution has decreased steadily; by 1997 mining only provided 3 per cent of exports (Figure 7.2). US dollar export revenue decreased sharply between 1980 and 1984⁴ but since then, mineral exports have been on a slow upward trend. However, even with 46 per cent growth between 1991 and 1995, their 1997 mineral exports were still less than two thirds of their 1980 peak (Figure 7.2).

Copper concentrates, copper metal and gold historically contributed most to mineral exports (Table 7.2). Copper concentrates' export share declined dramatically with reduced domestic production, although exports of smelted copper have held up better. The share of gold exports in total mineral exports has fallen by more than 50 per cent since the second half of the 1980s.

Figure 7.2

Minerals' Contribution to Exports Drops Sharply

Mineral Product Exports (US\$ million) and Share of Mineral Exports in Total Exports



Note: Comparing Figures 7.1 and 7.2 is not valid as the former is in constant prices while the latter is in current prices. Moreover, the data on mineral exports include direct exports of the mining and quarrying sector as well as exports of products such as smelted gold and copper rods from the manufacturing sector.

Source: Bangko Sentral ng Pilipinas, 1997.

⁴ Once again, exchange rate effects were important here. However, no subsequent dramatic turnaround occurred in export values in US dollars, indicating a sector with growing structural problems.

The share of the other exports category rose strongly after 1993 because exports of liquefied petroleum gas, LPG and naphtha were non-existent before then but rose sharply thereafter.⁵

Table 7.2

Exports of Copper Concentrates and Gold Declining Export Values (US\$ million) and Shares in Total Mineral Product Exports

Commodity within sector	Value of Exports (US\$ million)				Share (Per cent)			
	'85-90 ^c	'91-95 ^c	'96	'97	'85-90 ^c	'91-95 ^c	'96	'97
Copper concentrate	157	134	52	44	24	19	7	6
Copper metal	235	263	297	231	36	36	38	30
Gold	108	74	55	49	17	10	7	6
Iron ore agglomerates etc ^a	83	70	70	90	13	10	9	12
Chrome ore	13	12	8	6	2	2	1	1
Nickel	13	0.2	0	0	2	.03	0	0
Others ^b	38	167	290	343	6	23	38	45
Total	648	720	772	763	100	100	100	100

Note: a Although domestic iron ore production ceased, export of processed agglomerate continues; b key commodities in the other category include liquefied petroleum gas and naphtha, silver and miscellaneous scrap; c for these periods average export levels and average shares are provided.

Source: Bangko Sentral ng Pilipinas, 1997.

Investment Performance

The mining sector share of total investment has declined substantially since the second half of the 1980s. Between 1991 and 1994, mining generated less than 2 per cent of the value of investment approvals compared with over 6 per cent in the second half of the 1980s; its share is still falling, dropping from 1 per cent in 1995 to 0.6 per cent in 1996 (Table 7.3) (Securities and Exchange Commission, 1997). The 1995 and 1996 investment shares are less than mining's output share. Given the high capital intensity of mining, these investment levels are unsustainably low.

⁵ LPG is not broken out in this Bangko Sentral ng Pilipinas data. However, separate peso based export data indicate that the share of LPG and naphtha in total mineral product exports was 22 per cent in 1994, 21 per cent in 1995 and 29 per cent in 1996 (Philippine Institute of Development Studies, 1997).

Table 7.3

Investment and Foreign Participation in Mining Falling Average Annual Investment Approvals

Selected measures	Year		
	1981-85	1986-90	1991-94
Mining investment approvals (billion 1985 pesos)	0.5	1.1	0.6
Foreign mining approvals (billion 1985 pesos)	0.2	0.3	0.1
Mining share of all investment approvals (per cent)	5.0	6.1	1.9
Foreign share of mining investment approvals (per cent)	32.0	25.0	23.0
Foreign share of total investment approvals (per cent)	48.0	48.0	39.0

Note: 1985 pesos means the value of approvals are measured in constant 1985 prices.

Source: Board of Investments data, corrected for price index, National Statistical Coordination Board, 1995.

Employment

Despite the capital intensity of large scale mining and the relative decline of the sector in recent years, it still provided 120 000 jobs in 1996, many in relatively depressed rural areas (Figure 7.3). However, formal mining's employment share declined from 0.7 per cent to 0.4 per cent of total employment over the last decade. Self employed, informal sector miners are likely to number at least 300 000, if the conservative assumption of one employed person for each mining certificate is made.

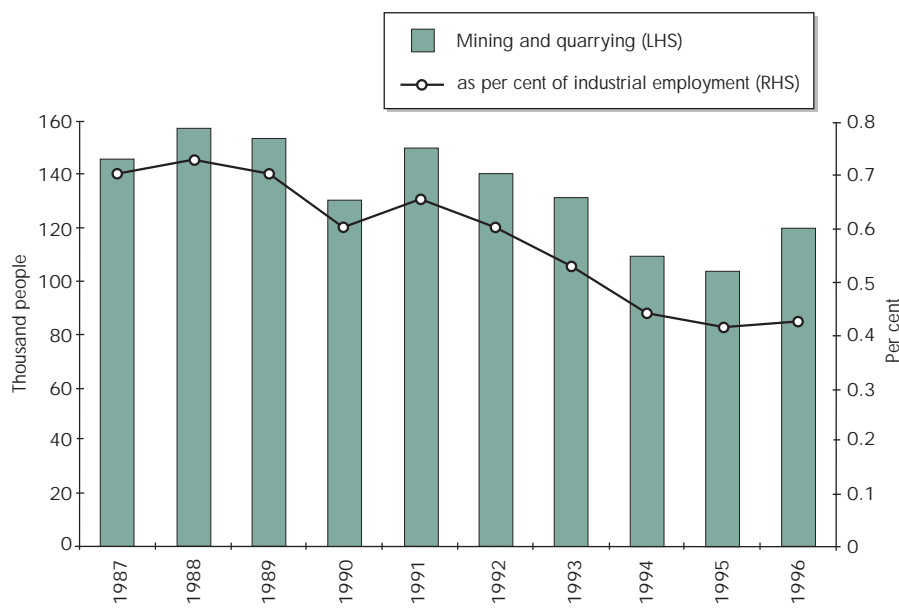
CAUSES OF THE MINING SECTOR'S DECLINE

Key factors behind the decreasing importance of mining to the Philippine economy since the early 1980s include a poor law and order situation and unfavourable mineral policies including an onerous tax regime, which all depressed new investment (Brimo, 1997) and a lack of foreign direct investment.

Law and Order

The large investments and long payback periods required by mining projects increase their sensitivity to risk. Political instability in the 1980s and a poor law and order situation in parts of the country due to military insurgencies adversely affected the mining industry. The remote areas in which mines often operate make the poor law and order situation a particularly strong constraint. This situation has improved significantly in the last decade, enabling mining in remote areas.

Figure 7.3
Remote Area Mining Jobs Declining
Employment in Mining and Quarrying, 1987-96 ('000)



Note: Figures for each year are as of October.

Source: National Statistical Coordination Board, 1996.

Restrictive Mineral Policies

Poor mineral sector policies also contributed to the industry's decline. In addition to corporate income tax, in 1974 the Marcos regime introduced a royalty of 1.5 per cent of gross non-metallic mineral and gold revenue, and 2 per cent of metallic mineral revenue. In 1980, the rates were raised to 3 per cent for non-metallics and 5 per cent for gold and metallics. By 1985, revenue from the royalty was more than double corporate tax revenue (Philippine Chamber of Mines, 1985) so firms in the mining sector were taxed twice as heavily as other firms. Since taxes were levied on gross earnings not profits, some companies could not pay the taxes due; subsequent regulations adjusted these rates for 'financially distressed companies' and provided deferments, but these exemptions were later withdrawn. Import duties on fuels and equipment needed for mining were also a significant burden.

The sudden increase in government taxes in the early 1980s when world market conditions and local industry prospects were favourable proved short-sighted. The increased royalties became a serious financial burden on local mining companies once normal long term conditions returned and were the single major cause of the sector's decline.

Other government interventions in the mining and minerals processing sector also contributed to its decline. In particular, the government promoted investment in smelters and lent extensively for this purpose through 'development banking'

entities. However, the Philippines was an energy importer with a shortage of capital and had no comparative advantage in many types of smelting. In some cases the industry borrowed unwisely to finance these ventures, and some mining companies were unable to sustain these debt levels in addition to taxes. The Government then was pressured to acquire the assets of several failed mining companies.

Lack of Foreign Direct Investment

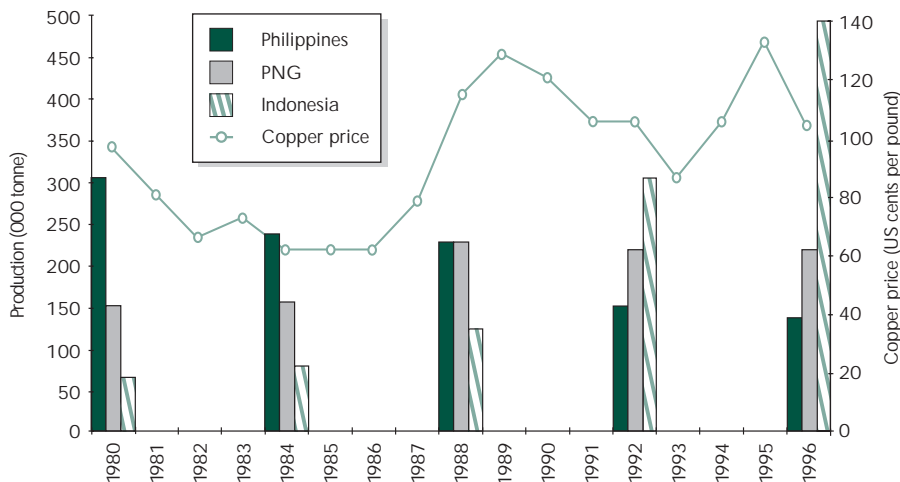
Legal restrictions on foreign participation in mining further constrain the industry. The low level of foreign direct investment in the mining industry, discussed later in the chapter has restricted access to modern technology and to sufficient levels of finance for large scale investment. This has been critical to industry performance as declining prices of some mineral commodities have imposed a need for technological upgrading to reduce production costs.

Falling Commodity Prices

The fall in some international commodity prices during the 1980s is sometimes mentioned as a factor behind the decline of the Philippine mining industry. However, by itself this fall cannot be accepted as a major factor since mining in other regional economies advanced in the same period. Gold and copper production in Papua New Guinea and Indonesia expanded markedly, both significantly overtaking the Philippines in the last 15 years (Figures 7.4 and 7.5). The major problem was the inability of the Philippine mining industry to make necessary investments to achieve productivity gains and cut costs.

Figure 7.4

Philippine Copper Output Overtaken by PNG and Indonesia South East Asian Copper Production and World Prices, 1980-96

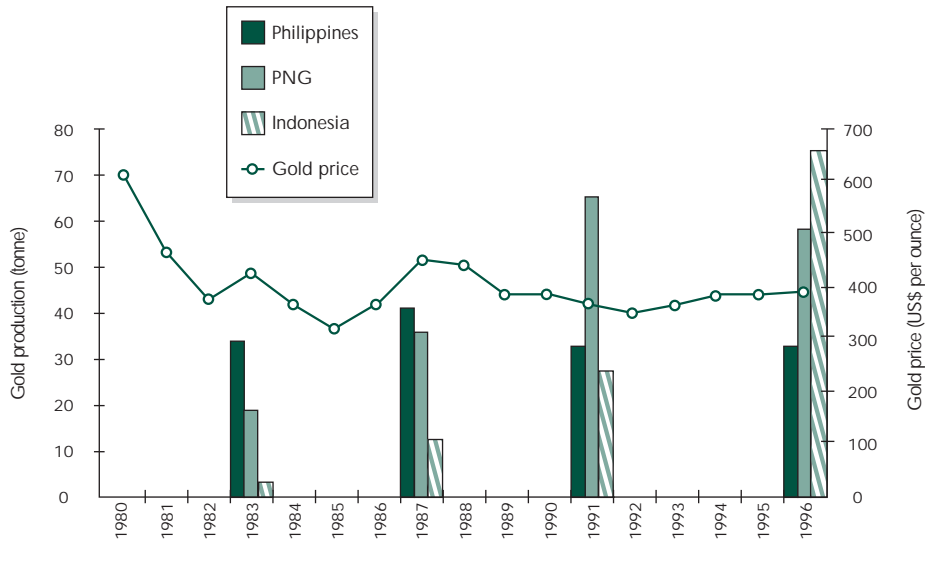


Source: International Mining and Exploration Committee, 1996; London Metal Exchange, 1997.

Figure 7.5

Gold Prices Sluggish - Other South East Asian Gold Producers Not!

South East Asian Gold Production and Prices, 1980-96



Source: International Mining and Exploration Committee, 1996; Gold Institute, 1997.

PROSPECTIVITY

The mining industry's decline since the early 1980s has occurred despite strong mineral endowments (Table 7.4). The Philippines has established reserves of 13 metallic and 29 non-metallic minerals.

Table 7.4

Natural Gas Potential Developing

Major Mineral Reserves,^a 1996

Selected minerals	Unit	Quantity
Chromite (all types)	million tonnes	37
Copper	million tonnes	4 789
Gold (primary)	million tonnes	227
Nickel	million tonnes	1 089
Coal	million tonnes	369
Natural gas	trillion cubic feet	1.9 to 3.9

Note: a All figures for metallic minerals are for ore bodies not metal content; b coal and natural gas data from Economist Intelligence Unit, 1997.

Source: National Statistical Coordination Board, 1997; Economist Intelligence Unit, 1997.

Metallic Minerals

On an area basis, the Philippines has one of the world's richest endowments of metallic minerals. Its area endowment of gold is ranked third in the world, copper fourth, nickel ore fifth and chrome sixth (Ramos and Jasareno, 1996). Some 13 significant porphyry copper-gold deposits have reserves greater than a million tonnes of copper equivalent. An estimated 11 significant epithermal gold deposits have more than a million ounces of gold. Prospects for nickel ores are also promising.

Past exploitation of minerals also indicates high prospectivity for other minerals. The Baguio district has produced 800 tonnes of gold, more gold than any goldfield in the western Pacific (Hutchison, 1996).

Moreover, discussion of the Philippines' mineral resource endowment needs to be qualified by two factors:

- only about one quarter of the country has been explored (Economist Intelligence Unit, 1996)
- little mineral exploration has used advanced techniques searching for ore bodies suited to modern, large scale mining.

Energy Minerals

Known Philippine oil reserves are small and located offshore in the Palawan region. The same region yielded a significant discovery of natural gas in the Camago-Malampaya basin offshore from Palawan Island. The consortium (Shell-Occidental) developing this field is negotiating purchase and transport contracts with a view to starting production of 400 million cubic feet per day by 2001-02 (Economist Intelligence Unit, 1996).⁶

Philippine coal production is relatively small; it ranged between 1.2 and 1.6 million tonnes per year in the early to mid 1990s. Coal reserves are modest by international standards and mostly lower grade.⁷ The Semirara basin is the most important coal deposit, where potential could reach 500 million tonnes of lignite to sub-bituminous grade coal.

Philippine coal seams occur in several different geological formations, but deposits are highly flexed and faulted and unlikely to provide massive economic deposits (Rees, 1978). Domestic coal supply has some technical features (salt, ash/slag fouling and handling problems) which often require it to be blended with higher grade imported coal for use in power generation.

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⁶ One major deal already finalised is a 22 year gas supply and purchase agreement with First Gas Power Corporation (Economist Intelligence Unit, 1998).

⁷ Of the Philippines' total coal reserves, 42 per cent are lignite to sub-bituminous, 55 per cent are sub-bituminous to bituminous and 3 per cent are a higher grade.

ONGOING STEPS IN COAL LIBERALISATION

Until the mid 1980s, the National Coal Authority administered all coal trade, controlling all domestic coal purchasing at fixed prices, arranging imports as required and selling coal locally at fixed prices. Import liberalisation now means that imported coal may be supplied directly to industry. However, all locally produced and imported thermal coal must still be supplied to the National Power Corporation.

Tariffs on imported coal are currently 10 per cent and due to drop to 3 per cent in 2000. However, domestic coal is further protected because it must be blended with imported coal, currently in a ratio of 1:10.⁸ This mandated share for domestic coal still effectively represents a quota on imports, a tax on coal users and a subsidy to coal producers.

RECENT REFORMS TO THE MINERALS LAW

Mineral policy reform began in 1987 and culminated in the Mining Act of 1995. The act's implementing rules and regulations were revised effective from January 1997 after the Marcopper spillage.⁹ The Mining Act replaced the previous systems of mineral tenure based on mining leaseholds and introduced the concept of miners entering mineral agreements or contracts with the Department of Environment and Natural Resources. Title under the previous legislation continues, including title established under other earlier enactments.

The Mining Act grants three major types of rights - exploration permits, mineral agreements, and Financial or Technical Assistance Agreements, FTAA's. Exploration permits and Financial or Technical Assistance Agreements are available for 100 per cent foreign owned companies. A mineral processing permit may be granted to either a domestic or foreign owned corporation.¹⁰

Exploration Permits

An exploration permit grants exclusive rights to the permit holder to explore a tract of land based on approved exploration and environmental work programs. If a viable mineral deposit is delineated, the permit holder can exercise priority rights to enter into any type of mining right with the Government. The maximum period for an exploration permit is six years.

⁸ This ratio of 1:10 means that the blend must have at least 10 per cent domestic coal.

⁹ The Marcopper spillage occurred when a tailings dam system failed at the Marcopper mine on Marinduque Island in March 1996. (See box later in the chapter for further details.)

¹⁰ Under a mineral production sharing agreement, MPSA, which is a form of mineral agreement, a domestic corporation may submit an approved work program including mineral processing.

SLOW STEPS IN MINING REFORM

- 1987 new constitution ratified permitting Financial or Technical Assistance Agreements, FTAA in mining; executive and administrative orders issued implementing FTAA provisions; Government proposed new mining law to Congress
- 1988 draft of new mining code prepared
- 1990 mineral production sharing agreement applications began; however, Supreme Court restraining order stopped implementation
- 1991 Government foreshadowed rules and regulations governing FTAA will lift investments for large projects. Supreme Court injunction against mineral production sharing agreements lifted
- 1994 excise tax on minerals lowered from 5 per cent to 2 per cent; four FTAA applications lodged
- 1995 Philippine Mining Act of 1995 signed into law (March); implementing rules and regulations issued (September)
- 1995 first two FTAA granted (March); these FTAA were not approved under the new Mining Act but under a previous ordinance linking back to the 1987 constitution where FTAA were first allowed
- 1996 Marcopper spillage (March); Department of Environment and Natural Resources stated that revisions of the new mining legislation or its implementing rules and regulations 'unlikely' as it prescribed stringent environmental mechanisms (May); Department of Environment and Natural Resources initiated public review of new mining legislation and its implementing rules and regulations (June); revised implementing rules and regulations signed (December), applicable from January 1997
- 1997 Mining Act and implementing rules and regulations challenged in the Supreme Court (February); Department of Environment and Natural Resources issued revised FTAA fiscal proposals (March); extensive negotiations on fiscal regime continued
- 1997 Indigenous Peoples' Rights Act signed (October) and accompanying consultative process launched
- 1997 Department of Environment and Natural Resources approved pro-forma FTAA contract and submitted it to the Office of the President for approval (November); decision still pending in April 1998
- 1998 Philippine presidential election (May)

Mineral Agreements (a Form of Mining Right)

Under a mineral agreement, the Government grants the holder an exclusive right to conduct mining operations within the contract area during a defined term, in return for a production share. Mining operations include exploration, mine development and the extraction of mineral resources.

The three mineral agreements differ in the way the government consideration is collected. Under the most common form, the mineral production sharing agreement, the government's consideration takes the form of an excise and other taxes due on mineral products. Only corporations with at least 60 per cent Filipino ownership can obtain mineral production sharing agreements. They may be granted for up to 25 years, with renewals for another 25 years. In contrast, under a co-production agreement or a joint venture agreement, the government share is negotiated and may include a share of physical product.

Financial or Technical Assistance Agreements

A Financial or Technical Assistance Agreement, FTAA, is a contract involving financial or technical assistance for large scale exploration, development and use of mineral resources.¹¹ A minimum investment commitment of US\$50 million is required for mine development and infrastructure. Philippine equity is not required. Foreign participation through the Financial or Technical Assistance Agreement structure also requires a contribution to community development activities, including improving education, farming and conservation techniques.

Under this agreement the mining company is effectively a contractor to the Philippine Government, with the exclusive right to conduct mining operations and extract mineral deposits within the contract area for 25 years, renewable for another 25 years. Financial or Technical Assistance Agreements are restricted to gold, copper, nickel, chromite, lead and zinc, and associated minerals and other strategic metals which the Mines and Geosciences Bureau may identify.

Two Australian companies, WMC (Philippines) Inc and Climax-Arimco, were granted the only Financial or Technical Assistance Agreements issued thus far.¹² Since these agreements were issued, negotiations about the fiscal provisions to apply to the new generation of Financial or Technical Assistance Agreements have been extensive and a range of legal uncertainties have developed.

Fiscal Provisions

In March 1997, the Government provided the broad outline of a revised fiscal regime. The key revision proposed was an extra tax on profits so that the government share (at national and local level and including all taxes and fees) would equal at

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¹¹ Specific activities identified to facilitate provision of technical assistance include training programs and exercising preference for local goods and Filipino employment subject to appropriate qualifications being met.

