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STAFF APPRAISAL REPORT

PHILIPPINES

TEXTILE SECTOR RESTRUCTURING PROJECT

March 26, 1982

Industrial Projects Department

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### CURRENCY EQUIVALENTS

Currency Unit	=	Peso (₱)
US\$1	=	₱ 8.10
US\$1 million	=	₱ 8.10 million
₱1	=	US\$0.123
₱1 million	=	US\$123,000

### WEIGHTS AND MEASURES

1 kilogram (kg)	=	2.2046 pounds
1 metric ton (mt)	=	1,000 kilograms = 2,204.6 pounds
1 meter (m)	=	1.0936 yards
1 square meter (m <sup>2</sup> )	=	1.2 square yards

### ABBREVIATIONS AND ACRONYMS

BOI	=	Board of Investments
Central Bank	=	Central Bank of the Philippines
DBP	=	Development Bank of the Philippines
GDP	=	Gross Domestic Product
Government	=	Government of the Republic of the Philippines
MAAB	=	Memorandum to Authorized Agent Banks
MTI	=	Ministry of Trade and Industry
NDC	=	National Development Company
NEC	=	Non-Essential Consumer Goods
NEDA	=	National Economic and Development Authority
PFI	=	Participating Financial Institution
PTRI	=	Philippines Textile Research Institute
SAL	=	Structural Adjustment Loan
tpy	=	Tons per year
UC	=	Unclassified Consumer Goods

### FISCAL YEAR

Government:	January 1 - December 31
DBP:	January 1 - December 31

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- 5-2 Disbursement Schedule

MAP

IBRD Map of the Philippines (IBRD 13915R2)

DOCUMENTS CONTAINED IN PROJECT FILE

1. Textile Sector Reconnaissance Mission, January 1981 Report by Industrial Projects Department Staff and Consultants.
2. Textile Industry Inter-Agency Committees Report, 1978 including sub-committee reports on spinning, weaving, knitting, finishing, hosiery, texturizing and financial aspects.
3. A Review of Institutional, Operational, and Financial Aspects of the Development Bank of the Philippines, Excerpts from SAR-Industrial Finance Project, Report No. 3331-PH.
4. Machine Requirements to Meet 1985 Demand October 1980, Study by Board of Investments and Consultants.
5. Manpower Development Plan for the Textile Industry (1981-1986), Study by Board of Investments and Consultant.
6. Presidential Decree No. 1764, dated January 11, 1981, on Regulations and Instructions on International Competitive Bidding for Major Industrial Projects.

## I. INTRODUCTION

1.01 The Philippine economy continues to be subject to severe pressures. During the 1960s, the country suffered chronic external deficits and, at the beginning of the last decade, the structure of the balance of payments was weak. This structural problem was aggravated by the 1973/74 oil price increase and the subsequent collapse in commodity prices. While substantial progress was made in adjusting to these disruptions, the 1979 oil price increase has offset this progress and necessitated a second major structural adjustment effort. Improved efficiency of resource use in the industrial sector and sustained growth in industrial exports will be crucial to the effort.

1.02 The Philippine Government (the Government) has introduced a comprehensive industrial policy reform program to allow the industrial sector to move to a structure more suited to the country's comparative advantage - based on its labor costs and raw material availability - which is efficient and competitive on international markets. This program involves three major areas: (a) tariff reform and trade liberalization; (b) export incentives and promotion measures; and (c) planning for industrial restructuring and subsector development. Measures have also been taken to improve the access of industry to finance, particularly term finance.

1.03 The Bank is heavily involved in assisting the Government in evolving and formulating its strategies for industrial and financial development, and is in broad agreement with the Government's policies for industrial change. The first Structural Adjustment Loan (SAL I) 1/ and the Industrial Finance Loan 2/ to the Government are designed to support these policies, and to serve as vehicles for continuing the dialog between the Bank and Government on industrial and financial policy.

1.04 The policy changes in tariffs, import restrictions and export incentives supported under the SAL I are aimed at improving the competitive environment within which industry will operate and will lead to substantial adjustment within the industrial sector. To assist in the adjustment, the Government is designing subsectoral programs to set the course of development for particular industries over a five year period. These programs will include financial and technical assistance to assist industry in adapting through new investment, rehabilitation of aging equipment, cost reduction and increased productivity. A program for restructuring the cement industry is now underway and the second major program - for textiles - is ready for implementation.

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1/ President's Report on the Structural Adjustment Loan to the Republic of the Philippines. Report No. P-2872-PH, August 21, 1980.

2/ President's Report on the Industrial Finance Loan to the Republic of the Philippines. Report No. P-3028-PH, April 13, 1981.

1.05 The textile industry 1/ is an important contributor to industrial output, comprising 6% of 1979 manufacturing value added and 13% of employment in manufacturing. The industry is, however, faced with severe operating and structural problems, arising from lack of specialization, obsolete and aging equipment, poor technical performance, and inadequate manpower training. It can thus operate only in a highly protected domestic market. The Government's subsectoral program seeks, as its primary objective, to make the industry more dynamic and competitive. The program involves phased tariff reductions and import liberalization to open the industry to more competitive pressures, technical assistance and training to improve industry operations, and finance for rehabilitation and renewal of equipment.

1.06 A Bank reconnaissance mission visited the Philippines in April 1980 to review the textile sector and to discuss with the Government the above-mentioned program for restructuring the sector. A sector report 2/, which was prepared by the mission, addressed major sectoral issues. On the basis of the findings of the mission and following subsequent discussions with the Government, a program for restructuring the textile industry was evolved. The Government thus requested Bank financing to assist in the implementation of this program. The proposed project, appraised by a Bank mission consisting of Messrs. H. Oteifa and N. Tin of the Industrial Projects Department and M. Joyce (Consultant) in March/April 1981, comprises a loan of US\$157.4 million (including provision for capitalized front end fee of about US\$2.4 million on the proposed Bank loan) of which US\$150 million is for investment in equipment and associated training and US\$5 million for technical assistance, which is an integral part of the subsectoral program. The proposed loan will finance about one-third of investment requirements for machinery and equipment over the next 4 year period, and provide most of the industry's technical assistance requirements during that period. The balance of the foreign exchange financing required would come from bilateral sources (mostly suppliers and buyers' credits). Local currency would be financed through the industry's own funds and by domestic financial institutions.

1.07 This would be the first loan made to the Philippines to assist in sectoral adjustment. As such, it is an important part of Bank involvement in structural change. The first and subsequent Structural Adjustment Loans will help the Government set the broad policy framework for adjustment, and this and future sectoral loans will ensure that such adjustment takes place at the industry level smoothly and with minimum disruption.

## II. THE INDUSTRIAL SECTOR

2.01 Industrialization has been a prime objective of Philippines economic development since independence. The industrial sector 3/ grew rapidly

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1/ The textile industry is defined to include spinning, weaving, knitting and finishing of man-made and natural fibers. Garment manufacture is not included, except where specified.

2/ A Sector Report titled "Textile Sector Reconnaissance Mission Report" is included in the Project File.

3/ The industrial sector includes mining, manufacturing, construction and utilities.

in the 1950s as the Government's import substitution policy, an overvalued exchange rate and the availability of long-term finance at low interest rates led to a significant replacement of imports by domestic production. This was followed by a period of slower growth through the 1960s. The industrial growth picked up temporarily between 1972 and 1974, but this improvement was short-lived, and growth rates fell sharply during the 1975 recession. The real growth rate of gross value added in the manufacturing sector dropped from 13.9% in 1973 to 3.5% in 1975; and since then has varied between 5.5% and 7.8%. Growth in 1980 dropped from 7.8% in the previous year to 5.4%, reflecting increased uncertainty and rising prices.

2.02 As shown in the following table, the industrial sector contributed 36.3% of GDP in 1980 of which 25.3% was from manufacturing. The manufacturing sector also accounts for about 30% of fixed investment and 12% of total employment.

Philippines - Distribution of GDP by Sectoral Origin (%)

<u>Sector</u>	<u>1970</u>	<u>1975</u>	<u>1979</u>	<u>1980 a/</u>
Agriculture, fishing and forestry	27.8	28.8	25.9	25.7
Industry				
Mining and quarrying	2.8	1.8	2.4	2.6
Manufacturing	22.5	24.8	25.2	25.3
Construction	3.6	6.2	7.3	7.3
Electricity, gas and water	0.7	0.9	1.0	1.1
Total Industry	<u>29.6</u>	<u>33.7</u>	<u>35.9</u>	<u>36.3</u>
Services	<u>42.6</u>	<u>37.5</u>	<u>38.2</u>	<u>38.0</u>
TOTAL GDP	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

a/ Preliminary

Source: National Economic and Development Authority.