¹² WMC (Philippines) Inc is part of WMC Ltd, formerly Western Mining Corporation.

least 50 per cent of net mining revenue.¹³ The details of this proposed new fiscal regime were the subject of extensive negotiations with the mining industry. Under the final proforma Financial or Technical Assistance Agreement contract, the fiscal regime consists of a basic government share, which includes all direct taxes and fees paid by the contractor including royalties to indigenous people, and an additional share which can be chosen from the following three models:

- the difference between cumulative net mining revenue and the total government share after cost recovery to achieve a minimum 50:50 sharing
- the difference between the total present value (cumulative, discounted) of the project cashflow and the total present value of the government share to achieve a minimum 50:50 sharing
- 25 per cent of the additional profit if the two year average ratio of the net income after tax over the gross revenue is 40 per cent or higher.

One key feature of the regime is that the Government's share is collected only when the project has fully recovered its pre-operating exploration and development expenses.¹⁴ This tax holiday, which is available for up to 5 years, has a larger impact on mines with shorter lives and thus may distort the choice of mines which actually move into a development phase.¹⁵ It may be worth looking for ways to increase the attractiveness of mining investment that are less biased towards short lived mines. Longer life mines may develop more links into the Philippine economy such as value adding, and provide a more durable economic base for mining areas.

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- ¹³ To determine net mining revenue the following were the proposed deductible expenses:
- mining, milling, transport and handling costs
 - general and administrative expenses actually incurred in the Philippines
 - consulting fees directly related to the project
 - environmental expenses to fully comply with the environmental obligations
 - expenses for developing host and neighbouring communities, and mining technology and geosciences
 - royalty payments to mining claim owners or surface landowners relating to the contract area
 - exploration and development expenses after operations begin
 - interest expense.
- ¹⁴ The pre-operating costs which the miner may recover over a period of up to 5 years before the payment of government share include:
- costs of mineral tenements
 - costs of exploration, evaluation, feasibility and environmental studies
 - production, milling, processing and rehabilitation costs
 - stockpiling, handling, transport, utilities and marketing costs
 - development expenses related to mining operations within and outside the contract area
 - all government taxes and fees
 - payments to landowners, claim owners and royalties to indigenous cultural communities
 - expenses relating to obligations for national development and training
 - consulting costs related to the mining operations
 - administration and financial costs (particularly interest).
- ¹⁵ This effect can be seen clearly in a comparative study of global mining taxation (Otto et al, 1997). For the Philippines, the results were based on the proforma FTAA as it stood before the additional revenue share for the Government was incorporated. For a hypothetical gold mine depleted over a 10 year period, an after tax rate of return of 17 per cent ranked the Philippines second after Argentina and Chile. However, for a hypothetical copper mine with a 20 year depletion, the Philippines ranked equal fifth out of a group of nine countries with an after tax rate of return of 12 per cent.

Other tax incentives include duty-free imports of capital equipment and exemption from value added tax. In addition, holders of Financial or Technical Assistance Agreements may access concessions available through the Board of Investments. (See Chapter 4 - *Investment*.)

A major problem with the proposed fiscal structure is that indirect taxes and local government taxes are not included in the calculations, so the total government share may be much higher than 50 per cent.¹⁶ These additional payments to government can seriously impair projects' risk-adjusted rates of return.

Overall, although the proposed fiscal regime is unlikely to be highly competitive in international terms, Malcolm Norris, Chairman of the International Mining and Exploration Committee, which represents foreign miners in the Philippines, described it as 'reasonable' (*Business World*, 18 November 1997).

Legal Uncertainties

In February 1997, the Legal Rights and Natural Resources Center Inc, a non-government organisation, filed a petition before the Supreme Court asserting that the Mining Act of 1995 and its implementing rules and regulations, including other instruments supporting Financial or Technical Assistance Agreements, were unconstitutional. The Philippine Government which, with WMC, is party to the action, is confident the petition will not succeed (Ramos, 1997). One reason for this optimism is the belief that the Mining Act is firmly rooted in the constitution.¹⁷ However, the existence of an unresolved legal challenge creates considerable uncertainty over tenure and the operating regulations of the Mining Act, discouraging foreign investors.

On 29 October 1997, the Indigenous Peoples' Rights Act was signed into law by President Ramos. The act recognised 'native title' control or ownership by indigenous people of ancestral lands and ancestral domain, including mineral and other natural resources. The fact that mineral resources may form part of ancestral domain appears to set up a conflict between this act and the constitution, under which mineral resources are considered to belong to the state. If the Government does not own the minerals, then its ability to grant Financial or Technical Assistance Agreements is questionable.

The Indigenous Peoples' Rights Act establishes a National Commission for Indigenous People which is charged with working out the detail of the act through the development of its implementing rules and regulations. These are unlikely to be ready before late 1998, and even then many more delays are possible as the commission sorts through the backlog of ancestral domain claims.

The passage of the Indigenous Peoples' Rights Act has caused considerable uncertainty among foreign mining companies. It is unlikely that further Financial or Technical Assistance Agreements will be signed until such fundamental issues as

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¹⁶ The director of the Mines and Geosciences Bureau, Horacio Ramos has reportedly said that governments collect about 60 per cent of a firm's mining revenue if indirect taxes are factored in (*Business World*, 18 November 1997, internet edition).

¹⁷ Sources within WMC share this optimism about the outcome.

control or ownership of mineral resources, procedures over access and levels of payment of compensation to indigenous owners are resolved; this will probably not occur until well into 1999. In an effort to progress their operations, some foreign mining companies may sign Exploration Permits. Others with Financial or Technical Assistance Agreement applications may have areas not covered by ancestral domain and could modify their agreement to just cover these areas. However, considerable uncertainty about what areas are covered by ancestral domain constrains this option.

Bureaucratic Logjam on Applications

The backlog of applications for all three types of mining rights is large (Table 7.5). Some delays occurred because resources were diverted from processing mining applications to holding public hearings about the new mining legislation. Other problems include lack of regional resources, different interpretation of requirements within the Department of Environment and Natural Resources and the need for various clearances.¹⁸ The international mining community is concerned about the apparent level of commitment to process and approve applications. Some international mining companies are closing down site operations and considering abandoning their applications partly because of these delays. In late 1997, some firms also reported staff redundancies and layoffs in exploration teams made idle through lack of access to exploration areas (International Mining and Exploration Committee, 1996; Adversario, 1997a; Adversario, 1997b).

Table 7.5

Large Backlog of Tenement Approvals

Tenement Applications and Approvals at June 1997^a

Exploration or minerals right	Applications	Approvals
Exploration Permits ^b	267	11
Mineral Production Sharing Agreements	1 500	69
Financial or Technical Assistance Agreements	112	2

Note: ^a A considerable number of exploration permits and mineral production sharing agreements were approved in November, with some reports of 17 approvals of these two types of tenements (Norris, 1998). However, even if all these approvals are factored in, the backlog still remains large; ^b figures for exploration permits are as of October 1997.

Source: Mines and Geosciences Bureau, 1997; Ramos, 1997; Mines and Geosciences Bureau, 1997.

¹⁸ The area clearance requirement discussed later is a prominent example.

Enhanced Environmental Protection

The Mining Act contains significant environmental protection provisions. Responsibilities for mining companies include:

- undertaking an environmental work program during the exploration period
- prior to developing the mining area, preparing an environmental impact statement and securing an environmental clearance certificate from the Department of Environment and Natural Resources
- submitting an environmental protection and enhancement program which deals with a range of issues directed toward a life-of-mine plan for compliance.

The revised implementing rules and regulations of the Mining Act also establish further financial obligations in relation to environmental protection expenditures including:

- an allotment of 10 per cent of initial investment to environment related expenditure
- expenditure of 3 to 5 per cent of direct mining and milling costs for annual environmental protection programs
- an annual independent environmental audit
- the raising of the fine payable on spillage from a nominal P 0.1 per tonne to P 50 per tonne.

These environmental regulations should not disadvantage international mining companies, which comply with high environmental standards in their home and other countries. However, if they are enforced, these regulations may significantly affect existing mining operations that have not adopted adequate environmental protection. Enforcement is increasing. In 1996, the Department of Environment and Natural Resources increased inspections and audits of existing mining operations, issuing orders to cease operations due to discharge into rivers, causing the Marcopper and Mariculum mines to close (Economist Intelligence Unit, 1996).

As a result of these regulations and the trend towards greater enforcement, the mining industry is likely to increase its demand for environmental technology, equipment and services both for new projects and to improve existing operations. This potential is examined further in a later section which considers opportunities for Australian environmental service companies.

Consent from Local Governments and Neighbouring Communities

Reforms to the Mining Act also address community concerns arising from irresponsible operations in the past. Before all tenements are approved, an area clearance certificate is required. This certificate requires consultation and agreement from other government agencies, local government and the representatives of indigenous people affected by the activity, before development starts.¹⁹ A related

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¹⁹ While local governments are involved in issuing area clearance certificates their approval is not, as yet, a formal part of the area clearance process.

requirement of the new implementing rules and regulations is that a further minimum 1 per cent of gross revenue must be directed to developing 'host and neighbouring communities'.

Obtaining area clearance consent can be complex and time consuming, obstructing the approval of tenement applications and further mining investment. One major source of delay is the poor tenement data base; often authorities do not know what other tenements are valid. They then defer a decision on the status of overlapping claims to a panel of arbitrators, further delaying the process.²⁰ Moreover, during exploration, which involves minimal environmental intrusion, local communities must approve areas far larger than the development area which might be finally required for a successful project.

Mining companies also must identify and negotiate with all the indigenous groups likely to be affected by their operations. A range of practical problems have emerged in fulfilling this requirement. In particular:

- many indigenous groups have not registered their interests in ancestral land with the Government and identifying them may be difficult
- long term, conflicting ancestral claims may be associated with land and formal land records are sparse or non-existent
- many indigenous communities have no formal organisational structures of democratic or traditional representation that can be recognised for purposes of negotiation and consent
- local people may have no existing structures or experience enabling them to own or improve facilities or receive fiscal payment
- a wide range of non-government organisations, with many differing goals and varying credentials, claim to represent or influence indigenous people.

The current uncertainty over how the Indigenous Peoples' Rights Act has affected the procedures for obtaining area clearance certificates only exacerbates the difficulties of gaining these certificates and the associated negative impact on mining investment. In particular, extensive consultation with the National Commission for Indigenous People will be required as the implementing rules and regulations of the Indigenous Peoples' Rights Act are developed.²¹ This will create yet more delay, without guaranteeing compatibility with the Mining Act. Most applicants for area clearance certificates are nervous about seeking approvals for applications in the interim period between passing the Indigenous Peoples' Rights Act and drafting the implementing rules and regulations.

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²⁰ This is a particularly big problem in the areas of historic mining activity where claims may be many decades old and not comply fully with the current legislation.

²¹ The National Commission for Indigenous People is responsible for developing the implementing rules and regulations of the Indigenous Peoples' Rights Act.

FOREIGN INVESTMENT IN THE MINING SECTOR

Since the 1992 Investment Priorities Plan, the Philippine Government has been committed to foreign direct investment contributing more to revitalising the mining sector. Its primary mechanism to attract foreign direct investment is the Financial or Technical Assistance Agreements.

The Philippines stands to gain tremendously from foreign investment in mining. Project output will provide much needed export revenue and generate additional employment, income, taxes and profits both directly and indirectly through associated service industries.

Foreign direct investment in the mining sector also will lead to more modern mining methods being applied. This should lead to technological upgrading of the local mining industry, increasing its international competitiveness and reducing environmental problems associated with mining.²² Moreover, mining often brings economic development to isolated and underdeveloped regions via employment and company provided infrastructure and social support facilities.

Historical Sensitivities

The Philippines is highly sensitive to foreign investment in mining. This was clearly illustrated by the Marcopper spillage and its aftermath. This sensitivity dates back to Spanish and American colonisation when the Philippines was unfairly denuded of some natural resources. Other factors specific to the mining industry include:

- significant environmental problems resulting from past mining activity. These problems were exacerbated by mines located in the geologically unstable highland areas, where abuses polluted populated downstream areas
- past governments failing to regulate violations by the mining industry (Carino, 1992)
- fear of loss of access to land or forced relocation reinforced by lack of knowledge about modern exploration and mining methods
- time honoured, traditional small scale gold mining activity coupled with possible lack of acceptance of state ownership of mineral rights.

Government and the mining industry have consulted extensively with a large range of interest groups to address these sensitivities. The government position is that its mineral development policy is pro-people and pro-environment (Ramos, 1997).

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²² The Philippine mining sector has a considerable base for upgrading skills. The Philippines has tertiary training unlike many regional countries - providing some 20 mining engineers or geology graduates per year and 3 postgraduates (Katz, 1994).

THE MARCOPPER SPILLAGE AND ITS AFTERMATH

Public perception and acceptance of mining received a major setback when the tailings dam system at the Marcopper mine on Marinduque Island failed in March 1996. The spillage released several million cubic metres of disposal waste into the Boac River, severely affecting the livelihood of fisherfolk and others downstream. While the design, construction, operation and regulation of this mine, which had 60 per cent Filipino ownership, was all under the old mining code, the incident focused intense opposition to mining and ironically, also to the new reform package which had significantly tightened environmental protection.

Disturbing features of the incident from the perspective of foreign investors are the junior foreign partner paid the entire US\$43 million reclamation bill (Placer Dome, 1997),²³ and the two Australian managers, who joined the company after the dam was sealed, are the only personnel facing charges.

Actual and Potential Contribution of Foreign Miners

In the second half of the 1980s, the mining sector was the second biggest recipient of foreign direct investment after manufacturing, with inflows averaging US\$40 million per year (Figure 4.2). In the early 1990s mining foreign investment fell to negligible levels but jumped to around US\$40 million in 1994 and 1995 due to the new mining legislation (Figure 4.2). However, increased investment was not sustained in 1996 and showed no signs of picking up in 1997, due to uncertainty over the Mining Act's legal status. With progress in mining law reform lacking compared to areas such as banking and infrastructure, mining's share in total foreign direct investment fell from 27 per cent between 1985 and 1989 to less than 7 per cent between 1990 and 1996. The foreign share of mining investment, always lower than the foreign share of total investment, has declined further since the early 1980s (Table 7.3).

If outstanding applications can be processed and some projects move into the development phase, foreign mining investment's contribution to the Philippine economy will increase dramatically. A survey of 13 major foreign mining companies showed that exploration expenditure in the Philippines increased from US\$8.7 million in 1994 to US\$59.3 million in 1996 (International Mining and Exploration Committee, 1997). The same survey indicated employment generation by foreign mining companies rose from 604 staff in 1994 (118 full time and 486 part time) to 2 375 in 1996 (1 460 part time and 915 full time). Had outstanding permits to explore been approved in 1997, expenditure on exploration would have risen to around US\$120 million and employment to 3 144 people. Such exploration expenditure approximately equals the sales of the largest Philippine mining company in 1994 (International Mining and Exploration Committee, 1996).

If new mining activities involving foreign participation move into an operational phase, the scale of foreign investment and employment would be substantially higher

²³ The Marcopper mine was a joint venture with 60 per cent Philippine equity and 40 per cent foreign equity.

again. A single world scale copper-gold development can involve investment of US\$350 million and employ 3 000 people (International Mining and Exploration Committee, 1996).

AUSTRALIAN PARTICIPATION

Over 30 Australian mining companies have direct or 'watching brief' interests in the Philippines. Some including Climax-Arimco, WMC, Placer Pacific, Oxiana, Eastern Copper, SOCDT and Arboyne, have had a presence for many years.²⁴ Other Australian companies such as United Pacific Drilling, GM Drilling, Leighton and Micromine provide services such as diamond drilling, earthmoving, contract mining and computer software in the Philippines.

Under its Financial or Technical Assistance Agreement, Climax-Arimco is proceeding with exploration and feasibility studies into a number of copper-gold deposits in its Didipio project in Nueva Vizcaya in central Luzon. WMC is continuing to explore its Tampakan copper project and has seven other copper-gold and gold prospects in the Philippines to explore.

In 1997 the Philippines was budgeted to receive 8.6 per cent of Australian exploration expenditure in Asia (Soulsby, 1997). Realised exploration expenditure was probably lower, given continued delays in approving tenements. For the Philippines to raise its share of total Australian exploration expenditure in Asia, it needs to finalise the issue of mineral resource ownership, restore investor confidence in the mining sector and process further Financial or Technical Assistance Agreements. In 1997, 70 per cent of the exploration expenditure of Australian resource companies in Asia was budgeted for Indonesia (Soulsby, 1997).²⁵ With the current economic turmoil and political uncertainty in Indonesia, mining companies may look for other prospective countries into which to diversify their risks.

Increasing the Philippines' Attractiveness to Foreign Miners

To increase foreign investment flows to mining, the sector must increase its attractiveness to foreign mining companies. In surveys by the *Mining Journal* in 1994 and 1995 the Philippines did not rate among the top ten emerging markets,²⁶ but in the 1996 survey it had moved up to ninth place.²⁷ However, by 1997 the Philippines had dropped out of the top ten again (*Mining Journal*, 1997).

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²⁴ With two exceptions these companies are involved in onshore mineral exploration. SOCDT is involved in offshore petroleum exploration while Arboyne is engaged in a project to re-open and refurbish the Nonoc nickel complex which ceased operations in the 1980s.

²⁵ The Philippines was a distant second followed by Malaysia (6.8 per cent), Pakistan (6.4 per cent) and India (4.9 per cent).

²⁶ In the 1994 survey, the Philippines ranked eighteenth while the 1995 survey only focused on the top ten.

²⁷ In the 1996 survey, the eight countries with higher rankings than the Philippines were Argentina, Chile, Peru, Brazil, Indonesia, Mexico, Ghana and Bolivia.

WMC - A DECADE OF EXPLORATION IN THE PHILIPPINES

Since WMC (Philippines) Inc was established in 1988, it has evaluated more than 200 exploration sites and examined a small number in detail.

In 1991, WMC took an interest in a copper and gold prospect in the highlands around Tampakan, South Cotabato on the island of Mindanao. Subsequently it applied for and in March 1995 was granted a Financial or Technical Assistance Agreement allowing exploration access to the area. The area granted for exploration was initially 89 667 hectares, but shrinks annually and within 5 years must be no more than 5 000 hectares or an appropriate area for developing minerals, subject to Department of Environment and Natural Resources approval. WMC has already spent in excess of A\$40 million on the project, although it has so far has made no commitment beyond its current exploration.

As part of its approach to sustainable development, WMC has established working relationships and consultative structures with the five indigenous peoples' groups in the vicinity of its exploration area and appropriate local government units. It also has assisted with developing various community facilities including schools, a reforestation project and a project aimed at marketing the handicrafts of the local indigenous people. These initiatives follow the terms of its agreement with the Philippine Government requiring respect for indigenous people and community programs.

As one of the first foreign miners exploring under the mining reforms, WMC has put much effort into allaying concerns and misapprehension about its presence, particularly following the Marcopper tailings spill.²⁸ Since 1994, it has conducted and published baseline environmental studies, partly to inform local communities. It has also introduced community based environmental monitoring for water quality and quantity. In late 1997, WMC won the President's environment award for minerals exploration in the Philippines. WMC operates under a publicly available environmental management plan and recognised international consultants independently review its activities.

Source: WMC, 1997.

The regulatory regime is crucial in making the Philippine mining sector more attractive to foreign miners. A survey of international mining companies shows that among the top dozen factors affecting decisions on mining investment, all but one, geological potential, are associated with the regulatory regime in the host country (Otto, 1994).

²⁸ WMC had no involvement in Marcopper (see previous box on Marcopper incident).

HIGHEST PRIORITY FACTORS FOR MINING INVESTMENT

The top dozen priorities of mining companies when deciding on investments are:

- geological potential for target mineral
- profitability
- security of tenure
- repatriation of profits
- consistency/constancy of mineral policies
- management control
- mineral ownership
- realistic foreign exchange regulations
- stability of exploration terms
- ability to predetermine tax liability
- ability to predetermine environmental obligations
- stability of fiscal regime.

Source: Otto, 1994.

Developments over the last two years reduce Philippine ratings on consistency and constancy of mineral policies, ability to predetermine tax liability and environmental obligations, and stability of the fiscal regime. Mining Act revisions, Financial or Technical Assistance Agreement fiscal regime renegotiation, the Indigenous Peoples' Rights Act and further tightening of environmental requirements all significantly reduce in certainty.

Liberalising the general investment and minerals regulatory regime in the past decade provides a structure for management control (through Financial or Technical Assistance Agreements), the ability to repatriate profits and realistic foreign exchange regulations. However, many other nations now also have liberal investment laws and mining legislation. Consequently, even in these areas the Philippine position may not have improved much compared to other emerging mineral producers, and may have deteriorated compared to many.

GROWING OPPORTUNITIES FOR MINING SERVICE SUPPLIERS

Regenerating mining on a sustainable basis in the Philippines would stimulate demand for a range of services, equipment and technology, both from new projects and existing mines. Australian firms are well placed to supply this demand, with some such as Philippine Explosives and Leighton already well established. The Mining Philippines 1997 exhibition, attended by 85 Australian companies, generated further new business.²⁹

²⁹ For example, Australian Mining Technology made sales of A\$730 000.

AUSTRALIAN COMPANIES PROVIDING SERVICES TO THE PHILIPPINE MINING INDUSTRY

Leighton Asia - a Value for Money Approach

Leighton Asia Limited established their Philippine branch office in 1996, after investigating the market for four years.

Leighton had a contract with Philex Mining Corporation, one of the Philippines' biggest mining companies, for repairing and upgrading infrastructure and for mine hauling, processing and stacking ore. Leighton believes the Philex contract boosted its credibility, opened significant opportunities, and prompted interest from other local mining houses for its participation in their projects. The Philippine market also provides contracts for Leighton engineering and construction divisions.

Leighton focuses on market opportunities to match its strengths, particularly in the mining and civil engineering sectors. Its major problem in gaining a foothold in the price conscious Philippine market was encouraging customers to recognise the value added component it provided. Leighton believes background knowledge, persistence and resilience are imperative for Australian companies entering the market. It also emphasises the need to be sensitive to the local environment, culture and business practices and not to be too aggressive.

Philippine Explosives Corporation

Philippines Explosives Corporation began in 1969 as a joint venture between ICI Australia (now called Orica) and Philippine partners. It initially imported then manufactured packaged explosives and initiating systems for the domestic market, particularly mining. A manufacturing facility was established in 1971 in Bataan and onsite plants at major mines.

The business has expanded since the 1980s becoming Orica's export hub to the rest of the Asia Pacific. Philippine Explosives Corporation is now a mature business with a dominant market share. In 1995, it established United Pacific Drilling as its drilling division in the Philippines.

Source: Bryant, 1997.

Demand for a wide range of environmental services is likely to grow due to more stringent standards for existing mining operations. This may involve laboratory and analytical services, equipment and consumables to treat water and effluents, mine drainage, material recovery and recycling, airborne and water emissions measurement and control systems, and a wide range of soil testing and surface reclamation services. The market to supply environmental services in the Philippines is extremely competitive, with strong competition from US and German firms.

Another source of demand once current legal uncertainties are resolved and new Financial or Technical Assistance Agreements are approved will be to support expanding exploration activity, particularly with assay laboratory, drilling and data processing services.

If exploration activity by foreign mining companies resurges, and is followed by mine design and development, demand for mining services would expand significantly in:

- mining, civil, mechanical and structural engineering
- environmental engineering
- earthmoving and contract mining
- mine planning and software
- community infrastructure design and development
- technical training
- data processing.

OUTLOOK

The longer term potential of the Philippine mining sector is immense if reform momentum can be regained and the regulatory regime stabilised. If not, the sector will continue to stagnate and under-contribute to Philippine economic development.

International exploration interest in the Philippine mining sector decreased significantly in 1997 and early 1998. After the presidential election, the Philippines should make every effort to restart the stalled reform process and as rapidly as possible resolve potential legal conflicts between the Indigenous Peoples' Rights Act and the Mining Act. Already a substantial number of mining companies have closed their representative offices and left the country. If the confidence of foreign mining investors in the Philippines can be restored quickly, Australian exploration expenditure in the mining sector could substantially increase.

If the reform process is not restarted, international exploration interest and expenditure will decrease further. Even if exploration continues, companies are unlikely to proceed with large investments in mine development until confidence is restored.

When the reform process is resumed, policy makers need to avoid the mistakes and inconsistencies that severely damaged the mining industry in the early 1980s, or making policy 'on the run' as in recent years. Strengthening and modernising the government minerals administration to improve service levels in policy and tenement administration will be important. Liberalisation of mining regimes elsewhere makes the urgency of reform greater if the Philippines is to make the most of its geological potential and secure a long term position as an internationally competitive minerals producer.

Even if the mining industry's output grows modestly into the next century, considerable opportunities will arise for Australian mining equipment, consumable and service suppliers as existing companies seek to modernise their operations and comply with new environmental regulations. These opportunities will multiply rapidly once more foreign firms are granted Financial or Technical Assistance Agreements.

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Chapter 8

AGRICULTURE AND FOOD: RECENT TRENDS AND ISSUES

Slow agricultural output growth during the 1980s and early 1990s, and its implications for rural poverty are major concerns of the Philippine Government. Weak agricultural productivity and competitiveness performance limits agricultural and rural income growth, and constrains rural demand growth and rural enterprise development. It also limits the capacity of the agricultural sector and rural economy to absorb labour, increasing rural urban migration and straining urban infrastructure.

High performing Asian economies show that reasonable agricultural production growth, based on small holder farming, is a precondition to significantly reduce poverty. Sound agricultural sector growth keeps food prices low and provides a cheap flow of agricultural raw materials, underpinning growth and competitiveness in the more dynamic industrial and service sectors. However in the Philippines, agriculture provides little if any stimulus for the rest of the economy.

An overvalued peso (pre 1997), inadequate rural infrastructure investment and extension services, past taxation policies, monopoly trading and government intervention in several agricultural sectors, inadequate credit access and heavy trade protection caused agricultural investment and output to stagnate and competitiveness to decline since the 1980s. In the last decade, the stalled land reform program has engendered uncertainty, reduced investment incentives and exacerbated fundamental problems. While the peso's recent depreciation offers agriculture a short term reprieve and agricultural trade liberalisation began with Philippine WTO entry in 1995, until other long term problems are addressed the agricultural sector will fail to achieve international competitiveness or contribute significantly to the national economy.

Over the past decade, the Government has implemented various reform programs to improve agricultural performance and reduce rural poverty. While these help to reduce the bias against agricultural investment, several policies still distort incentives, constrain private agricultural investment, unduly penalise consumers and lead to misallocation of agricultural resources. This chapter reviews recent Philippine agricultural performance compared to regional neighbours and the sector's changing structure. It examines government policies towards major crops and agricultural activities, identifying remaining policy distortions and analysing activities' competitive position since depreciation. It also examines major constraints to agricultural growth and trade performance, and recent trade policy developments affecting agriculture.

ROLE AND STRUCTURE OF AGRICULTURE

In 1997, agriculture contributed approximately 20 per cent of Philippine GDP and employed about 11 million people or 41 per cent of the workforce. More than half the population lives in rural areas. Agricultural and fishing exports accounted for about 7.5 per cent of 1997 export revenue, and processed food another 1.4 per cent.

The agriculture and food sector is central to the economy's overall performance; its rejuvenation is crucial to alleviate poverty and increase equity. Higher incomes for those depending on agricultural activities would increase rural purchasing power, stimulate investment and create employment in services and industry. Agricultural productivity gains also would lower food prices and raise export revenue, thereby raising real living standards, containing inflation, increasing saving, financing essential imports and reducing the current account deficit.

At present, low agricultural productivity means high food prices; Philippine families spend almost half their income on food, 13 per cent on rice alone; the poorest families (over half the population) spend 62 per cent of their income on food (EIU, 1998). These ratios are considerably higher than those of other ASEANs and similar to India, a much lower income country. Poor agricultural performance prevents significant reductions in rural poverty. Although overall poverty has declined with economic recovery since 1988, it is still heavily concentrated in rural areas, home to twice as many poor families as urban areas (Table 1.12).

The agricultural sector is dualistic; many small rural producers co-exist with a few large agribusiness production units. Small rural producers often use low productivity, traditional technologies and are only marginally integrated into the market economy, while agribusiness units are highly integrated and use sophisticated production techniques.

Changing Structure of Agricultural Output

Philippine agriculture is not diversifying away from low profit, traditional commodities; traditional crop production still accounts for over 50 per cent of total sectoral gross value added. The relative importance of coconuts has declined but the contribution of rice, corn, sugar cane and bananas has changed little since the mid 1980s. Even the dramatic 1970s expansion in 'other crops' - mostly new, higher return products - has slowed significantly. However, livestock, poultry and fishing are growing; they accounted for almost 40 per cent of net agricultural output in 1996 compared to 27 per cent in 1980 (Table 8.1).

Lack of structural change in agriculture is partly due to policies pursued in the 1970s and 1980s including: price controls and other government intervention in commodities like rice, coconuts, corn and sugar; a slow down in irrigation and rural infrastructure investment; low budget allocations for agricultural research; and weak extension services.

Slow diversification also results from current government policies that emphasise rice self-sufficiency and protect traditional crops like corn and sugar in which the Philippines has no comparative advantage. Public research and extension systems also focus on traditional crops at the expense of other crops.

Table 8.1

Share of 'Other Crops' Increases
Contribution to Total Agricultural Gross Value Added, 1970-96

	Share in gross value added (per cent)				Growth rate (per cent per year)		Contribution to growth (per cent)	
	1970	1980	1990	1996	1970-80	1980-96	1970-80	1980-96
Crops								
Rice	19.0	13.5	15.5	17.0	4.1	2.5	13.9	29.6
Corn	6.1	5.5	6.8	5.6	4.9	1.5	5.6	6.7
Coconuts	5.3	8.3	4.4	4.1	5.3	-3.2	5.4	-15.4
Sugar cane	6.7	3.6	2.3	2.7	3.0	-1.8	3.4	-4.1
Bananas	5.0	2.7	1.7	1.6	12.4	-1.9	16.8	-3.3
Other crops	10.7	22.8	22.8	23.4	10.6	1.5	28.0	27.2
Total crops	52.8	56.4	53.5	54.4	6.8	0.9	73.0	40.6
Livestock								
Poultry	4.1	4.8	7.6	10.1	10.3	5.8	10.3	30.8
Fisheries	17.6	15.0	19.2	18.6	4.1	3.1	13.0	41.5
Forestry	13.5	12.7	4.6	na	-3.5	-15.2	-6.0	-56.3
Agricultural services								
	na	4.2	4.7	5.0	na	2.6	na	9.4
Total	100.0	100.0	100.0	100.0	4.9	1.3	100.0	100.0

Source: World Bank, 1997.

Income Potential of Different Crops

Failure to diversify from traditional crops reduces agricultural output value and rural incomes because traditional crops generally have low earnings per hectare (Table 8.2). While rice, coconut, sugar cane and corn constitute the top four agricultural commodities in terms of the total output value, only sugar cane produces a high output value per hectare. One third of agricultural land, or 3.4 million hectares is devoted to rice, while corn and coconuts account for a further 5.8 million hectares, so 92 per cent of Philippine farm land is devoted to crops with low earnings per hectare. Small average plot sizes (Table 8.4) also constrain farm income growth. Many higher income earning crops, including rubber, garlic, onions, cabbages, tomatoes and eggplants¹ are among the least frequently grown although some high earning crops like pineapple and mango are grown more widely. Rice self-sufficiency and price support schemes, agricultural protection and other policies supporting traditional crops reinforce this poor allocation of resources. Furthermore, the poor state of marketing infrastructure raises transports costs for inputs and outputs and limits access to land suitable for diversification.

¹ However, crops like garlic and onions are profitable only because they receive high levels of protection (Appendix Table 8.1).

Table 8.2

Low Income Earning Corn, Coconut and Rice Dominate Production
Total Production and Average Production Value per Hectare, Various Crops:
1996 (Preliminary)

Crops	Average production value per hectare ('000 pesos per year)	Total production value (pesos billion)
Corn	10.0	27.4
Coconuts	9.3	28.8
Peanuts	9.9	0.5
Abaca	12.1	1.3
Mungbeans	18.6	0.6
Rubber	20.5	1.8
Palay rice	23.4	92.6
Leafy vegetables	25.1	4.5
Cassava	29.5	6.6
Tobacco	30.6	1.8
Coffee	36.0	5.0
Fruiting vegetables	37.3	12.5
Bananas	38.4	12.4
Tomatoes	48.4	0.9
Other fruit	50.2	17.3
Spices	51.6	2.2
Sugar cane	57.4	21.5
Eggplants	66.4	1.2
Pineapples	96.0	6.7
Cabbages	98.5	0.8
Mangoes	146.1	1.8
Onions	213.0	1.7
Garlic	236.6	1.6

Source: Bureau of Statistics, 1997.

COMPARATIVE PERFORMANCE OF PHILIPPINE AGRICULTURE

Sluggish and uneven agricultural performance since 1980 has failed to generate rural growth. In the 1970s when improved hybrid seeds developed at the International Rice Research Institute near Manila were introduced, per capita agricultural production rose but since the 1980s it has declined. In the early 1990s, among regional neighbours, only Bangladesh, Nepal and, surprisingly, Thailand had a poorer agriculture performance than the Philippines (Table 8.3).

Table 8.3

Philippine Agricultural Production Growth One of Asia's Weakest
Annual Growth in Per Capita Agricultural and Food Production in Selected Asian
Countries, 1961-94
(Per cent)

	1961-70		1971-80		1981-90		1991-94	
	Agriculture	Food	Agriculture	Food	Agriculture	Food	Agriculture	Food
Bangladesh	-0.34	-0.54	-0.17	-0.18	0.58	0.47	-4.01	-4.06
India	-0.09	-0.18	-0.05	-0.11	1.63	1.53	1.07	1.08
Indonesia	0.87	0.73	1.86	1.87	2.79	2.58	0.81	0.66
Malaysia	2.97	2.70	4.33	2.72	5.61	3.67	2.09	1.08
Nepal	-0.36	-0.30	-0.79	-0.81	2.15	1.97	-1.20	-1.25
Pakistan	1.43	1.60	0.66	0.30	0.41	0.83	0.53	-1.71
Philippines	0.57	0.56	1.74	1.92	-0.68	-0.76	-0.26	-0.56
Sri Lanka	0.71	0.29	2.60	1.20	-1.24	-1.52	2.49	1.83
Thailand	0.96	1.24	1.45	1.47	-0.37	0.12	-2.99	-1.33

Source: Food and Agriculture Organisation, 1995.

Many factors contribute to the poor state of Philippine agriculture; the following sections focus on some main ones, including the land reform program, the extent and nature of government intervention in agriculture, failure to provide adequate rural infrastructure and extension services, poor credit access and agricultural trade policies.

LAND REFORM

Philippine land reform has a long history. While earlier land reforms aimed at improving the tenure status of existing tenants and distributing corn and rice land, the Comprehensive Agrarian Reform Program, CARP launched in 1988 involved the compulsory sale of farms over 5 hectares to tenants and other beneficiaries. The Comprehensive Agrarian Reform Law (1988) stated that:

- land leased or owned by multinational corporations would be acquired within three years from mid 1988; for example Dole and Del Monte land leases from the National Development Company would be transferred to farm workers' cooperatives and collectively owned
- commercial farms, defined as private agricultural land devoted to commercial livestock, poultry and swine, aquaculture, fruit farms, orchards, cacao, coffee, and rubber plantations, would be subject to compulsory acquisition after 1998²

² The Supreme Court later exempted livestock and poultry farms from CARP coverage provided they existed before June 1988. A similar exemption was later granted to aquaculture farms. Only 35 000 hectares of farms took advantage of the ten year deferment option.

- commercial farms could distribute shares of stock rather than land titles to their farm workers, within two years from the act taking effect.

Less than 30 commercial farms took advantage of the last option.

To date, land reform implementation has not been satisfactory. Farmers use Land Bank loans amortised over 30 years to buy plots from previous owners at prices the Government determines.³ However, complex land valuation and compensation processes and inadequate government budget allocations delay implementation. Low land valuations can result in court cases that continue for years.⁴

The Government estimated CARP would redistribute 8.2 million hectares to about 3.7 million small scale farmers and landless families by 1998. However, by December 1996, only 4.3 million hectares or 53 per cent of the target had been transferred to farmers (World Bank, 1997). Slow implementation and inadequate funds will delay expected land reform completion until after 2004.

Impact on Agricultural Efficiency

While land reform may help redistribute wealth, its benefits to agricultural efficiency are uncertain. Under the comprehensive agrarian reform law, landowners can retain 5 hectares of land and eligible heirs a further 3 hectares each; tenants and other land reform beneficiaries can own up to 3 hectares. Consequently, average farm size is from 2 to 3 hectares (Table 8.4) and 85 per cent of farms are less than 5 hectares. Subsequent consolidation of plots is prohibited. This severely affects farm management, as farms using modern cultivation and harvesting technologies usually cannot achieve economies of scale in farm equipment and services, or efficient coordination of planting, harvesting, quality control or delivery schedules on such small plots. Small plot size usually is not a problem for raising chickens and pigs and farming fish. However, a typical Philippine farm consists of a major crop, with rice, corn and coconut as common base crops, and a few head of livestock and poultry. Furthermore, new landowners generally are poor and widely distributed across the countryside; servicing them strains farm input and output marketing systems.

Before land reform, reasonably well managed plantations produced major export crops; land reform could damage this unless plantation managers successfully introduce one of the alternative centralised management methods CARP permits (Clarete, 1997). Major US agribusiness firms like Del Monte and Dole usually employ one of the two approved methods, land leasing and contract farming. In addition the Departments of Agrarian Reform and Agriculture are now promoting joint venture operations for large export oriented tropical fruit plantations but to date there are few examples.

³ The Government, through the Land Bank, pays the landowner 25 to 35 per cent of the land's value in cash and 65 to 75 per cent in ten year maturity bonds with interest rates linked to the 91 day Treasury bill rate. The CARP beneficiaries pay the Land Bank in 30 annual amortisations at 6 per cent interest per year.

⁴ Government determined land prices often are below their true commercial value, because they are based not only on comparative sales in the area and capitalised net income from farm production but also values declared for taxation purposes. Owners often understated their land's value to avoid tax (Clarete, 1997). Thus land reform is meeting stiff resistance from powerful owners.

Leasing Land

Some agribusiness companies like Del Monte, Dole and Filipinas Palm Oil Industries lease land back from their farm worker cooperatives. They then employ their workers on a full time or contractual basis. Lease tenure and renewal value has caused friction between management and workers at Dole and Filipinas Palm Oil Industries, creating investment uncertainty. Furthermore, the Department of Agriculture does not encourage leasing.

Contract Farming

Some agribusiness companies employ the farmers on a contract basis to grow crops on their own land. Companies provide the market and technology; government banks provide the financing. Major companies undertaking contract farming include T'boli Agricultural Corporation, with 3 000 hectares of pineapples involving about 10 small growers' cooperatives; Dole Tropicfresh Division, with 1 000 hectares of asparagus in small and medium growers' cooperatives; and Dole's banana operations, which contract production to small and large farmers.

Joint Ventures

In plantation joint ventures, small landowners provide labour and equity in the form of advance lease rentals for landuse,⁵ while corporations provide management skills, marketing and new investment. The Department of Agrarian Reform and the Department of Agriculture promotes this approach.

Uncertainty about future outcomes under CARP suppresses new agricultural investment. Already the program has been in progress for ten years and is expected to drag on for another six or more years. Throughout this long period, landowners with more than 5 hectares have been unwilling to invest in fixed assets like irrigation canals, soil improvement, fencing or farm buildings, as they expect to have to relinquish land to former tenants. Also, banks have been unwilling to lend for such projects because of uncertainty in the case of default about their recourse to land subject to CARP. On the other hand, tenants who are prospective landowners also are unwilling to invest until they actually own the land and in any case, they cannot obtain credit for new investments until then. Even after they buy their land, they may be too indebted to be able to undertake new investment for some years. These considerations have suppressed agricultural investment in the past decade, constraining productivity growth.

AGRICULTURE TRADE POLICY REFORMS UNDER THE RAMOS ADMINISTRATION

While popular resistance resulted in the reversal of early reforms to liberalise trade in corn and livestock, which small farmers mainly produce, liberalisation continued in other imported products such as beef, which large farmers mainly produce. Beef and live cattle imports actually boosted meat processing and cattle fattening industries. Liberalising fish imports also resulted in an emerging fish canning industry.

.....
⁵ Land of CARP beneficiaries cannot be used as equity until ten years after full payment of the land to the Government.

Ratification of agriculture agreements under the Uruguay Round required WTO member countries to reduce domestic support for agriculture, lower subsidies on agricultural exports, improve market access for agricultural imports and harmonise sanitary and quarantine measures. Agriculture was one of the main reasons why in 1994, the Senate almost decided to delay accession to the WTO. Opponents argued liberalising the country's agricultural import rules would destroy the livelihood of farmers. However, the larger cost of being isolated from the international trading community, coupled with assurances from the Government that it would introduce competitiveness enhancing measures convinced waverers.

In 1995, the Government announced that it would tariff quantitative restrictions on all agricultural imports except rice, as part of its WTO commitments. In 1996, after some controversy, Congress passed implementing legislation, allowing the import of all products except rice at tariffs of 100 per cent for out-of-quota imports and 30 to 50 per cent for in-quota imports. Tariffs on out-of-quota imports were to decline to 50 per cent in 2004 according to the WTO agreement. However, as the new tariffs exceeded the previous tariff equivalent rates for most products, agricultural protection initially rose (Appendix Table 1).⁶ In retrospect, excessive tariffication was necessary and inevitable to encourage Congress to pass this unpopular agricultural tariffication law. Given time, the law making body would have understood the importance of setting the appropriate tariff protection on agriculture products, but the Philippines did not have that time, because when RA 8 178 was passed, the USA was intending to take the Philippines to the dispute settlement body in the WTO for failing to honour its contractual obligations under agriculture.

The February 1998 trade liberalisation reforms reduced many tariffs and eliminated some quotas on food imports.

Tariff Rate Quotas and Meat Imports

Tariff rate quotas or minimum access volumes introduced in 1996 enabled agricultural commodities traditionally imported under quotas before tariffication to continue to enjoy access at tariffs lower than 100 per cent. For major imports like corn and frozen beef, existing importers received tariff rate quotas. For products rarely imported previously, such as pork, local producers received quotas on the basis of their output.

Not surprisingly, since domestic producers have an incentive to minimise imports, the latter arrangement resulted in underuse of minimum access volumes, particularly for pork, chicken meat and sugar (Appendix Tables 8.1 and 8.2). Bilateral disputes between the Philippines and key trading partners resulted in penalties for non-use of import licences. Trading partners want traders and processors rather than producers to have access to minimum access volume licences. Despite these problems, the volumes and values of most agricultural imports except sugar have increased strongly (Appendix Table 8.3).

.....
⁶ For example, the tariff equivalent of quantitative import controls on corn was 60 per cent and the new tariff is 100 per cent. The tariffication process actually strengthened rather than reduced the protection accorded to the agriculture sector (Appendix Table 8.1). This excessive tariffication is legal in the WTO, provided the tariffied rate is within the tariff binding commitment of the government.

Post Depreciation Liberalisation

In February 1998, the Government reduced the impact of depreciation on imported food prices by reducing tariffs and removing quotas on a wide range of agricultural imports, including frozen beef, live cattle, cereal preparations, fruit and vegetables. Details of these reductions follow. (Also see Chapter 3 - Trade.)

MAJOR COMMODITY POLICIES AND PERFORMANCE - PRE AND POST DEPRECIATION

In 1997, total agriculture production reached almost P 500 billion, or US\$17 billion. Crops accounted for 54 per cent, livestock 17 per cent, poultry 12 per cent, and fisheries and aquaculture 17 per cent. Rice, corn, coconut and sugar cane are the main crops, grown on almost 85 per cent of farms (Table 8.4).

RICE

In 1997, rice the main staple, used one third of agricultural land but accounted for only 16 per cent of gross agricultural value added, or P 88.6 billion (US\$3 billion). Farmers produced 11.3 million metric tonnes of palay or unprocessed rice, or 7.3 million metric tonnes of rice equivalent. Only 65 per cent of rice growing land is irrigated and the average rice farm is less than 2 hectares. The Philippines is not a competitive rice producer or processor due to the relative scarcity of land and low agricultural productivity; its average yield per hectare is just over 3 metric tonnes, compared to Indonesia's 4.3 metric tonnes, China's 5.9 metric tonnes, and Australia's 8.4 metric tonnes (Food and Agricultural Organisation, 1994a; Bureau of Agricultural Statistics, 1998).

In the past ten years, rice output has grown by 2.9 per cent per year, slightly more than population growth at 2.3 per cent per year. Demand for rice is expected to increase to 2.5 to 3 per cent per year in the medium term.

Low rice yields can be traced to:

- the small proportion of irrigated land due to declining irrigation investment in the 1980s; yields are 40 per cent higher on irrigated land
- use of poor quality seeds; less than one quarter of rice areas are planted with new seed varieties
- low rate of fertiliser use
- inadequate extension services, exacerbated by the Government decentralising these services in the 1990s
- low level of farm mechanisation and small farm sizes
- frequent occurrence of dry spells.

Table 8.4
Rice, Corn and Coconut Dominate Agricultural Land Use
Distribution of Farms by Agricultural Activity, 1991

Type of farm	Total number of farms	Total physical area of farms (hectares)	Average farm size (hectares)
All types	4 610 041	9 974 871	2.16
Temporary crops	3 297 608	6 238 319	1.89
Palay (rice)	1 939 998	3 427 864	1.77
Corn	1 110 042	2 194 175	1.98
Sugar cane	45 919	329 444	7.17
Tobacco	6 369	6 515	1.02
Tuber, root crops	119 105	145 823	1.22
Vegetables	36 438	35 418	0.97
Pineapples	6 243	42 011	6.73
Other temporary crops	33 494	57 069	1.70
Permanent crops	1 034 510	3 577 018	3.46
Citrus	14 535	38 626	2.66
Bananas	93 260	194 247	2.08
Mangoes	22 963	66,541	2.90
Coconut	761 970	2 733 474	3.59
Coffee	43 604	127 382	2.92
Fibre crops	19 730	64 939	3.29
Other permanent crops	78 448	351 808	4.48
Livestock	136 415	93 288	0.68
Cattle	18 383	34 512	1.88
Pigs	94 114	41 929	0.45
Other	23 918	16 847	0.70
Poultry	77 010	36 725	0.48
Chickens	63 977	33 223	0.52
Other poultry	13 033	3 502	0.27
Others	64 497	29 521	0.46

Note: Census figures may not tally with the actual hectareage of the Bureau of Agricultural Statistics.

Source: National Statistics Office, 1991.

The government's long history of intervening in the rice industry also has lowered performance. In 1972, President Marcos established the government owned National Grains Authority to integrate the rice, corn and wheat industries. The authority regulated industry by registering and licencing grain distributors, controlling grain prices, procuring grain harvests, maintaining mandatory buffer stocks, distributing grain and monopolising international grain trade.

In 1981, the National Food Authority replaced the National Grains Authority and added supervision of fishing, meat production and livestock to its functions. However, in May 1985, under IMF programs after the mid 1980s economic crisis,

non-grain food commodities were removed from National Food Authority control; its functions were limited to rice, corn and if necessary, wheat. In 1998, rice is the only crop subject to market intervention.

For food security purposes, the National Food Authority maintains strategic rice reserves equivalent to 15 days of national rice consumption. Furthermore, on 1 July each year, the national Government and designated cooperatives must hold stocks equal to 30 days of national rice consumption.

In 1993, the Department of Agriculture launched the grains production enhancement program for rice and corn as part of the Medium Term Agricultural Development Plan. It uses the key production areas approach, supporting specific priority areas. In May 1996, the new Secretary of the Department of Agriculture launched the Gintong Ani or 'golden harvest' program for both rice and corn aimed at ensuring food security, organising and transforming farmers into viable entrepreneurs, enhancing farm incomes, and stabilising palay and rice prices equitably for producers and consumers. The program includes a package of technology and support services.

In recent years, Congress has passed legislation, like the December 1997 Agricultural and Fisheries Modernisation Act, to improve agricultural productivity. While the implementing rules and regulations of this legislation have yet to be passed, in the past, agricultural program implementation has been weak and actual budget allocations a fraction of those legislated.

Rice Self-Sufficiency and Price Support Policies

Like most countries in the region, the Philippines has operated a policy of rice self-sufficiency for several decades (Table 8.5) although this policy does not preclude imports to secure food supplies and stabilise prices when harvests are poor. Average self-sufficiency ranged from 93 per cent in the 1970s to nearly 96 per cent in the 1980s. The Philippines was 98 per cent self-sufficient in rice in the first two years of the 1990s but the level fell to only 91 per cent by 1997 (Bureau of Agricultural Statistics, 1998). As a result, rice imports increased, averaging 412 000 metric tonnes over the five years to 1997 and reaching 725 000 metric tonnes in 1997.

Because rice growing generates a low income per hectare, a price support scheme and trade barriers support the rice self-sufficiency policy. Two thirds of government agricultural assistance goes to rice production, essentially to help achieve self-sufficiency (Clarete, 1997).

The National Food Authority buys domestic paddy rice at support prices which supposedly guarantee farmers a 30 per cent rate of return. While buying less than 10 per cent of total marketed rice, it sets a floor price for market purchases. Including imports, it sells approximately 15 per cent of rice. If rice supply is high, this government purchase price is a maximum; if demand is high, it is the minimum. In most recent years, the National Food Authority has purchased much less than 10 per cent of the crop because its prices were below the market level.

Table 8.5

Philippine Rice Self-Sufficiency High but Falling in 1990s
Rice Self-Sufficiency Ratios, 1970-92
(Per cent)

Country	1970-79	1980-89	1990-92
Bangladesh	98.16	98.63	99.47
India	99.67	100.25	100.49
Indonesia	94.68	98.72	99.45
Japan	101.97	101.58	99.86
Republic of Korea	93.77	95.45	99.99
Malaysia	87.40	85.41	84.07
Burma	105.88	103.88	101.43
Pakistan	117.83	128.46	132.89
Philippines	97.53	99.52	98.16
Sri Lanka	80.68	93.59	93.53
Thailand	113.65	128.59	130.92
Average	93.13	95.94	95.30

Note: A percentage over 100 indicates the country exports rice.

Source: International Rice Research Institute, *World Rice Statistics* reported in Clarete, 1996.

The National Food Authority also has a monopoly right to import rice, retailing it at a so-called release price of P 14 to P 15 per kilo. As the release price is below the current retail price of domestic rice, at P 16 to P 21 per kilo, imported rice forces private trading margins down, causing complaints from local traders. If a rice shortage is forecast and the Government is not expected to import rice, prices start to rise 6 months before shortages are expected to develop.

In future, the growing population, higher per capita income and land shortages increasingly will constrain the rice self-sufficiency policy. Competition from other land uses will increase land prices reallocating it to higher value agricultural or non-agricultural uses, unless higher barriers are raised to imported rice, as in Japan and the Republic of Korea.

Although improved rice technology and irrigation would improve productivity, if trade barriers remain in place, rice prices will not fall to international levels. Instead, trade barriers will underwrite inefficiency in rice production and distribution. If farmers receive extra profits from rice growing as a result of trade barriers, agricultural land prices will merely rise reflecting the higher expected present value of future profits from rice growing.

Advocates of self-sufficiency argue that with Philippine entry to the WTO, rice markets will open up, albeit slowly, allowing Thai and other more efficient producers to significantly penetrate the market. In a developing country where most of the population depends on food production activities, they fear this may cause widespread poverty. The Philippine Government is concerned about food security issues and the country's vulnerability to price fluctuations, and particularly after the currency crisis, major exchange rate movements.

Underlying the argument that opening the local rice market to foreign competition will threaten most of the population's livelihood, is the assumption that rice producers cannot switch to other agricultural or non-farm activities. However, rice farming generates such low incomes (Table 8.2) that rice farmers would be better off moving to more profitable crops if they could. Their continued rice production reflects the bias of government agricultural and rural infrastructure investment policies, for example towards rice specific irrigation. Furthermore, over 30 per cent of rice production still meets the subsistence needs of farmers, and growing rice at least ensures farming families can survive.⁷ Encouraging farmers to move out of semi-subsistence agriculture into more profitable crops and activities would require improved agricultural market information (so farmers can decide what crops to grow and where, and at what prices they should sell), improved distribution and purchasing channels for new crops, and major investments in non-sector specific rural infrastructure, like farm-to-market roads (Clarete, 1997). However, continued commitment to rice self-sufficiency will constrain a more rational allocation of agricultural land and labour that optimises farm incomes and national output.

Concern by self-sufficiency advocates about exposure to international price fluctuations is unfounded. Considerable empirical evidence indicates that grain prices fluctuate considerably less in international markets, where millions of growers in different climatic zones supply produce, than in isolated local markets, where growers are subject to similar climatic conditions (Department of Foreign Affairs and Trade, 1996a; 1996b). In most low income countries including the Philippines, staple food price rises due to poor local harvests are a major source of inflation.

Impact of the Peso's Depreciation

The 1997-98 peso depreciation reduced but did not eliminate the margin between domestic and international rice prices. Before depreciation, the landed cost, insurance and freight, cif price of imported rice was P 7.90 per kilo; since depreciation the landed cif price of imported rice is P 12 per kilo. The 1998 government supported farmgate price of domestic palay (unprocessed rice) is P 8 per kilo. Given a 65 per cent mill recovery rate, the rice equivalent costs P 12.30 per kilo, and with milling costs at P 0.50 per kilo the minimum wholesale price of rice is P 12.80 per kilo, only 7 per cent above the cif rice price. However, high private distribution costs result in domestic prices of P 16 to P 21 per kilo, still 33 to 75 per cent above imported rice prices.

The National Food Authority does not levy import duty on its rice imports but adds a margin to cover handling and storage costs. It held release prices for imported rice constant at the pre depreciation price of P 14 to P 15 per kilo, but now claims it cannot cover its (high) distribution costs at this price. President Ramos plans to keep rice release prices constant until after the May election.

Rice Trade Barriers

Since 1972, grain imports have been subject to quantitative restrictions. In 1985, the Government deregulated producing and trading food grains and related agricultural

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⁷ A further 8 per cent goes to landlords as rent; 18 per cent is used for seeds and animal feed; and only 42 per cent is marketed.

inputs, yet the National Food Authority retains exclusive authority to import rice on presidential authorisation. The Secretary of Agriculture must certify a domestic shortage exists before requesting rice imports. An inter-agency committee on grain imports determines the magnitude of the shortage after public consultations.

Under WTO entry conditions, rice was exempted from import restrictions because it is a politically sensitive food staple.⁸ However, the Philippines must guarantee minimum import access for rice, rising from 1 per cent in the first year of implementation to 4 per cent after ten years, and must install effective production restraining measures. The Department of Agriculture assigned the National Food Authority the first right to import the rice minimum access volume. While tariffs were set at 50 per cent, the National Food Authority has duty-free access for its rice imports. The Government also excluded both rice and corn from its liberalisation commitments under the Association of South East Asian Nations, ASEAN Common Effective Preferential Tariff Scheme, CEPT.

While the National Food Authority has a monopoly to import rice, it now can auction or allocate import rights to the private sector. However, except for small quantities of fancy rice varieties, the National Food Authority continues to import all rice. In the courts, the Philippine International Trading Corporation, a state owned trading firm under the Department of Trade and Industry, has challenged this monopoly.

Private millers and traders have pressured the National Food Authority to ensure it only imports rice in times of extreme shortage, arguing that this maintains prices for farmers. Failure to import sufficient rice in the 1995 drought resulted in significantly increased rice prices and sharply increased national inflation.

Since the depreciation wholesale domestic rice prices are very close to international levels (P 12.80 per kilo for domestic milled rice compared to P 12 for imported rice); it may be opportune for a new administration to rethink rice policy. Dismantling the inefficient rice import monopoly and price control schemes and replacing them with a minimal tariff only regime would not jeopardise farm income or the self-sufficiency policy, as the cost of distributing imported rice throughout the Philippines would naturally protect local rice growers. This reform would increase pressure for productivity improving investment in the sector and rural infrastructure; the Government's priority to agriculture and commitment to solving other constraints to rural productivity growth such as the stalled land reform program should match such a reform. Allowing free access to the rice distribution trade⁹ and competition from imported rice would keep distribution margins competitive, forcing improved efficiency in the domestic distribution sector.

CORN

Since 1993, corn production has fallen 10 per cent to 4.3 million metric tonnes in 1997. In 1997, Philippine corn yields of 1.6 tonnes per hectare were well below China's 4.8 tonnes per hectare, Thailand's 3.0 tonnes per hectare and Indonesia's 2.2 tonnes per hectare (Food and Agricultural Organisation, 1994b). Low

⁸ The Government committed to an in-quota import volume of 119 000 metric tonnes in 1995 and 219 000 metric tonnes in 2004 at 50 per cent duty.

⁹ Distribution generally is reserved for Filipinos.

productivity comes from the low use of hybrid seeds, fertiliser and mechanised tilling; high levels of subsistence farming; and poor infrastructure. While corn production employs 22 per cent of agricultural land (Table 8.4), it generates only about 6 per cent of agricultural value added (Table 8.1). Gross production value per hectare from corn production was the lowest of all major crops (Table 8.2). About 70 per cent of corn production is used for animal feed and 20 per cent for food. The high cost of corn has made both the pig and chicken industries uncompetitive as corn accounts for about 50 per cent of the feed ration. Rapidly growing demand for pork and chicken over the last five years has led to corn shortages. Over the three years 1995-97, corn imports averaged 300 000 metric tonnes, or about 7 per cent of total consumption (Bureau of Agricultural Statistics, 1998).

In 1995, with its WTO entry, the Philippines committed to replacing its quantitative restrictions on corn imports with bound¹⁰ tariffs of 35 per cent for in-quota volumes and 100 per cent for out-of-quota volumes, declining to 35 per cent in 2004. The initial quota was 130 160 metric tonnes and the 2004 quota will be 216 940 metric tonnes. This commitment was implemented in March 1996 through the Agriculture Tariffication Act which removed quantitative restrictions on all products except rice. While corn imports were liberalised, National Food Authority regulation of milling, trading and licencing remain. At P 6 per kilo, the 1998 National Food Authority support price for corn is well below the current domestic corn price, so purchases of corn are negligible and the price support system is effectively inoperative.

Impact of the Peso's Depreciation

Before the peso's recent depreciation, the landed cif price of corn was US\$140 per metric tonne, or P 3.70 per kilo. Even with the in-quota 35 per cent tariff and port and other charges, its price was about P 5.60 per kilo compared to the domestic wholesale price of P 7.40 per kilo. After depreciation (March 1998), corn's landed cost rose to P 6.40 per kilo, and with in-quota tariffs cost P 9.30 per kilo, about 30 per cent more than the domestic wholesale price. Domestic prices have not increased due to soft demand for animal feed and sharply rising domestic interest rates, which discourage traders from storing local corn. The Department of Agriculture recently approved the duty-free import of 300 000 metric tonnes of corn following intense lobbying by pig and poultry raisers and feed millers.

In the medium term, demand for corn should continue to increase as both the pig and poultry industries grow. Now that domestic corn prices are only 16 per cent above international levels, it would be opportune to introduce a modest tariff only regime for corn and abandon import quotas.

COCONUTS

Coconut production occupied about 2.7 million hectares, or about 27 per cent of agricultural land, but contributed only 6 per cent of the agricultural production in 1997 (Bureau of Agricultural Statistics, 1998). Production has stagnated for over a

¹⁰ Actual tariffs cannot be raised above bound tariffs levels, but can be lower.

decade; 1997 copra production of 2.4 million metric tonnes was 9 per cent below the 1986 crop. About 80 per cent of total production is exported, contributing about 40 per cent of total agriculture exports. Farm productivity is less than 1 metric tonne of copra per hectare; far below the optimal productivity of 2.5 to 3 metric tonnes per hectare, mainly because of the high proportion of senile trees, at least 40 per cent of the total, and a chronic lack of fertiliser use (Dy, 1998). Of all major crops, income per hectare from coconut production is second lowest, higher only than corn (Table 8.2).

The coconut industry has a long history of government intervention. Republic Act 6 260 created the Coconut Investment Fund that levied coconut producers for ten years from 1972. The proceeds were supposed to increase the industry's vertical integration. In 1973, following dramatically increasing world prices, the Coconut Consumers Stabilisation Fund collected another levy. Total collections reached P 9.7 billion. The proceeds were used primarily to purchase coconut oil mills, a commercial bank and shares in San Miguel Corporation, at the time the largest private corporation in the country. The levy's value expanded to more than P 50 billion by 1995. Since 1996, ownership and control over the levy proceeds has been the subject of several court cases.

An export tax was imposed on coconut exports in mid 1973, followed by a premium duty in early 1974. The Government reportedly collected over P 4 billion from this tax. In 1978, to promote vertical integration, President Marcos established United Coconut Oils Mills, which by 1979 acquired over 80 per cent of total national oil milling capacity, creating a coconut milling and exporting monopoly. Copra exports were banned to ensure raw material supply for mills, reducing prices farmers received to below world prices. The Marcos regime's excessive coconut industry taxation and the milling and export monopoly nearly destroyed the industry's international competitiveness. Profitability fell sharply; little new investment occurred to replace old trees; and production stagnated. Short sighted greed and corruption sapped the industry's long term viability. At the same time, world demand and international prices for coconut oil and products was falling.

In early 1985, under World Bank and IMF pressure, President Marcos dismantled United Coconut Oils Mills and abolished the copra export tax. In 1991, 50 per cent import duties were introduced on coconut oil. In 1995, as part of its WTO commitments, the Government bound this tariff at 70 per cent dropping to 50 per cent by 2004. In 1995, Executive Order 264 reduced the tariff to 30 per cent by 1996 and to 20 per cent by 1998. Pressure exists to reduce the coconut oil tariff further, to 5 per cent by 2003, since it is included in the AFTA-CEPT. After the peso's recent 40 per cent depreciation, this tariff protection became redundant.

SUGAR

Sugar production has stagnated over the last six years; the 1996-97 crop of 1.83 million metric tonnes of raw sugar was 10 per cent below the 1990-91 crop. Low productivity is due to poor cane varieties; inefficient handling, transport and milling; and poor infrastructure. Mill capacity use is poor due to insufficient cane supply. About 85 per cent of production is for the domestic market.

The sugar industry was strongly influenced by the Philippine 13.5 per cent quota of the US sugar market, now 250 000 to 300 000 metric tonnes per year (down from

1.7 million tonnes in mid 1970s). Prior to 1974, Philippine free access to the heavily protected US market under the Laurel Langley Agreement resulted in rapidly growing sugar production. Sugar sold under this quota received about double the world price, raising prices growers expected to receive for the rest of the crop.

In the mid 1970s, the Government created the National Sugar Trading Company, Nasutra, a marketing monopoly that severely weakened the industry. In 1984, following IMF and World Bank pressure, President Marcos abolished the National Sugar Trading Company. In 1986, President Aquino established the Sugar Regulatory Administration to perform industry regulatory, research and development functions. Industry profitability fell as a result of these schemes and the comprehensive agrarian reform program further reduced industry investment.

In 1991, an import duty of 70 per cent was imposed on raw sugar, declining to 50 per cent by 1994, with no quantitative restrictions. Under WTO entry conditions, the Government committed to a bound tariff of 100 per cent in 1995, dropping to 50 per cent by 2004. The agreed in-quota import levels were 38 430 metric tonnes in 1995 and 103 400 metric tonnes in 2004. The Tariffication Act of March 1996 established a two tiered tariff rate: 50 per cent for in-quota volumes, and an out-of-quota tariff of 100 per cent in 1995 dropping to 65 per cent in 2000.

Despite these commitments, serious sugar import restrictions persist, including the archaic law RA 809 of 1952 that instituted the sugar sharing scheme. While importing sugar without government permission became legal in 1992, Sugar Regulatory Administration regulations effectively prevented sugar imports for a further two years; significant import controls are still in place in 1998.¹¹ Cane growers have a case pending in an appeals court to allocate minimum access volume licences to them rather than to sugar traders. Consequently, sugar imports are far behind minimum access volume commitments (Table 8.6, Appendix Table 8.2).¹²

Sugar also is an issue under ASEAN arrangements. Under the 1977 ASEAN Preferential Trading Arrangement, the Philippines offered a margin of preference of 35 per cent for ASEAN imports. As a result, the effective tariff on ASEAN refined sugar was only 32.5 per cent before Executive Order 313 took effect in March 1996.

In mid 1997, following lobbying by sugar producers, Executive Order 249 placed sugar under the AFTA-CEPT. This move increased the out-of-quota tariff on ASEAN sugar to 65 per cent versus 80 per cent from non-ASEAN countries. In

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¹¹ The Sugar Regulatory Administration regulations implement a law sharing local sugar production, sugar imports and the US sugar quota among sugar cane growers and millers according to a formula. As import liberalisation threatened this market sharing arrangement, the Sugar Regulatory Administration intervened, exercising its import licencing powers even though the President had effectively authorised the liberalisation of sugar imports. Powerful vested interests in the sugar industry have supported the Sugar Regulatory Administration's stance.

¹² The unusually high level of imported sugar in 1995 reflects traders' price speculations in that year. In 1995, the tariff on sugar was reduced to 50 per cent but was expected to increase to 100 per cent because of the agricultural tariffication law, RA 8 178. Traders imported large volumes of sugar anticipating the price rise, pushing down prices and compelling the Government to order the National Food Authority to buy sugar from producers to prevent prices from falling any further. In the following year, the volume of imports dropped to only 2 000 tonnes, clearly below the country's tariff rate quota commitments (Appendix Table 8.2).

addition, the order sought to renegotiate with the ASEAN the transfer of sugar from the Temporary Exclusion List to the Highly Sensitive List, thereby excluding sugar from 0 to 5 per cent duty by 2003.

Impact of the Peso's Depreciation

Peso depreciation in July 1997 significantly improved the competitiveness of domestic sugar compared to imported sugar. Before depreciation, the wholesale price of domestic sugar was P 12.80 per kilo, compared to a duty-free price of imported sugar of P 7.11 per kilo. The tariff inclusive price of imported raw sugar was P 11.27 per kilo for in-quota sugar, bearing a 50 per cent tariff; P 12.33 per kilo for out-of-quota ASEAN sugar with a 65 per cent tariff; and P 13.40 for out-of-quota sugar from the rest of the world with a 100 per cent tariff.

After depreciation, in March 1998, the domestic wholesale price hardly changed at P 13.00 per kilo but the duty free price of imported sugar rose to P 10.40 per kilo and is now P 15.70 per kilo for in-quota sugar, P 17.20 per kilo for out-of-quota ASEAN sugar, and P 18.70 per kilo for out-of-quota sugar from the rest of the world. Sugar tariffs therefore could be reduced significantly, to 25 per cent, and quotas abolished before imported sugar would undercut domestically grown sugar.

In 1998, growth in sugar demand is likely to be soft. According to the Philippine Sugar Millers Association, production for crop year 1997-98 (ending in September) will reach 1.85 million tonnes, similar to the previous year's production level. Imports of about 150 000 metric tonnes are likely during the third quarter of 1998. El Niño will heavily affect production in crop year 1998-99 and large imports are again likely. Sugar demand is projected to grow between 3 and 5 per cent per year in the medium term.

In March 1998, the Department of Agriculture launched the Gintong Ani sugar plus program to increase industry productivity and competitiveness. Given the smaller gap between international and domestic sugar prices, rationalising sugar protection and abolishing controls on imports would contribute significantly to increasing the industry's production and milling efficiency.

BANANAS

Bananas are a dualistic crop. Some 300 000 hectares of small plots primarily produce native varieties. Another 30 000 hectares are devoted to plantations, producing the Cavendish banana variety, mostly for export. Many of these plantations use world class technology and market under global brands. Of total production, 30 per cent is eaten fresh, 33 per cent is exported, and 37 per cent is processed for local dishes, chips and industrial products including tomato sauce and animal feed. About 60 per cent of exports go to Japan, 16 per cent to China, and another 20 per cent to the Middle East.

The Philippine banana export industry began in the late 1960s and by the 1970s had the largest market share in Japan. In 1973, President Marcos issued a Letter of Instruction limiting the hectareage of export bananas to only 21 000 hectares to

protect existing investors and, allegedly, to stabilise supply in the Japanese market. This was followed by another Letter of Instruction in 1979 increasing the banana production area to 25 000 hectares. The advent of the agrarian reform program in 1988 discouraged investments in new plantings and plantation rehabilitation.

Existing companies and new players have effectively made the Letters of Instruction inoperative. Now plantations belong to agrarian reform program beneficiaries. The peso's depreciation provides a breather for the industry, compensating for rising labour costs, and the industry has bright prospects with the growing China market and improving situation in Iraq.

While about 30 local companies market bananas grown for the international market, most do not directly export. Their produce is marketed under global brands such as Dole, Del Monte, Chiquita and Sumitomo.

LIVESTOCK

Pigs

Pigs account for about 80 per cent of the total livestock subsector; in 1997, the farmgate value of production was P 66.2 billion. From 1992 to 1997, production increased by 5 per cent per year. Of the estimated 9 million pigs, 20 per cent are on commercial farms and 80 per cent are in backyard operations. Many pig farms are in regions surrounding Metro Manila. The average per capita consumption of pork was only 12 kilos in 1997, just over one third of Chinese per capita consumption.

The pig industry in the Philippines primarily developed through private sector initiative; except for trade barriers, the Government offers little support or intervention. For many years, pork was subject to quantitative restrictions. In 1995-96, the Government committed to bound tariffs of 100 per cent, falling to 60 per cent in 2000, and established in-quota tariffs of 30 per cent for quotas of 32 530 metric tonnes in 1995 rising to 54 210 metric tonnes by 2000. Pig raisers complained the initial quota should have been based on 1 per cent of average consumption during 1986-88, and was much higher than agreed.

Meanwhile in 1997, several WTO members, especially the USA, questioned the criteria for accessing the quota, claiming it favoured domestic pig producers. In early 1998, the Department of Agriculture revised the criteria.

Prior to depreciation, the high cost of domestic corn due to tariffs and quotas on imported corn was the pig industry's most contentious issue. Pig raisers maintained this made them uncompetitive as corn accounts for up to 80 per cent of feed costs. While this concern is valid, many pig raisers are highly inefficient in litter productivity and feed conversion rates (Dy, 1998).

Impact of the Peso's Depreciation

Before the peso's depreciation, the duty-free cif price of imported pork carcasses was P 43.50 per kilo, and P 60.87 per kilo at the in-quota duty of 30 per cent and P 91.31 per kilo at the out-of-quota duty of 100 per cent. The wholesale price of domestic pork was P 74.00 per kilo.

Since depreciation, the competitiveness equation has changed. The duty-free price of pork is P 66 per kilo, while the in-quota imports are P 92.40 per kilo and out-of-quota imports are P 125.40 per kilo. The domestic price is now P 77 per kilo, so a tariff of 17 per cent would equalise import and domestic prices. Domestic corn prices are now closer to international levels, so pig producers are more likely to attain full international competitiveness.

In 1998, soft demand and high costs make industry prospects flat. Recovery is expected to begin in 1999. Medium term prospects are bright as domestic per capita pork consumption is well below other Asian countries.

Cattle and Beef

The Philippines has only 2 million cattle, mostly in backyard operations. By the second half of the 1980s, the local cattle population had dwindled significantly, a result of law and order problems in the countryside during the last years of the Marcos regime; Department of Agriculture cattle experts projected the cattle population would be wiped out in the early 1990s (Clarete, 1998). Stagnant herd growth resulted in live cattle imports from Australia, enabling beef production to grow at an average 9 per cent per year over the last five years. Imports of fattening cattle expanded due to the tariff rate differential; imported cattle weighing less than 330 kilograms were subject to a 3 per cent tariff while heavier cattle imports carried a 30 per cent tariff.¹³ However, this policy was liberalised in February 1998 when the 3 per cent tariff was applied to all live cattle imports to reduce the inflationary effects of the peso's depreciation on food prices. In 1996, 184 166 cattle were imported, mainly for fattening.

Beef imports were liberalised in 1992, allowing meat processors to import manufacturing grade materials for their businesses. Rapidly growing meat demand for processing and fast food chains have dramatically increased Australian frozen beef and buffalo meat imports from India over the last six years, up 430 per cent from 10 685 to 56 600 metric tonnes.

On WTO entry in 1996, the Government committed to bound tariffs on frozen beef of 30 per cent for in-quota volumes and 60 per cent for out-of-quota tariffs, declining to 45 per cent in 2000 for all grades, with minimum access volumes of 4 000 metric tonnes in 1995 and 5 570 metric tonnes in 2004. However, domestic meat processors lobbied for increases so the Government raised this quota to over 21 000 metric tonnes in 1996 and 71 000 metric tonnes in 1998.

In February 1998, to reduce the inflationary impact of depreciation on food prices, the Government eliminated all frozen beef import quotas and set tariffs for all beef grades at 30 per cent in 1998, dropping to 10 per cent in 2000.

Impact of the Peso's Depreciation

The beef industry is not a globally competitive industry. Before the peso's depreciation in July 1997, the landed cost of manufacturing grade, frozen boneless beef from Australia was P 42.20 cif per kilo including port handling costs,

¹³ Executive Order 313 of March 1996, established an in-quota duty of 30 per cent and an out-of-quota duty of 40 per cent declining to 35 per cent in 2000 for feeders in excess of 300 kilos.

P 59 per kilo for in-quota beef subject to a 30 per cent tariff and P 88.50 per kilo for out-of-quota at a 50 per cent tariff. Buffalo meat from India cost P 54.60 per kilo at the in-quota rate and P 81.90 per kilo at the out-of-quota rate. The domestic wholesale price was P 85 per kilo.

After depreciation, the gap between imported and domestic beef prices narrowed significantly. March 1998, cif Australian beef imports were P 67.00 per kilo and Australian beef in-quota was P 89.60 per kilo and out-of-quota was P 102.40 per kilo. Indian buffalo meat in-quota was P 82.88 per kilo and out-of-quota was P 94.72 per kilo. Meanwhile, the domestic price has increased to P 87.50 per kilo. Removing quota restrictions in February 1998 and applying a 30 per cent tariff to all imported beef therefore was an appropriate government response. However, Australian beef imports will still cost 50 per cent more than in-quota imports prior to depreciation, so the demand for this beef will drop in the short to medium term unless supply prices drop. Industry experts indicate Australian live cattle prices have dropped significantly due to oversupply resulting from sharp falls in Indonesian imports. Longer term prospects favour beef demand as average Philippine consumption was only 3.2 kilos per capita in 1997. The rapidly growing fast food industry also will stimulate increased demand.

Poultry

Chicken accounted for about 9 per cent of agricultural output, or P 46 billion in 1997. In 1997, contract growers kept almost 90 per cent of the total chicken flock estimated at 142 million, on commercial farms. During the last five years, production grew at an average of 7 per cent per year; rapid expansion of the industry in 1996 and 1997 resulted in oversupply which depressed prices.

On WTO entry, the Government committed to a bound tariff of 100 per cent in 1995 falling to 40 per cent in 2004. In March 1996, in-quota tariffs were set at 50 per cent in 1995 and 45 per cent in 2000. The quota volumes for poultry meat were 14 090 metric tonnes in 1995 and 23 490 metric tonnes in 2004. Like the pig industry, the chicken industry vehemently protested about the initial quota calculation which was above 1 per cent of average consumption in 1986-88.

Impact of the Peso's Depreciation

Before the peso's depreciation, the landed cost of frozen chicken cif was P 36.10 per kilo; at the in-quota duty was P 57.80 per kilo and at the out-of-quota duty was P 75.80 per kilo. Domestic chicken cost P 59.90 per kilo. Depreciation dramatically changed the situation. Since depreciation the corresponding prices for imported chicken are: P 54.80 per kilo cif, P 84.90 per kilo and P 104.12 per kilo. As the domestic chicken price is now P 64 per kilo, the domestic industry could compete at a 17 per cent tariff and no quota.

In 1998, domestic chicken industry prospects are bleak. The industry is downsizing and commercial production could fall by 5 to 10 per cent. The medium term prospects are brighter as average per capita consumption is only 5 to 6 kilos, far lower than the 30 to 40 kilos in Malaysia, Singapore and Taiwan. Industry analysts believe demand easily could grow by 6 to 8 per cent per year.

OTHER CROPS

Peso depreciation will benefit several fruit and vegetable crops, including pineapples, mangoes, asparagus and onions and import substitutes like mungbeans and peanuts.

Pineapples, a stable traditional export, are primarily produced in Mindanao where there are about 40 000 hectares of pineapple plantations, the largest controlled by Del Monte and Dole. In 1996, the Philippines exported about US\$160 million fresh and preserved pineapples and pineapple concentrates and juices.

Fresh mango exports of 40 000 metric tonnes earned about US\$40 million in 1996. Japan and Hong Kong are the major markets. The Philippines supplied about 30 per cent of total fresh asparagus imports into Japan in 1996, 5 600 metric tonnes worth US\$13.6 million. Fresh onions are primarily exported to Japan (6 500 metric tonnes) during the peak season. Meanwhile, increased import costs will encourage more domestic production of mungbeans and peanuts. In 1996, about 28 000 metric tonnes (US\$13.5 million) of mungbeans and almost 60 000 metric tonnes (US\$42 million) of peanuts were imported.

AGRIBUSINESS OPPORTUNITIES AND PROSPECTS AFTER DEPRECIATION

The 1997-98 peso depreciation, the sharpest since 1984, has dramatically affected the competitiveness of many products by changing input and output prices. The impact on exports is highly beneficial. Many exporters had advocated currency depreciation since the peso began appreciating in 1992 following inflows of portfolio capital and foreign investment. The peso's fall to P 37:US\$1 (April 1998) from P 26.40:US\$1 (average for January-June 1997) caused a:

- 40 per cent revenue gain for agricultural exporters
- 40 per cent additional 'protection' to producers of agricultural import substitutes
- 40 per cent increase in the landed cost of imported raw materials, inputs and finished goods.

The value of Philippine food and agricultural exports reached almost US\$2 billion in 1997. Among the major exports were coconut products, fruits (fresh bananas, pineapple products and mangoes), and marine and aquaculture products (tuna, shrimps, seaweed and carrageen). While depreciation will significantly raise export revenues, competitor countries, particularly Thailand, have devalued even more than the Philippines. Thailand is a global player in pineapples, tuna, shrimps and processed food. Moreover, already overseas buyers are demanding discounts on quoted US dollar prices for agricultural products.

As discussed previously, import substitutes such as corn, sugar, pork and chicken which together represented almost 30 per cent of agricultural production value in 1997, benefit substantially from the peso's depreciation.

Meanwhile, the 40 per cent rise in import costs are likely to dampen import demand for both raw materials and finished goods in 1998. Among the major imports are wheat, soybean meal, live cattle, frozen meat, dairy products and fruit.

Decelerated domestic demand for imports and import substitutes should not be attributed solely to the devalued peso. The strategy of the Bangko Sentral ng Pilipinas, the central bank, to contain speculative pressure on the peso has produced abnormally high interest rates. (See Chapter 2 - *Macroeconomic Environment*.) Before depreciation, bank prime rates were at 12 to 15 per cent; since depreciation, these surged to 22 to 30 per cent in December 1997 declining to 20 to 22 per cent by mid March 1998. Almost nine months of high interest rates and weak demand have taken a huge toll on corporate profits, investment, employment growth and wage incomes. Unrelated negative factors include El Niño effects and chicken broiler industry downsizing. All these factors will contribute to reduced consumer incomes in 1998 and sharply declining agriculture output, except in export oriented activities.

The magnitude of economic recovery in other Asian economies and the rate of Philippine economic recovery will influence business prospects in the next five years. Asian countries absorb 40 per cent of Philippine agriculture exports (Table 8.8). Domestically, demand for imported products and import substitutes hinges on recovery in consumer incomes and demand.

Export Prospects

Exports will benefit from the peso's depreciation, provided the Philippines can remain competitive relative to competitor countries. The following products have good export prospects.

Bananas

While Japanese consumption remains static at 6 to 7 kilos per capita, the Chinese market only consumes 0.3 kilo of imported bananas per capita. The Philippines supplies the bulk of this market. Assuming Chinese consumption rises to 1 kilo per capita consumption, this could double the current Philippine plantings of 26 000 hectares.

Tuna

Export prospects will remain attractive given the Philippines' locational advantage over Thailand. Major fishing grounds are in the western Pacific, so Philippine tuna canneries in Mindanao are strategically located. According to industry sources, the Philippines should continue to gain market share in the USA.

Other Fruits

Mango exports have become more competitive in Japan, the largest market, where Mexico is the major competitor. Similar prospects also apply to solo papaya where Hawaii continues to be the dominant player.

Onions

The Philippines has a 'window of opportunity' in the Japanese and US markets where exports could increase, provided cost competitiveness and quality are maintained and improved.

Asparagus

The Philippines supplies about 30 per cent of Japan's fresh asparagus market. However, El Niño has heavily affected growers in Mindanao.

Dried Fruits

Dried fruits such as banana chips and dried mango offer good prospects but are constrained by the high cost of domestic sugar.

Rubber

Rubber prospects have improved following the launching of the Department of Agriculture's rubber development program. As 40 per cent of output is exported, producers are earning higher profits. However, about 40 per cent of the country's rubber trees are senile and require replanting.

Imported Agricultural Commodities

The sharp rise in import costs and the slow down in consumer incomes will reduce import demand or sharply curtail growth in 1998. The following imports are mainly affected.

Fresh and Frozen Foods

Live cattle, frozen beef, milk and fruit such as grapes and oranges will be adversely affected. From peak growth rates of 15 to 25 per cent over the last five years, meat processing growth is likely to slow over the next two years.

However, as part of the February 1998 reform package, the flat 20 per cent tariff on oranges, mandarins, grapefruit, apples and stone fruit will fall to 15 per cent in 1999 and 10 per cent in 2000 and tariffs and quotas on live cattle and frozen beef were reduced.

Raw Materials

Depreciation also will adversely affect imports of soybean meal and fishmeal (partly due to downsizing in the poultry and pig industries), malt (for beer), wheat (for flour) and dairy products. According to the Philippine Association of Flour Millers, wheat imports could drop to 1.7 million metric tonnes in 1998 from 1.9 million metric tonnes in 1997.

In the February 1998 reform package, 30 per cent tariffs on roasted cereal preparations (set to fall to 20 per cent in 2000) fell to 20 per cent in 1998 and 15 per cent in 2000.

Demand for goods such as frozen potato (for fast foods), confectionary and chocolates will slow. Sales of fast food industry inputs have grown by 20 to 25 per cent per year over the last ten years but 1998 and 1999 are expected to be difficult years.

Import Substitutes

The outlook for import substitutes will be mixed. Suddenly rising import costs will dramatically reduce the entry of finished agri-based products and should improve the market share of domestic goods and brands, including:

- processed meats for frankfurts and corned beef
- snack foods such as potato chips, corn chips and nuts
- confectionery and chocolate
- natural and artificial flavoured juices
- fruit jams and preserves.

OTHER CONSTRAINTS TO AGRICULTURAL PRODUCTIVITY AND GROWTH

Production has stagnated in many traditionally protected agricultural crops, like corn, rice, coconuts and sugar where demand has outstripped supply; imports have increased and exports have languished. Growing sectors including beef, chicken and pork production benefit from the market opening to imported corn and live cattle, as do fruit, vegetables and fish, industries in which the Philippines has strong export competitiveness.

As discussed, the poor performance of traditional crops is a legacy of corrupt and short sighted intervention, monopoly policies and excessive taxation during the Marcos regime resulting in decades of low investment. Vestiges of some of these schemes persist today, supported by strong vested interests, in industries like sugar. Continuing trade intervention in rice, sugar and corn hinder agricultural land and labour reallocation and prop up inefficient production, processing and distribution practices at the expense of more profitable activities. The protracted and rather ill conceived land reform program has generated uncertainty and inefficiency, and reduced agricultural investment in the past decade.

Other policy failures compound these problems. Inadequate and poorly allocated private and public investment often focuses on crop specific infrastructure for low return traditional crops, rather than broader rural infrastructure. Weak agricultural research, poor training and extension programs and inadequate access to rural credit for small farmers cause further problems.

As virtually all arable land is already under cultivation, increased agricultural sector growth must come from expanding areas under irrigated agriculture, improving water use, yielding bigger crops from increased fertiliser use and better seeds, improving efficiency of cropping patterns and increasing productivity of livestock and coastal fishery activities. To improve agricultural productivity and alleviate rural poverty, key investment programs and support services are needed to provide irrigation, rural infrastructure, agricultural credit, improved seeds, fertilisers and post harvest, technology and to strengthen agricultural extension services.

Rural Infrastructure

While rural infrastructure deficiencies vary by geographic area and sector, agricultural areas lack sufficient roads, water supply/sanitation facilities and small scale irrigation schemes. One major constraint in providing infrastructure relates to insufficient funds to finance rural capital investment. The 'lumpiness' of capital expenditure for roads, small scale irrigation and water supply/sanitation make such investments difficult, unless rural communities have access to capital markets or government or donor grants. Recent initiatives to develop municipal bond markets may help overcome such constraints. (See Chapter 6 - *Infrastructure*.)

Land scarcity and high population growth make irrigation development essential to enhance agricultural performance. Steeply declining expenditure in public irrigation in the 1980s and early 1990s transformed the Philippines from a rice exporter in the late 1970s and early 1980s to a rice importer. However, irrigating rice crops may not achieve high rates of return if the Philippines has little comparative advantage in rice growing; irrigating fruit and vegetable crops should produce higher returns. Funding cuts, institutional weakness of public units installing irrigation systems and failure to make funding sustainable by charging farmers economic water tariffs constrain irrigation expansion.

The inadequate road transport system is the major infrastructure constraint facing the Philippines. (See Chapter 6 - *Infrastructure*.) Lack of adequately maintained rural roads connecting farms to markets prevent farmers moving from low return subsistence crops to higher value cash crops and activities like livestock rearing and fish farming. The dispersed nature of the Philippine archipelago means the logistics of providing rural infrastructure are institutionally complex, involving costly administration and supervision. Even when funding is adequate, funds frequently are redirected from their original purpose or inefficiently employed. Decentralised government exacerbates the problem of overseeing public infrastructure expenditure and effectively implementing projects.

Inadequate maintenance persists, pervading national, provincial and rural infrastructure. While many government programs and donor initiatives provided infrastructure over the last decade, with poorly managed and funded maintenance programs, much of it has deteriorated, often to the point of disuse. Bilateral development assistance programs provide technical assistance for maintenance management programs, but results are mixed depending on the commitment of local governments. (See Chapter 9 - *Implications*.)

THE AUSTRALIAN CENTRE FOR INTERNATIONAL AGRICULTURAL RESEARCH PHILIPPINE PROGRAM

The Australian Centre for International Agricultural Research, ACIAR¹⁴ was established in 1982 to assist and encourage Australia's agricultural scientists to use their skills for the benefit of developing countries and Australia. The program aims to reduce poverty, improve food security and promote sustainable natural resource development through international agricultural research partnerships between scientists in developing countries and Australia. The centre brokers these research partnerships using \$40 million per year provided under the Australian government aid program.

The Australian Centre for International Agricultural Research has been active in the Philippines since 1982, completing approximately 60 projects worth A\$18 million. Over half this money was used for projects on post harvest technologies and farming system economics. The current Philippine program comprises 17 projects, 70 per cent involving land and water resource management, crop science and forestry. Expenditure in 1997-98 will be A\$1 million.

The Philippine partnership, coordinated with the Philippines Council for Agriculture, Forestry and Natural Resources Research and Development, involves researchers associated with several major universities and government authorities, including the Departments of Agriculture and Science and Technology. Australian partners include universities, the CSIRO and state research agencies.

March 1998 consultations between the Australian Centre for International Agricultural Research and its Philippine counterpart agreed future collaborative research priorities should include water and soil conservation and management; coastal management and fisheries research policy; post harvest technologies; pest management and residues; crop biotechnology applications; animal profitability in small holder mixed farming systems and alternative tree species for wood and composite products. The program offers postgraduate fellowships at Australian universities for promising young Philippine scientists working on sponsored projects.

Agricultural Research and Extension

A strong research-extension system is important to increase agricultural productivity and support crop diversification. The Philippine agricultural research system and extension services face numerous constraints reducing their effectiveness, including a lack of technical and support staff, poor mobility and lack of operating funds, and inadequate field and laboratory equipment and facilities for conducting research. While facilities and equipment need upgrading, creating a better managed research environment with qualified research staff is more important. Design deficiencies, inappropriate technologies, inadequate implementation capacity and lack of

¹⁴ ACIAR is a statutory authority within the Foreign Affairs and Trade portfolio.

effective participation of local communities have reduced the impact of many projects and programs and increased their costs. Local community participation helps to ensure research priorities are relevant to farmers' needs.

In particular, devolving the single national agricultural extension services to 75 provincial, and over 1 350 city and municipal agricultural extension services has fragmented and duplicated services, diminishing overall extension effectiveness. Excessive staffing levels and budgetary constraints have inhibited the provision of cost effective and modern extension services.

Agricultural Credit

A serious shortage of agricultural credit significantly constrains broad based agricultural growth. The formal rural finance system consists of four types of institutions:

- a small number of commercial banks with rural branches
- thrift banks
- family owned local rural banks
- specialised government banks.

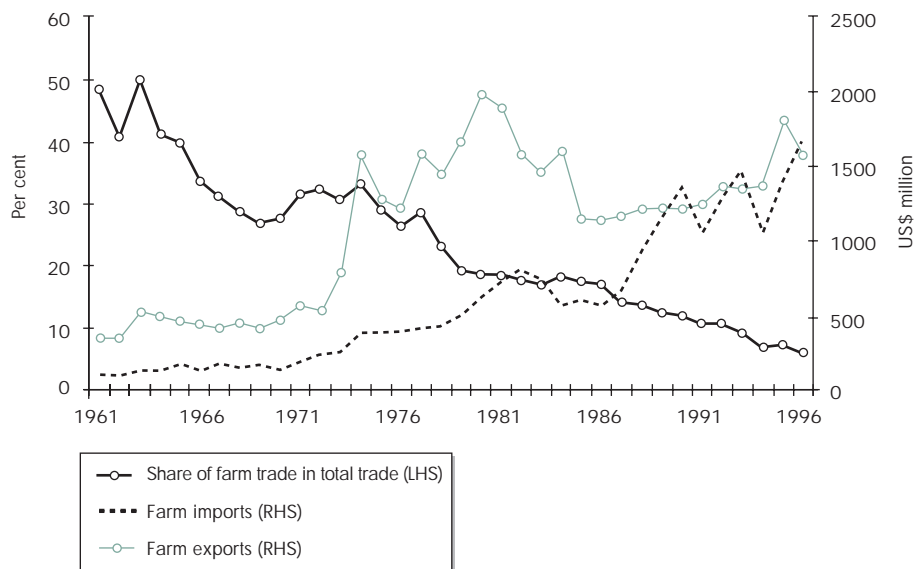
The semi-formal financial market segment includes credit cooperatives, non-governmental organisations and grass roots 'people's organisations'; moneylenders, who charge very high interest rates, form the informal market. Only 10 to 15 per cent of the farming population have access to formal credit. The informal sector services the rest (World Bank, 1997).

Over the past decade, formal agricultural credit's share of total banking sector loans declined significantly (Table 2.12). Although agriculture produced 21 per cent of total value added in 1996 (Table 1.2), formal loans to agriculture dropped from about 15 per cent of bank lending in 1991 to only 4 per cent between 1990 and 1994. This fall occurred despite the (inefficient) legal requirement that banks provide 25 per cent of their loans to agriculture and agri-processing. (See Chapter 2 - *Macroeconomic Environment*.)

Agricultural credit providers face problems in identifying low risk borrowers and activities, and devising suitable credit delivery mechanisms. Much agricultural activity produces little profit, limiting borrowers' ability to undertake viable projects. Poor bank organisation, complicated bank procedures, high transaction costs and lack of collateral also discourage small farmers from applying for loans. Often borrowers need such small loans that this limits their access to bank credit. High borrower transaction costs due to transport, time or income lost in completing the loan application, and fees like stamp duty and other government charges, also reduce potential demand for loans. Collateral is a problem for many borrowers who generally do not have land titles or other property. This problem is exacerbated by banks' unwillingness to accept land subject to the agrarian reform program as collateral due to uncertainties associated with its value and eventual ownership.

Figure 8.1

Agricultural Trade Surplus Disappearing Agricultural Imports and Exports, 1961-96



Source: Food and Agriculture Office, 1995, for data 1961-93; Bureau of Agricultural Statistics, 1998, for data 1994-96.

TRENDS IN AGRICULTURAL TRADE

Primary agriculture's share in total merchandise trade has declined steadily since the 1960s (Figure 8.1) from close to 50 per cent in 1961 to 7.5 per cent in 1997. While such a trend is a natural outcome of industrialisation, until relatively recently the Philippines experienced little structural change (Table 1.2), so this trend mainly reflects agricultural stagnation and the bias against agricultural exports. The Philippines is the world's largest exporter of coconut products, but their world price has been in long term decline.

From 1961 to 1997, total merchandise trade grew twice as rapidly as agricultural trade (10.3 per cent versus 5 per cent). Throughout this period, agricultural imports grew twice as rapidly as agricultural export values (8 per cent versus 4 per cent). While traditionally agricultural trade has been in surplus, this has declined and in 1996 went into deficit when rice was imported due to drought (Figure 8.1, Table 8.6). Since the mid 1980s, farm imports have increased sharply due to low agricultural investment and productivity growth, peso appreciation (before 1997), import liberalisation and strong demand growth due to rapid population and income growth.

Composition and Performance of Agriculture Trade

Before the 1997-98 depreciation, an overvalued peso and high tariffs on manufactured imports combined to bias the trade system against agricultural production and exports. (See Chapter 3 - Trade.) Reducing tariffs and dismantling

the coconut and sugar export marketing monopolies reduced this bias,¹⁵ as did the recent peso depreciation. All export taxes except on logs were lifted on 1 July 1986.

While agricultural exports grew only 2 per cent in 1997, this was better than the 11 per cent fall in 1996 (Table 8.6). Coconut products (coconut oil, copra meal and desiccated coconut) formed the largest agricultural export category at 44 per cent of all agricultural exports in 1997, followed by fruit and vegetables, particularly bananas, pineapples and pineapple products, and mangoes at 24 per cent, and fish and marine products (shrimps, tuna, seaweed and carrageen) at 15 per cent (Table 8.6).

Table 8.6
Traditional Exports Stagnate; Most New Products Struggle
Before Depreciation
Agricultural Exports: 1991-97
(FOB value, US\$ million)

Whole year	1991	1992	1993	1994	1995	1996	1997
Total exports	8 840	9 693	11 376	13 483	17 447	20 543	25 228
Agri-based products	1 480	1 531	1 576	1 675	2 096	1 862	1 899
Coconut products	447	635	532	639	989	730	836
Coconut oil	299	475	358	475	826	571	573
Sugar and products	136	110	129	77	74	140	99
Fruit and vegetables	393	368	439	429	458	486	459
Canned pineapple	95	95	94	90	81	93	86
Pineapple juice	9	7	8	9	10	11	9
Pineapple concentrate	27	24	22	22	24	27	28
Bananas	173	158	226	215	224	237	217
Mangoes	24	28	27	30	43	40	40
Others	65	56	62	63	76	78	79
Other agri-based products	504	418	476	530	575	506	505
Fish and prawns	33	281	343	379	378	296	291
Raw not roasted coffee	5	1	1	8	7	1	1
Abaca fibres	17	20	19	20	23	21	22
Unprocessed tobacco	43	33	26	23	21	29	29
Natural rubber	13	9	12	14	28	33	25
Raw or roasted ramic fibres	3	1	1	1	0	0	0
Dried seaweed	21	18	18	22	39	42	33
Rice	2	6	0	0	0	0	0
Others	47	49	56	63	79	84	104

Source: National Statistics Office, 1998; Bangko Sentral ng Pilipinas, 1998.

¹⁵ Empirical evidence supports the fact that trade policy reforms have reduced the bias against agriculture. Using a CGE model of the Philippine economy, Clarete (1998) computed the general equilibrium impact of trade reform, finding more crops, livestock, and fishery products were produced in the economy as a result of tariff reforms. Crops benefited most; forestry and mining also gained, with forestry output increasing by 0.17 and mining by 1.20 per cent.

On the other hand, almost all agricultural import categories expanded rapidly in the 1990s (Table 8.7, Appendix Table 8.3). Grain (mainly rice, wheat and corn), the biggest import category grew extremely rapidly, 270 per cent from 1991 to 1996. This was followed by dairy products and eggs (up 85 per cent). Two of the fastest growing categories are live animals (up 540 per cent), and meat (up 475 per cent). Live cattle imported mainly from Australia are fattened for consumption in the Philippines. Like meat products, cattle imports have expanded mainly as a result of trade policy reforms. However, for most of these imports, growth will be slower or will decline in 1998 as a result of peso depreciation and slower domestic growth.

Sources and Destination of Agricultural Trade

The USA, Japan and the European Union import most Philippine agricultural products. The USA received over 30 per cent of Philippine agricultural exports in 1996, Japan about 20 per cent (down from 27 per cent in 1991) and the EU 17 per cent (Table 8.8). The high proportion of agricultural exports sold outside the region should protect Philippine agricultural exporters from the worst of the drop in demand expected as a result of the Asian currency crisis.

Table 8.7

Agricultural Imports Grew Strongly Before Depreciation Agricultural Imports 1991-97 (Cif value, US\$ million)

Philippine imports by Commodity group	1991	1992	1993	1994	1995	1996	1997
Total imports	12 051	14 443	17 597	21 333	26 391	31 885	35 936
Feed grains for animals	153	186	234	195	263	197	311
Animal and vegetable oils and fats	22	34	24	38	38	57	58
Food and live animals chiefly for food	460	562	637	815	1 204	1 578	1 436
Dairy products	211	253	260	316	409	389	405
Fish and fish preparations	62	61	49	53	59	69	70
Rice	0	0	36	0	76	69	70
Fruit and vegetables	37	54	66	99	97	123	137
Others	150	194	226	347	563	703	612

Source: National Statistics Office, 1998; Bangko Sentral ng Pilipinas, 1998.

Table 8.8

Australia an Increasingly Important Source of Agricultural Imports
Philippine Agriculture Trade, by Place of Origin and Destination,
1991 and 1996
(US\$ million)

Economy/ region	Imports				Exports			
	1991	1996	1991	1996	1991	1996	1991	1996
	FOB value	Per cent share	FOB value	Per cent share	FOB value	Per cent share	FOB value	Per cent share
ASEAN	91	9.2	514	19.6	84	4.8	251	11.3
Australia	129	13.0	377	14.3	21	1.2	21	1.0
Canada	21	2.1	50	1.8	32	1.9	40	1.8
China	55	5.6	74	2.8	66	3.9	52	2.4
Taiwan	17	1.7	32	1.2	17	1.0	29	1.3
European Union	153	15.6	225	8.6	311	17.8	389	17.6
Hong Kong	10	1.0	25	0.9	57	3.3	88	4.0
Japan	53	5.3	29	1.1	482	27.6	456	20.6
Latin America	11	1.1	150	5.7	8	0.5	12	0.5
Middle East	17	1.7	80	3.1	38	2.1	54	2.5
New Zealand	32	3.3	94	3.6	3	0.2	7	0.3
Others	67	6.8	110	4.3	33	1.9	37	1.7
South Asia	44	4.4	164	6.3	8	0.4	4	0.1
Republic of Korea	12	1.2	27	1.0	68	3.9	75	3.4
USA	274	27.8	673	25.7	518	29.7	701	31.6
Total	984	100.0	2 621	100.0	1 746	100.0	2 215	100.0

Source: National Statistics Office, 1998.

The ASEAN market more than doubled its share of Philippine agricultural exports between 1991 and 1996, up from less than 5 per cent to 11 per cent. These numbers partially reflect the impact of the ASEAN Free Trade Agreement; however, the existing preferential tariff agreement and more importantly robust income growth in the ASEAN region are the most likely explanations.¹⁶ If, as expected, income growth slows in ASEAN economies over the next two to three years, their share in Philippine agricultural exports will probably contract, and US, Japanese and EU markets will be sought to make good the shortfall.

¹⁶ In 1991, ASEAN heads of state agreed to set intra-ASEAN tariffs at no more than 5 per cent by 2003 for most products and 2010 for sensitive products, which are mostly agricultural. As the mechanism for implementing this agreement, the Common Effective Preferential Tariff, CEPT, was only introduced in 1996, the AFTA-CEPT has probably not yet had an impact.

The USA is the major supplier of agricultural imports, providing 25 per cent of the total. The EU, second in size in 1991, was displaced by the ASEAN economies by 1996; their market share doubled in the five years to 1996 (Table 8.8). Australia is now the third largest supplier of agricultural imports to the Philippines, ahead of the EU. Latin America, South Asia and the Middle East also increased their share of the Philippine market, while the shares of Japan, China and Canada declined in the first half of the 1990s. In part, economic growth and the trade policy reforms during the Ramos administration explain these shifting market shares, as imports are increasingly sourced from the most efficient suppliers.¹⁷ Over 60 per cent of agricultural imports are processed food items, where Australia is the second biggest supplier after ASEAN. The USA dominates the primary food import market (Table 8.9).

PROSPECTS FOR AGRICULTURE

Apart from reducing the impact of peso depreciation on food prices, the February 1998 agricultural tariff and quota reforms will help allay concerns that high tariff rates resulting from tariffication of quantitative restrictions in 1996 would fail to prepare agricultural producers for future competition. High tariffs were supposed to ease adjustment costs to open markets and give protection while necessary infrastructure was installed. However, by artificially supporting producers' incomes, these tariffs may actually mask the urgency of agricultural modernisation by reducing farmers' incentives to minimise production costs, and allow government to slow necessary infrastructure and extension service investments.

Given international trade commitments under the WTO and AFTA, in six years the agricultural sector, including politically sensitive products, will face serious competition. In 2003, CEPT tariff rates will be 5 per cent for most agricultural products and 20 per cent for 25 sensitive farm products. In contrast, the MFN tariff rate applied to imports from non-AFTA countries will be 40 per cent. Therefore agricultural tariff protection must be steadily reduced to minimise adjustment problems when the AFTA-CEPT scheme is fully implemented. If agriculture is to compete at that time, rather than merely lobbying for renewed trade barriers, the new administration will need to start now in addressing the sector's long term problems of underinvestment, stalled land reform, small plot sizes, poor infrastructure and marketing and distribution channels, weak extension and research services and lack of access to credit.

The 1997-98 peso depreciation will give a short term breathing space for these reforms, but is not a substitute for action. The peso's real value will gradually appreciate as more dynamic sectors like manufacturing take off in the next decade. Without wide ranging action to address agriculture's problems, the sector will continue its long term cyclical decline, with serious implications for the economy and rural poverty alleviation.

¹⁷ In 1992, under Executive Order 1 992, the Ramos administration relaxed agricultural import rules, one of the first policy pronouncements of the new government.

Table 8.9
Australia and ASEANs Supply Processed Foods
Sources of Agricultural Imports, by Commodity Groups, 1991 and 1996
 (Per cent)

Source	Live animals and primary food products		Crude animal vegetable materials		Processed food items		Beverages		Inedible crude materials		Animal/vegetable oils, fats, waxes	
	1991	1996	1991	1996	1991	1996	1991	1996	1991	1996	1991	1996
Agricultural imports (per cent of total agricultural imports)												
Source:												
APEC without ASEAN	26.0	24.3	0.2	0.1	35.0	22.4	0.2	0.5	2.7	2.7	0.7	0.5
ASEAN	0.6	2.5	0.01	0.01	3.9	17.0	2.4	0.19	0.3	0.5	1.4	1.7
European Union	0.3	0.1	0.03	0.01	13.5	7.9	2.4	0.9	0.4	0.1	0.3	0.1
Rest of the world	1.4	3.9	0.0	0.01	7.5	14.1	0.01	0.02	0.7	0.5	0.08	0.02
Selected countries												
USA	18.4	17.0	0.12	0.07	9.3	8.0	0.11	0.2	1.3	1.7	0.4	0.3
Australia	1.8	3.9	0.01	0.01	12.7	11.4	0.02	0.08	0.2	0.08	0.07	0.1
Japan	28.3	0.3	0.12	0.07	0.8	0.2	0.01	0.01	0.03	0.02	0.06	0.01
Total	30.8	30.8	0.3	0.2	60.0	61.4	4.9	1.5	4.1	3.8	2.5	2.3

Source: Bureau of Agricultural Statistics, 1997.

Table 8.10
USA and Japan Major Export Markets
Destination of Agricultural Exports, by Commodity Groups, 1991 and 1996

Source	Live animals and primary food products		Crude animal vegetable materials		Processed food items		Beverages		Inedible crude materials		Animal/vegetable oils, fats, waxes	
	1991	1996	1991	1996	1991	1996	1991	1996	1991	1996	1991	1996
Agricultural exports (per cent of total agricultural exports)												
Destination:												
APEC without ASEAN	27.6	19.8	0.01	0.01	31.1	30.6	0.7	0.4	2.4	2.0	11.5	16.4
ASEAN	0.4	1.1	0.01	0.06	1.0	2.6	0.1	0.08	0.04	0.3	0.4	2.6
European Union	4.1	1.8	0.0	0.0	7.1	5.4	0.01	0.01	1.7	2.6	6.2	8.6
Rest of the world	1.2	1.1	0.0	0.01	3.0	3.8	0.2	0.1	0.2	0.1	1.0	0.3
Selected countries												
USA	11.9	9.3	0.0	0.0	10.1	9.0	0.1	0.02	0.4	0.6	8.9	14.1
Australia	0.2	0.01	0.0	0.0	0.7	0.7	0.1	0.01	0.1	0.3	0.01	0.0
Japan	14.2	7.8	0.01	0.01	13.0	12.7	0.1	0.01	0.6	0.2	1.4	0.8
Total	33.2	23.8	0.05	0.06	42.2	42.4	1.0	0.6	4.4	5.0	19.1	28.0

Source: Bureau of Agricultural Statistics, 1997.

Appendix Table 8.1

Uneven Tariffs

Applied Tariff Rates and Estimated Tariff Equivalent Rates on Selected Agricultural Products, 1994

Sector	Domestic price (pesos/kg)	Foreign price (pesos/kg)	Tariff rate replacing a non- tariff measure (per cent)	Average tariff rate equivalent (per cent)
Feed/livestock				
Yellow corn	5.4	4.1	100	60
Second class pork	49.2	44.5	100	11
Broiler chicken meat	36.1	26.5	100	37
Second class beef	72.6	76.2	60	-5
Vegetables				
Garlic	87.5	17.6	100	397
Red onions	19.0	8.7	100	118
Cabbage	10.3	7.3	100	40
White potato	12.6	9.0	100	40
Commercial crops				
Raw sugar	10.1	6.3	100	61
Coffee, robusta	27.7	41.8	100	-34

Source: De la Peña, 1993; Clarete, 1998.

Appendix Table 8.2

Planned Tariffs

The Philippine Tariff Rate Quota Commitments in the WTO

Product description	Tariff	Initial quota	Initial in-quota tariff	Final quota	Final tariff	Implementation
Horses '000 head	HS0101	57.0	30	57.0	40	1995-2004
Cattle '000 head	HS0102	12.2	30	20.3	40	1995-2004
Live pigs '000 head	HS0103	2 570.0	30	2 570.0	40	1995-2004
Live goats '000 head	HS0104	49.4	30	82.3	40	1995-2004
Live poultry '000 head	HS0105	5 708.1	40	9 513.5	40	1995-2004
Beef '000 metric tonnes	HS0201	4.0	30	5.6	30	1995-2004
Pork '000 metric tonnes	HS0202	32.5	30	54.2	30	1995-2004
Goat meat '000 metric tonnes	HS0204	0.7	30	1.1	40	1995-2004
Poultry meat '000 metric tonnes	HS0207	14.1	50	23.5	40	1995-2004
Potatoes metric tonnes	HS0701	930.0	50	1 550.0	40	1995-2004
Coffee metric tonnes	HS0901	5.9	50	5.9	40	1995-2004
Corn '000 metric tonnes	HS1005	130.2	35	216.9	35	1995-2004
Rice '000 metric tonnes	HS1006	ST	59.0	50	119.5	1995-1999
Rice '000 metric tonnes	HS1006	ST	119.5	50	238.9	1995-2004
Sugar '000 metric tonnes	HS1701	38.4	50	103.4	50	1995-2004

Note: ST means the lifting of quantitative restrictions is deferred for ten years.

Source: Department of Agriculture, 1994a; Department of Agriculture, 1994b; Clarete, 1998.

Appendix Table 8.3

Big Increases in Liberalised Commodity Imports Post WTO Entry
Volume and Value of Imports of Selected Agricultural Commodities: 1992-96
 (Quantity in metric tonnes; Value fob in US\$ million)

Commodity	1992		1993		1994		1995		1996	
	Quantity	Value	Quantity	Value	Quantity	Value	Quantity	Value	Quantity	Value
Corn	604.0	0.179	647.8	0.297	894.1	0.42	208 023.6	33.44	402 344.7	85.70
Poultry meat	14.6	0.037	182.1	0.249	542.0	0.70	850.6	1.14	1 270.0	1.20
Pork	416.7	0.356	39.1	0.022	233.5	0.21	1 017.0	0.69	4 315.9	6.76
Onion	0.01	0.000	209.6	0.054	0.1	0	0.8	0.01	1 374.2	0.15
Cabbage	80.7	0.029	2.0	0.001	0.4	0	0.3	0.01	2.2	0.01
Garlic	0	0	0	0	0	0	0	0	165.7	0.67
Rice	633.8	0.249	201 605.3	35.760	163.8	0.08	263 250.7	75.70	862 384.9	294.04
Raw sugar	0	0	0	0	0	0	128 572.5	48.60	2 000.0	0.78
Potatoes	0.01	0.000	0.3	0.001	21.7	0.03	135.6	0.07	12.0	0.01
Barley	6 252.0	0.651	4 951.5	0.626	6 224.8	0.76	5 120.1	0.70	56 291.0	1.15
Feed wheat	0	0	0	0	0	0	40 339.0	7.40	0	0

Source: Bureau of Agricultural Statistics, 1997.

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Chapter 9

IMPLICATIONS FOR GOVERNMENT AND BUSINESS

PHILIPPINE ECONOMIC OUTLOOK

While the Philippines has progressed significantly in several key policy areas, such as providing infrastructure, and liberalising trade and investment, many major issues still must be addressed. The currency crisis makes many of these more urgent, but in other cases, peso depreciation should help solve long standing economic biases and distortions. The major issues confronting the Government include:

- inflexible labour market and wage setting mechanisms
- highly inadequate transport, telecommunications, water supply and rural electricity infrastructure
- the need for ongoing financial market reform
- falling educational and human resource development standards
- high levels of social inequality
- continuing bias against agriculture
- confusion about mining sector reform causing new investment to stall
- a relatively low savings rate
- structural current account imbalances
- an inefficient and unpredictable legal system
- official corruption and poor quality government administration, particularly at junior and middle levels, that is especially damaging in taxation and trade administration.

Wages and Manufactured Exports

The recent depreciation means the peso now is more appropriately priced against the US dollar and the Philippines has improved competitiveness vis-a-vis China, Vietnam, Mexico and Caribbean countries but not compared to other major labour intensive manufactured exporters like Indonesia and Thailand. Inflexible labour market practices and wage setting mechanisms increase the real cost of Philippine labour in dollar terms adjusted for productivity compared to such competitors, and depress employment in low skilled labour intensive manufactures like textile, garments, and footwear industries.

The fastest growing manufacturing output and exports in recent years are the more skilled, labour intensive industries like electronics. Large infusions of foreign direct

investment in export oriented electronics and electrical equipment projects feed this growth. The overvalued peso encouraged high import content and low domestic value adding. Skilled labour is more competitively priced, but shortages of such labour will eventually raise wages. Moreover, the Philippines relies heavily on semiconductor exports; this exposes it to excessive risk from rapid technological change in these industries and potentially rapid price falls.¹

To improve the international competitiveness of manufacturing, labour pricing needs to be more realistic, primarily by strongly linking wage adjustments by regional wage boards to labour productivity changes or, preferably, using collective bargaining.

Inadequate Infrastructure

Decades of neglect have left Philippine transport, water, telecommunications and, till recently, energy infrastructure in poor shape, compared to other East Asian nations. This undermines the competitiveness of all sectors of the economy, but particularly those dependent on transport to distant markets, like export oriented agriculture. Infrastructure shortages have caused the rapid growth of special economic and export zones, but these zones are not strongly linked to the rest of the Philippine economy, representing enclave economies within the Philippines.

Recent policy innovations have attracted significant private sector investment to supply power and most recently, telecommunications and transport infrastructure. However, bureaucrats and policy makers need skills and commitment to transparency to ensure the unbundling of infrastructure services produces competitive markets that provide the best outcomes for consumers. Ill prepared policies can result in long delays, disputed decisions and possibly consumer and voter disillusion with the privatisation process.

Financial Market Reform

While Philippine prudential regulations are reasonably strong compared with other ASEAN nations, further progress is desirable. Priority areas to strengthen include consolidating bank supervision, incorporating a risk weighting scheme into the definition of capital adequacy and promoting stronger representation of outside shareholders on bank boards. Another priority is to reduce the gap between bank lending and deposit rates by continuing to move statutory reserve requirements towards regional averages, abolishing mandatory credit allocations and increasing competition.

Education and Human Resource Development

Although Philippine literacy rates and enrolment rates at the secondary and tertiary level are relatively high, education quality has deteriorated; in the last decade, the percentage of examinees who passed national college entrance examinations and completed secondary education both declined. To deepen its comparative advantage in skill intensive industries, the Philippines needs to improve human capital

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¹ Other Asian countries experienced these risks in 1996 in industries highly reliant on DRAM memory chips.

development in technical fields. Related to this is the need to improve the institutional and human capability to absorb, adapt and possibly innovate technologies. The experience of successful regional economies suggests this requires strong private sector interaction and involvement in training and research.

Improved primary health care also is needed to raise human capital, productivity and welfare. Fiscal constraints and devolving health care responsibility to local government have led to falling health delivery standards in some areas in recent years.

Social Inequality

Despite steady economic growth and transformation since 1993, poverty remains critical. Although poverty incidence is now lower than in the 1980s, it is much higher than in other South East Asian countries.

Since about two thirds of the country's poor families live in rural areas, poverty continues to be predominantly a rural problem. Sustained high, labour intensive industrial and service sector growth in urban areas will expand opportunities for rural migrants. In rural areas, rejuvenated agricultural activities and decentralised agri-industrialisation would increase rural incomes; however, this strategy requires improved roads, transport and communications. Also needed to significantly reduce rural poverty, is a more targeted provision of basic facilities, such as primary health care, water supply and farm-to-market roads to facilitate faster trickle-down of growth.

Agriculture

The agricultural sector poses a major challenge for the Philippines. Agricultural production has barely kept pace with population growth due to low public and private investment in rural infrastructure, agricultural research, mechanisation and fertiliser use.

Private investment is weak due to the sector's low profitability resulting from poor infrastructure, the overvalued exchange rate, past government taxation and monopoly marketing policies, rigid wage setting policies and a flawed land reform program. By concentrating on rice self-sufficiency and other low return, traditional crops like coconuts and corn, farmers' incomes have dropped. By contrast, fruit, vegetables and fish products return high prices in export and domestic markets.

If the devalued peso is maintained in real terms, it should boost agricultural profitability and reduce competitive pressures from imports. This windfall should be used to improve productivity and achieve sustainable long term growth. To do this, increasing investment in rural infrastructure, fertilisers and research, and resolving the land reform impasse will be critical. Several export oriented agricultural sectors will need to develop successful models to enable large scale production like those being developed by large producers of export fruits and vegetables.

Mining Reform Stalled

Despite its past significant contribution to output and exports, the mining sector stagnated in the 1980s due to excessive taxation levels, security problems in isolated mine sites and heavy restrictions on foreign investment. Bold attempts to reform the

mining sector investment regime began in 1995 but stalled. Strong initial international interest is waning rapidly due to uncertainty created by court cases and stricter environmental requirements after the Marcopper mine spillage, legal challenges to the constitutional validity of the new mining legislation, uncertainty created by the new indigenous peoples' legislation and a failure to issue new mining contracts prior to the presidential election.

The new administration will need to quickly address these complex and politically sensitive issues or lose the opportunity to regenerate this potentially valuable sector for some years. If conflicting interest groups can be satisfied and new, environmentally sensitive, financially viable projects that satisfy indigenous people concerns can proceed, this sector could contribute much to the Philippine economy. More capital for new mining developments would provide much needed employment, infrastructure and development opportunities for many poor and isolated regions.

Given the chequered history of Philippine mining developments, authorities legitimately want to improve the implementation of environmental safeguards and ensure indigenous people's rights are protected to secure public support for mining developments. However, reputable and experienced foreign mining companies are likely to raise local standards in managing such issues, as well as lift the sector's productivity and competitiveness to international levels.

Low Savings Rates

East Asian experience indicates that savings rates increase when incomes rise rapidly and demographic growth rates slow. High population growth and low income growth have reduced Philippine saving rates well below those of other regional economies. Recently improved macroeconomic policy management in lowering inflation and improving the fiscal position have helped stimulate greater savings by the Philippine Government and business sector, but to substantially improve the Philippines savings performance, household savings must be raised. For this, rising incomes and more efficient and available banks and credit cooperatives are needed in rural areas to ensure rural savings find their way into the formal banking system and are available for investment.

Structural Current Account Imbalances

Until the recent peso depreciation, the currency was chronically overvalued, some analysts believe since World War II. This, combined with low savings and high government spending resulted in current account deficits in most years in recent decades and prevented export led growth, particularly from labour intensive manufactures and agriculture. For most of the last decade, foreign investment, foreign aid and reverse capital flight from the Marcos and Aquino years produced balance of payments surpluses.

Despite depreciation, the current account data to September 1997 still indicated a significant deficit of over 4.7 per cent of GDP. This situation may improve in 1998 as the depreciation attracts more export oriented investors, and domestic producers and consumers source more purchases locally. For longer term Philippine economic development, the real value of the peso's depreciation must be maintained. This will

provide the Philippines with the opportunity to aggressively develop labour intensive export industries, providing higher productivity employment for most workers still employed in low return agriculture and other informal sector activities,² thereby making important inroads into rural and urban poverty. In the past, successful East Asian economies followed this route to economic prosperity, but it has been largely denied the Philippines to date because of the overvalued exchange rate.

Legal System

Following the 1986 people's power revolution, the new constitution enshrined elaborate checks on the executive's power to ensure no recurrence of past abuses. However, aspects of the present system, like the continual appeal of court decisions without new evidence, waste court and litigant resources, and potentially deter domestic and particularly foreign investment. In particular, many foreign businesses and the Ramos administration believe high profile court decisions on commercial disputes have lacked consistency with precedent. Increased professionalism and consistency and a reduced capacity to undermine legitimate legislative and executive functions would enhance the Philippine legal environment.

Bureaucratic Efficiency and Transparency

Significantly improving tax administration and streamlining the bureaucracy would encourage investment confidence and profitability. Corruption persists in revenue generating agencies such as the Bureau of Internal Revenue and Customs, and in those agencies undertaking or overseeing large infrastructure projects and public works maintenance. Public service reform will upgrade the Government's overall administrative capability to manage socio-economic development and respond to public needs.

Central to strengthening the Philippine bureaucracy is increasing public servant remuneration and emphasising merit-based selection and promotion. Given the fiscal constraints, increased government salaries would require a leaner, streamlined and more merit-based administration.

The Local Government Act, which ensures 40 per cent of inland revenue goes to local government makes improving the institutional capacity of local government a priority.

Prospects

Like the rest of the region, the Philippines now embraces export-led growth, private sector development and a supportive rather than intrusive role for the state. The relatively favourable performance of the Philippine economy during the regional currency crisis, in contrast to the Thai and Indonesian economies, suggests that structural reforms, particularly in financial market control over the past decade have reduced the country's vulnerability to external shocks. The peso's depreciation in recent months in tandem with the regional currency crisis should provide a reprieve for beleaguered labour intensive manufacturing.

.....
² These include low productivity activities like peddling and scavenging.

Nevertheless, further financial market reforms are needed for the Philippines to remain resilient to financial market volatility and imbalances. Moreover, the saving rate is still very low; the agriculture sector requires immediate attention; poverty remains serious; the industrial sector has failed to generate rapid employment; and wage determination mechanisms are rigid and could erode gains in competitiveness from the recent peso depreciation. As the debate on the 1997 comprehensive tax reform program indicated, popular demands will continue to tug at pragmatic governance and challenge the next administration after President Ramos ends his term in mid 1998. If the Philippines successfully addresses the challenges of increasingly open and competitive international and domestic economic environments, the country should sustain high economic growth and rapidly improve its living standards.

IMPLICATIONS FOR THE AUSTRALIAN GOVERNMENT

The increased profile of Australian-Philippine relations since President Ramos's 1995 visit to Australia reflects growing confidence in Philippine economic development and Philippine concern to be more integrated in the world economy, and particularly the dynamic Asia Pacific region. Australia-Philippine political and economic interests are converging as the Philippines has become a more vibrant democracy, and a more rapidly growing and reforming economy. This report highlights several areas of mutual interest and shared opportunity for the two governments.

BILATERAL RELATIONS

Australia-Philippine bilateral relations are extremely positive. Bilateral ties are strengthened by a long history of links and similarities in political institutions, language, religion, close geographic proximity and common outlook on key regional, economic and security issues. The strengthening bilateral relationship is underpinned by a growing Filipino community in Australia of over 140 000 in 1997.

Australia is participating in a range of recent initiatives to build trade and investment relationships and increase mutual awareness. Australia provides the second largest grant aid program to the Philippines and leads in Defence Cooperation assistance. The relationship was advanced in November 1997 with the Philippine-Australia Dialogue and the November 1998 'All the Best - From Australia' promotion in Manila should boost the relationship further.

TRADE NEGOTIATIONS

The Philippines is undertaking significant trade liberalisation unilaterally, via the WTO, AFTA and APEC and in February 1998 announced further relaxation of quotas and tariffs on food imports, including beef, live cattle and fruit. Trade liberalisation and income growth has fostered rapidly growing bilateral trade since the mid 1990s. Prospects for future trade growth are strong given natural complementarities in the Australian and Philippine economies. (See Chapter 3 - *Trade*.)

However, the Philippines still erects significant trade barriers, particularly to 'sensitive' agricultural imports, and effective protection actually rose as a result of quota tariffication required by WTO entry. As a result of the recent peso depreciation, many quota and tariff barriers are redundant or excessively high and could be removed altogether or substantially reduced. (See Chapter 8 - *Agriculture*.) Philippine authorities should not waste this opportunity to make compensating cuts in protection; otherwise the depreciation's domestic inflationary impact will be unnecessarily high and local producers will have little incentive to improve productivity and competitiveness as their effective protection will rise by the full amount of depreciation.

OFFICIAL DEVELOPMENT ASSISTANCE

After PNG, Indonesia and Vietnam, the Philippines is Australia's fourth largest foreign ODA recipient. The program focuses on training and education, but also provides significant allocations to health, governance, infrastructure and rural and community development. (See Chapter 1 - *Development Policies*.) Current developments in the new five year country strategy for Australian ODA to the Philippines, 1998-99 to 2002-03, recognise the need to adjust the program to align with emerging Philippine priorities.

The Australian aid program's increased focus on institutional strengthening foreshadowed in the Government's response to the Simon Report (1997) is relevant to the Philippines which faces many institutional strengthening and governance challenges.

In dollar terms, official development assistance flows to strengthen governance, public service reform and the macroeconomy are modest compared to similar flows to directly install infrastructure and meet basic human needs. However, well directed programs to help build capacity in local government, the financial market and taxation reform could help the Philippines to increase its capacity to invest sustainably from its own resources and contribute significantly to economic development over the next decade.

Australian ODA funds already provide a technical advisory service facility to fund technical assistance for central government ministries responsible for economic management and to train local and central government officials. A new governance initiative being considered focuses on several key policy development areas and should help in pursuing cooperation with the Philippine Government in areas outlined below.

Macroeconomic Management

The currency crisis highlights the importance of continuing commitment to rapid economic reform, transparent economic management and regulation, and strong banking system prudential controls in insulating economies from international shocks. In the medium term, the most valuable development assistance will be to strengthen governmental capacity to formulate and implement such reforms.

Philippine officials indicated they welcome technical assistance from Australian institutions for bank supervisors and security regulators in the short term. Experts in Australia's banking and securities sectors and public sector regulatory agencies could be drawn on to develop this assistance.

While financial system reform has progressed well with multilateral and bilateral assistance its further deepening and strengthening would reduce the need for foreign private and concessional capital flows to the Philippines by mobilising private domestic funds for investment in infrastructure, labour intensive manufacturing and agriculture. Developing municipal, corporate and longer term infrastructure bond markets will be crucial, as will expanding the insurance sector, pension funds, mutual funds and similar institutional borrowers which could purchase these long term assets.

Competent prudential control of such markets would ensure public confidence in these savings vehicles. Australia has considerable expertise in regulating and overseeing financial markets; this could be offered to the Philippines as its markets develop. Projects to increase savings rates and improve prudential controls could be cofinanced with the World Bank and Asian Development Bank or in conjunction with the International Monetary Fund.

Taxation and Expenditure Management

While the Philippines has improved significantly its fiscal position in the past three to four years and devoted considerable effort to taxation reform and enforcement, much remains to be done. Some analysts estimate that only half the tax payable is actually collected. The Australian Taxation Office has considerable experience in taxation enforcement, which could be made available under the aid program.

Public investment allocation at national and local government levels also needs improving. Resources not subject to proper administrative scrutiny, such as the Countrywide Development Fund and the Public Works Fund, can be seriously misallocated. Technical assistance under the aid program could build institutional capacity to monitor flows of public money, including purchasing procedures, within government departments to ensure more rigorous fiscal control by central financial ministries.

In the Philippines, considerable interest exists in Australia's medium term fiscal framework. This tool, which allocates funds to various types of expenditure over a number of years, could reduce the scope of vested interests to appropriate public money for private purposes or for low return, low priority projects.

Private Sector Infrastructure Provision

Infrastructure reform in New Zealand and most recently in Victoria in electricity, transport and water creates an opportunity for Australia to offer technology transfer and training to the Philippines to expand its efficient use of private sector funds for infrastructure. Knowledge transfer is a major theme of new approaches to ODA by a number of bilateral donors and multilateral banks.

While the Philippine Government is overcoming the infrastructure crisis it inherited, the huge backlog in infrastructure needs and rising demand for

infrastructure services as growth accelerates necessitates continual innovation in this sector. Central and local governments need to share knowledge on best practice approaches to unbundling, privatisation, deregulation and appropriate government oversight of infrastructure sectors so private providers maximise consumer gains. This will significantly benefit the Philippine people and consolidate political support for further reforms, generating future efficiency and welfare gains. Australian ODA may well assist in spreading good infrastructure reform models from the Philippines, Australia and elsewhere.

The major areas of potential assistance for private sector infrastructure provision include technical assistance to:

- enhance the overall legal environment, including property rights, environmental regulation, accounting standards and specialised legislation to validate and encourage domestic and foreign private sector participation in infrastructure
- develop legislation to unbundle infrastructure into natural monopoly and contestable components and establish efficient and credible regulatory bodies
- upgrade financial sector regulation to increase the ability and ease of raising funds and reduce the cost of finance
- develop risk allocation and mitigation policies and mechanisms to identify the risks associated with infrastructure projects, determine who is best able to bear these risks, and develop appropriate risk mitigation strategies
- develop appropriate infrastructure tariff and supplementary fiscal policies to improve the economic efficiency of tariff and subsidy policies
- develop relevant policy, regulatory and management skills within central economic ministries, public authorities, regulatory agencies and financial markets through training schemes and employ short term consultants to work with local officials.

The Local Government Code of 1991 and the 1993-98 Philippine Development Plan increased local government autonomy in developing, operating and maintaining local transport facilities. Local governments are now responsible for local roads, bridges, traffic signals, public transport terminals and ports in their areas, including those the national government funds. However, many local governments, unfamiliar with private sector participation in infrastructure and the required regulatory issues would benefit from training and assistance. In many cases, they lack the resources to properly evaluate and choose between alternative potential infrastructure projects and to determine appropriate forms of private sector involvement.

Australia already has assisted provincial and local governments under the Regional and Municipal Development Project cofinanced with the World Bank, and the Technical Assistance to Physical Planning Project. Further assistance could promote the appropriate use of private sector infrastructure funding. For instance, local government units may benefit from assistance to develop expertise in cost-benefit analysis to use when choosing between different infrastructure investments that could be made with scarce funds.

Agriculture

The lack of rural infrastructure, particularly farm-to-market roads and irrigation, adversely affects agricultural development. Aid program technical assistance to develop local funding mechanisms through improving local tax collection, strengthening capital markets and increasing private infrastructure participation would help local authorities fund infrastructure.

Apart from inadequate provision, poor maintenance persists in and pervades national, provincial and rural infrastructure. While many government programs and donor initiatives over past decades provided infrastructure, with poorly managed and funded maintenance programs many of these facilities have deteriorated, often to the point of disuse. In the past Australia provided technical assistance to local government units to plan and strengthen maintenance management programs, as well as fiscal mechanisms to finance such programs. Long term sustainability depended on local government commitment and competence. Careful selection of local governments based on their past record increases the likelihood of sustaining maintenance improvements.

Given the current difficulties of Philippine research and extension services, a review of the organisation and delivery of services might be timely. Australia might assist through the Australian Centre for International Agricultural Research, ACIAR.

The lack of available marketing mechanisms and information for small, dispersed farmers discourages farmers from growing more lucrative cash crops. Australia has considerable private sector experience in exporting and domestic marketing of agricultural products grown by many small producers; this could be made available commercially or through technical assistance.

Mining

Australia, with its large internationally competitive mining sector, has considerable expertise in developing fiscal regimes and environmental requirements for mineral projects. The Mines and Geosciences Bureau and the Department of Environment and Natural Resources and Ministry of Finance could be assisted in developing workable and equitable fiscal and environmental control regimes for new mining projects.

Implications of the Currency Crisis for ODA

The Philippine Government's fiscal position, which improved considerably in the three years prior to 1997, was seriously eroded by the higher foreign debt service costs caused by the peso's depreciation and by slowing economic activity. In early 1998, government department funding was cut by 25 per cent, mainly by reducing new capital works. This may affect the Government's capacity to provide counterpart funding for ODA projects. AusAID may need to consider repackaging assistance to ensure the continuity of ongoing and new activities.

IMPLICATIONS FOR AUSTRALIAN BUSINESS

The Economic Outlook Given the Asian Currency Crisis

While the Philippines appears to be weathering the currency crisis reasonably well, high interest rates are threatening some companies' viability and are slowing growth. Many small and medium sized firms report heavy exposure to US dollar denominated borrowings. Consumer spending on imported goods, particularly luxuries, has dropped sharply due to the peso's depreciation.

Trade Opportunities

Trade liberalisation is transforming the Philippines from one of the most closed economies in the region to one of the more open. Ongoing trade reforms under AFTA and APEC should complete the transition to relatively free trade early next century. The 1997 peso depreciation should remove the pressure that was increasing before June 1997 to retain trade barriers.

A key factor affecting the short term prospects of Australian exporters to the Philippines will be whether exports are for final consumption in the domestic economy or inputs for export oriented industries. Luxury good exports for domestic consumption already are suffering and will continue to do so in the short to medium term (one to two years). For imported inputs into export industries, maintaining credit lines will be essential to ensure Philippine customers have sufficient trade finance and working capital to carry the higher costs. If credit lines are available, prospects for imported inputs to export industries should be good. For example, with electronics exports likely to continue to grow strongly, copper imports should grow well.³ However, as most processed food exports involve tropical fruits and coconuts rather than beef or dairy products, major Australian agricultural exports will not benefit from being further processed for export from the Philippines.

In February 1998, some food tariffs and quotas, including on Australian beef, live cattle and fruit were relaxed ahead of schedule to moderate imported food price increases from the peso's depreciation. These measures still leave the Philippine price of Australian food exports well above pre-depreciation levels, so demand will contract in the short term. (Chapter 8 - *Agriculture*.) In the medium to long term, as incomes rise with renewed growth, if the Government resists protectionist pressure to reinstate quotas and higher tariffs as the peso's real value appreciates, these market opening initiatives should improve the prospects of Australian food exporters to the Philippines.

Peso depreciation has made the Philippines a more cost competitive producer of many agricultural products, but for most major importables like rice, corn, beef and sugar, it is still a high cost producer by international standards. However, virtually no domestic suppliers exist for dairy products and only a limited number supply beef, two of Australia's major food exports to the Philippines.

³ If the Philippines can reinvestigate its mining sector it could reemerge as a substantial producer and exporter of copper.

In the medium to long term, lower agricultural tariffs and quotas should result in a restructuring of Philippine agriculture along more profitable and rational lines. With its large, rapidly growing population and limited arable land, the Philippines has no comparative advantage in relatively low value, land intensive broad acre crops like rice, corn or sugar. Plantation or small acre production of labour and capital intensive tropical fruit and vegetables for domestic and particularly export markets more profitably use limited land resources. Thus the Philippines should become a substantial importer of grains and other broad acre crops; Australia is a competitive exporter of these crops. The Philippines should also become an increasingly important exporter of tropical fruits and vegetables and processed foods.

The Philippines' lack of comparative advantage in rice production may mean rice self-sufficiency can be achieved only if the Government raises significant trade barriers against imported rice (as in Japan and the Republic of Korea), pushing up food prices and the cost of living, or pays large price subsidies, with high fiscal costs.

The Philippine Government is becoming more aware of environmental issues, particularly in mining. Australian firms expert in sustainable mining, forestry and agriculture, clean energy, and water and waste treatment could assist Philippine farmers, manufacturers and miners in developing frameworks to deal with environmental issues. In some cases, it may be cheaper to establish local production facilities for simple environmental products.

Continuing reforms in Philippine infrastructure sectors to encourage private sector investment should provide major opportunities for the many Australian firms expert in constructing and managing transport, electricity generation, telecommunications and water supply infrastructure. Many corporatised or privatised Australian public sector infrastructure providers also could assist Philippine government infrastructure authorities in privatising and improving their regulatory and management systems to attract private investment. Australian firms would strengthen their bids for BOT and concession projects if they drew on this expertise to offer a full package of services to Philippine infrastructure customers, including management and regulatory expertise, financing, construction and operation.

Serious weaknesses in Philippine transport infrastructure and distribution systems impede the national distribution of perishable products. However, shortcomings in the distribution and transport systems also provide opportunities for Australian firms with expertise in land and air transport, logistics and storage.

The opening of Philippine banking, other financial services and insurance sectors in recent years is likely to continue and could accelerate as a result of the Asian currency crisis, providing significant opportunities for Australian financial institutions. Many smaller Philippine banks will need to enter joint ventures or be sold to foreign investors in the next few years. However, banking investors may experience delays in receiving full national treatment for their Philippine branches.

Given the high value Philippine students and parents place on education, Australian educational institutions could increase their current modest exports of educational services, both by establishing campuses and courses within the Philippines and providing training and education for Philippine students in Australia. Several Australian universities already are exploring joint ventures with Philippine universities. Peso depreciation may reduce the traditional Philippine bias towards

US educational institutions, but Australian educational institutions will need to increase Philippine awareness of their quality.

With the large peso depreciation, Philippine imports into Australia are likely to become more competitive, creating opportunities for Australian importers to distribute and add value to these products.

Positives and Negatives for Investors

Major factors attracting Australian investors to the Philippines include political stability; low labour costs; a relatively skilled, English speaking workforce; a large consumer market; high expected economic growth; opportunities to extend business networks; government investment incentives; markets servicing or supplying Australian companies in the Philippines; and the relatively easy regulatory environment.

On the other hand, negative factors include slow government decision making; foreign exchange risk; restrictions on foreign ownership; infrastructure shortages; personal safety problems; corruption; high company and personal taxes; concern about long term political stability; residual regulatory controls; and the slowing pace of economic reform. Nevertheless, improvements in the past five years and reasonable expectations of further improvements make the Philippines an increasingly attractive investment destination.

Impact of the Peso's Depreciation on Potential Investors

Peso depreciation should significantly improve the Philippines' competitiveness as a manufacturing base; it has reduced the cost to foreign firms investing in all sectors, making this a good time to enter the market. Indebted local firms also may be more willing to acquire or expand foreign equity. However, as usual, Australian firms will need careful due diligence assessments of potential acquisitions to ensure they are not carrying hidden debts, and carefully assess new joint venture partners. (See Chapter 5 - *Business Environment*.)

To date, most Australian investment has serviced the Philippine domestic market. However, the peso's depreciation should radically alter the relative profitability of export and domestically oriented and nontraded sectors. Domestically oriented sectors like construction, infrastructure and building materials, distribution, retailing and services generally are likely to suffer from the currency crisis for the next year or so. On the other hand, profitability of export oriented sectors like garments, electronics, agriculture and mining, and many sectors producing import substitutes should improve so long as firms maintain access to trade and working capital finance.

Australian firms could consider investing in export oriented manufacturing to supply Australia or third markets. Export activities also are eligible for Board of Investments or economic zones tax and investment incentives. (See Chapter 4 - *Investment*.) Investments in export oriented agri-business will also be more attractive. (See Chapter 8 - *Agriculture*.)

Infrastructure Investment

Australian companies have increased their investment in private sector infrastructure in recent years. Many new opportunities are developing in transport,

ports and water supply, in addition to the power and telecommunications sectors which have received high levels of foreign investment in the past five years. Recent peso depreciation will reduce the local cost of undertaking infrastructure investments but also the foreign exchange value of peso tariffs, at least in the short to medium term. Few projects, like international telecommunication operations have access to foreign exchange revenue. The impact will vary from project to project, but will generally disadvantage infrastructure projects with a high import component, like electricity generation and telecommunications more than road and rail transport projects with high local costs.

Mining Investment

In the next decade, a major area for potential Australian investment is in mining and related mining services. However, unless stalled mining reforms are restarted by the next administration, international exploration interest and expenditure will decrease further and this potential will remain unrealised. Even if exploration continues, companies are unlikely to invest in mine development until confidence is restored. If the confidence of foreign mining investors can be regained quickly, Australian exploration expenditure could substantially increase as many companies seek stable investments, particularly given uncertainty in other parts of the region.

Australian Filipinos

Australia's large Filipino community, many with valuable skills and Australian qualifications represent a significant resource for potential traders and investors in the Philippines. Australian firms could make good use of Filipino-Australians' language, cultural skills and contacts when doing business in the Philippines.

Information Sources

Access to quality and timely information on forthcoming opportunities and the operating environment increases success in all markets, and the Philippines is no exception. Avenues providing such information include:

- Austrade offices in Manila and Australia. Firms need to register their capabilities with Austrade in Australia to allow trade opportunities to be passed on to them.
- *The Philippines Country Brief* produced periodically by the Department of Foreign Affairs and Trade
- private consultancy firms in Australia and the Philippines
- publications like the Philippine Economic Intelligence Unit's excellent monthly, *Philippine Alert*
- World Bank and Asian Development Bank publications, internet sites and briefings
- the list of business contacts at the end of this report.

PROSPECTS

Assuming continued political stability and reform commitment in the new administration, as seems likely, the Philippines' prospects are the most favourable for many decades. As a result, Australian Philippine bilateral and business relations appear set to strengthen significantly over the next decade. Many areas of economic complementarity, cultural and institutional similarities, shared views on regional developments and strong people to people links will underwrite this relationship, but creative approaches by Australian and Philippine business people and officials will help ensure opportunities are maximised.

CONTACTS IN THE PHILIPPINES

Australian Government Representatives

Australian Embassy
Dona Salustiana Dee Ty Tower
104 Paseo de Roxas (corner Perea
Street)
Makati City
PO Box 1071
Makati City
Tel: (632) 750 2850
Fax: (632) 754 6268
Hours: Mon - Fri 0800 - 1630

Austrade
Dona Salustiana Dee Ty Tower
104 Paseo de Roxas (corner Perea
Street)
Makati City
PO Box 1071
Makati City
Tel: (632) 750 2833
Fax: (632) 754 6263

International Organisations

Asian Development Bank
6 ADB Avenue
Mandaluyong City
0401 Metro Manila
Tel: (632) 632 6065/ 66
Fax: (632) 632 5560
Internet: <http://www.asiandevbank.org>

World Bank
23rd Floor, Taipan Place
Emerald Avenue
Ortigas Centre
Mandaluyong City
Tel: (632) 637 5855 to 64
Fax: (632) 637 5870
Internet: <http://www.worldbank.org>

Business Organisations

**Australian New Zealand Chamber of
Commerce**
3rd Floor Doña Salustiana Dee Ty
Tower
104 Paseo de Roxas
(corner Perea Street)
Legaspi Village
Makati City
Tel: (632) 816 3836
(632) 892 2875
Fax: (632) 893 8208
Email: anzcham@suntray.com

Chamber of Mines
Room 204, Ortigas Building
Ortigas Avenue
Pasig City
Tel: (632) 635 4123
Fax: (632) 635 4160

**Hotel and Restaurant Association of
the Philippines**
Room 205, Regina Building
Aguirre Street
Legaspi Village
Makati City
Tel: (632) 815 4659
Fax: (632) 815 4663

IDP Education Australia
Ground Floor, Dona Salustiana Dee
Ty Tower
104 Paseo de Roxas (corner Perea
Street)
Makati City
Tel: (632) 816 0755
Fax: (632) 815 9875

International Mining and Exploration Committee

3rd Floor, 111 Paseo de Roxas
Makati City
Tel: (632) 894 4999
Fax: (632) 818 4437

Makati Business Club

2nd Floor, Princess Building
104 Esteban Street
Legaspi Village
Makati City
Tel: (632) 751 1134
Fax: (632) 750 7406
Email: mbc@portalinc.com/
mbc@globe.com.ph

Philippine Association of Supermarkets Inc

c/- Shoppersville Supermarkets
355 Katipunan Street
Quezon City
Tel: (632) 994 291
Fax: (632) 971 304

Philippine Chamber of Commerce and Industry, PCCI

Philippine International Convention Centre (PICC)
Roxas Boulevard
Pasay City
Tel: (632) 831 0340/ 41
Fax: (632) 833 8895

Philippine Chamber of Food Manufacturers

Room 1216, Cityland 10 Tower 2
Ayala Avenue
(corner HV Dela Costa Street)
Legaspi Village
Makati City
Tel: (632) 894 0388
Fax: (632) 893 3893

Philippine Constructors Association Inc

3rd Floor, Padilla Building
Emerald Avenue
Pasig City
Tel: (632) 631 3135
Fax: (632) 631 2788

Philippine Electronic and Telecommunications Federation

6th Floor, Telecoms Plaza
316 Sen Gil J Puyat Avenue
Salcedo Village
Makati City
Tel: (632) 815 8921
Fax: (632) 818 6967

Philippine Hospital Association

Unit 502, One Corporate Plaza
Condominium
845 Pasay Road
Makati City
Tel: (632) 815 0325
Fax: (632) 819 2702

Philippine Medical Association, PMA

PMA Building, North Avenue
Quezon City
Tel: (632) 992 132
Fax: (632) 974 974

Philippine Shipbuilders and Repairers Association

2nd Floor, PPL Building
1000 United Nations Avenue
Manila
Tel: (632) 582 7111
Fax: (632) 521 9172

Philippines-Australia Business Council, PABC
 Office of the Secretariat Infinity Plus Inc
 Suite 8B, LPL Towers
 112 Legaspi Street
 Legaspi Village
 Makati City
 Tel: (632) 817 8596
 (632) 892 6971
 Fax: (632) 817 0191
 (632) 894 5887

United Architects of the Philippines
 Upper Basement, CCP Complex
 Roxas Boulevard
 Metro Manila
 Tel: (632) 832 1125
 Fax: (632) 832 3711

Philippine Government Ministries

More detailed commercial information is available from the following Philippine authorities. This is not intended as an exhaustive list, but rather a guide to market regulators and economic policy formulators.

Economic Development Policy

Asset Privatisation Trust
 10th Floor, BA Lepanto Building
 8747 Paseo de Roxas
 Makati City
 Tel: (632) 815 9201/ 05
 Fax: (632) 818 4591

Bangko Sentral ng Pilipinas, Central Bank

Central Monetary Authority
 A Mabini (corner Vito Cruz Street)
 Ermita
 Tel: (632) 524 7011
 Fax: (632) 522 3987
 (632) 523 2608

Department of Finance
 Executive Tower Building
 BSP Complex, Mabini Street
 Ermita
 Tel: (632) 526 8466
 (632) 523 4255
 Fax: (632) 521 9495
 (632) 521 2948

Maritime Industry Authority, MARINA
 PPL Building
 1000 United Nations Avenue
 Manila
 Tel: (632) 523 8651
 Fax: (632) 521 8511

National Economic Development Authority
 PO Box 419
 Greenhills
 Mandaluyong City
 Tel: (632) 631 0945 to 68
 Fax: (632) 631 3747

Environmental Assessments

Department of Environment and Natural Resources
 DENR Building
 Visayas Avenue
 Diliman
 Quezon City
 Tel: (632) 929 6626
 Fax: (632) 920 4352

Foreign Investment

Board of Investments, BOI

Industry and Investments Building
Sen Gil Puyat Avenue
Makati City

Tel: (632) 897 6682

Fax: (632) 895 0905

BOI One Stop Action Centre

Tel: (632) 890 9308

(632) 897 6682

Fax: (632) 895 3521

(for inquiries in Australia, contact the Philippines Trade and Investment Promotions Office, listed below under Australian contacts)

Clark Development Corporation

Clark Special Economic Zone
Building 2127
CP Garcia (corner Quirino Street)
Clark Ecozone
Pampanga

Tel: (6345) 599 2042 to 69

Fax: (6345) 599 2088

15th Floor, JMT Corporate

Condominium

ADB Avenue

Ortigas Center

Pasig City

Tel: (633) 867 1634/ 1626 to 29

Philippine Export Zone Authority, PEZA

PEZA Building
Roxaz Boulevard (corner San Luis
Street)

Pasay City

Tel: (632) 891 6381 to 83

(632) 891 6444

Fax: (632) 891 6380

Securities Exchange Commission

SEC Building

EDSA

Greenhills

Mandaluyong City

Tel: (632) 780 931 to 39

(632) 704 757

Fax: (632) 725 4399

(632) 722 0990

Subic Bay Metropolitan Authority

Subic Bay Freeport Zone

Building 229

Waterfront Road

Olongapo City

Tel: (6347) 252 4242/ 4123

(632) 817 3994

Fax: (6347) 222 5278/3563

Internet: <http://www.subic.com>

Importing, Licencing and Technology Transfer

Department of Agriculture

Elliptical Road

Diliman

Quezon City

Tel: (632) 920 4323/ 58

Fax: (632) 929 8183

Bureau of Patents, Trademarks and Technology Transfer, BPTTT

Ground Floor, Trade and Industry
Building

361 Sen Gil Puyat Avenue

Makati City

Tel: (632) 818 5274/ 3090

Fax: (632) 819 1887

Department of Science and Technology

Gen Santos Avenue

Bicutan

Taguig

Tel: (632) 837 2071 to 82

Fax: (632) 837 2937

Department of Trade and Industry
 Industry and Investments Building
 385 Sen Gil Puyat Avenue
 Makati City
 Tel: (632) 890 4901
 Fax: (632) 895 3513

Department of Transportation and Communications
 16th Floor, Philcomcen Building
 Ortigas Avenue
 Pasig City
 Tel: (632) 632 0453
 Fax: (632) 631 5183

Taxation
Bureau of Internal Revenue
 National Internal Revenue Building
 Diliman
 Quezon City
 Tel: (632) 929 7676/ 02
 Fax: (632) 922 4894

Trade Commissioner - Northern Australia and BIMP-EAGA
 Australian Trade Commission
 GPO Box 2449
 Darwin
 NT 0801
 Tel: (08) 8981 8686
 Fax: (08) 8981 4349

Philippine Government Representatives

Embassy of the Philippines
 1 Moonah Place
 Yarralumla
 ACT 2600
 Tel: (02) 6273 2535
 Fax: (02) 6273 3984

Consulate General of the Philippines
 Level 5, 122 Castlereagh Street
 Sydney
 NSW 2010
 Tel: (02) 9216 8412
 (includes commercial consulate)

Honorary Consul General of the Philippines
 Suite 5, 127 Melville Parade
 Como
 WA 6152
 Tel: (08) 9367 4189
 Fax: (08) 9368 1022

Honorary Consulate General of the Philippines
 7 Hamilton Street
 Erindale
 SA 5066
 Tel: (08) 8431 7311

Honorary Consulate of the Philippines
 Floor 3, 267 Collins Street
 Melbourne
 VIC 3000
 Tel: (03) 6531 409

CONTACTS IN AUSTRALIA

Australian Government Agencies

Department of Foreign Affairs and Trade
 Philippines, Singapore, Malaysia and Brunei Section
 RG Casey Building
 John McEwen Crescent
 Barton
 ACT 0221
 Tel: (02) 6261 2860
 Fax: (02) 6261 2342

Australian Trade Commission, Austrade
 Austrade South-East Asia Office
 RG Casey Building
 John McEwen Crescent
 Barton
 ACT 0221
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