A. Structure of Manufacturing Industry

2.03 The industrial sector, including manufacturing, is predominantly privately owned and has a highly dualistic structure. The "unorganized" sector, defined as establishments with less than five workers, employs nearly two thirds of the manufacturing work force, but contributes less than 5% of value added. The "organized" sector produces more than 95% of manufacturing value added, but provides more limited employment opportunities. However, it is in the organized sector that the greatest opportunities lie for growth in value added resulting in increased employment.

2.04 The sectoral composition of manufacturing since 1970 is shown in Annex 2. Although manufacturing value added grew by an average annual rate of 6.7% between 1970 and 1979, the relative sectoral share did not change significantly. The major growth industries were chemicals and rubber products (14.2% per annum), beverages and tobacco (7.9%) and transport equipment (8.1%). Textiles and apparel have maintained a steady share of output of around 10%.

#### B. Manufacturing Investment

2.05 After substantial increases in investment in the first half of the 1970s, the level of new investment declined as a consequence of the 1975 recession. This was reflected in a fall in new projects registered with the Board of Investments (BOI) from 217 in 1974 to 152 in 1975, and 86 in 1976. Registrations have improved since then to 142 in 1977, 139 in 1978, and 146 in 1979. Overall investment will be boosted by the Government's plans to encourage eleven major industrial projects, including equity participation through the National Development Company (NDC). These projects include heavy industry to develop further national resources such as copper smelting, rationalization of existing industries such as cement, and the development of heavy industrial infrastructure such as an integrated steel mill. These projects could have a significant impact on the country's industrial development, and the Government intends to approach them in a prudent and flexible manner, going ahead only after a rigorous financial and economic analysis has established their viability.

#### C. Export Performance

2.06 Manufactured exports grew slowly until the late 1960s. The 1970 devaluation, followed by the floating of the Peso and the introduction of import duty rebates, contributed to an increase in the growth of manufactured exports, especially garments, handicrafts and electronic products, which rose from US\$226 million in 1973 to US\$1,041 million in 1978, US\$1,500 million in 1979, and about US\$1,750 million in 1980. Exports of garments increased from US\$404 million in 1979 to US\$433 million in 1980. Most of these exports are based on raw materials imported and processed in bonded manufacturing warehouses, thus avoiding the tariffs and restrictions applied to imports for domestic use. In effect, these exports are produced in enclave factories, with little value added and little backward linkages to the domestic manufacturing sector.

#### D. Industrial and Financial Policies

2.07 The key elements of Government policy towards industry are tariffs and import regulations and the system of fiscal and financial incentives. 1/ Before the Government's recent tariff reductions discussed below in para. 2.13, nominal tariffs ranged from 10 to 100%, with the highest rates for consumer

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1/ The existing policy structure and the measures being taken to improve it are discussed in detail in the President's Report No. P-2872-PH on the Structural Adjustment Loan I.

goods and the lower rates for intermediate and capital goods. The tariff protection of the domestic market has been reinforced by an extensive system of import licensing restrictions administered by the Central Bank. Imports of certain finished commodities are banned because they are considered luxuries or are domestically produced. Imports of other intermediate goods, which are important inputs into domestic and export production, are regulated by the Central Bank. The combination of tariffs and import restrictions has led to an inefficient use and allocation of resources. Production of consumer goods for the domestic market has been encouraged at the expense of producer goods and exports. The lack of competition from imports has allowed inefficient, high cost producers to survive, and has added a substantial cost burden to the Philippine economy and to consumers.

2.08 Further distortions in the industrial sector have arisen from the system of fiscal incentives administered by the BOI. Since 1967, industry has been assisted through a wide range of incentives. These incentives, however, have had a strong capital-cheapening effect. Policies that have encouraged the use of capital include full or partial exemption from import duties on imported capital equipment, accelerated depreciation allowances on capital investment, and exemption from income tax of funds used in project expansion. The BOI fiscal incentives are estimated to reduce the user cost of capital for an individual firm by as much as 45% in certain cases. Further encouragement of capital-intensive projects has arisen because the determination of investment priorities through the annual Investment Priority Plans has not paid adequate attention to labor intensity. Finally the detailed administrative requirements of the BOI have effectively favored relatively large firms with representatives in Manila that could cope with the additional overhead costs.

2.09 The financial system has further reinforced the capital-intensive bias of the investment incentives. Bank lending rates have been subject to administrative ceilings, which have tended to reduce the user cost of capital for selected firms eligible to borrow. Due to the inability of the banking system to align interest rates with risk, other rationing devices (such as excessive reliance on collateral and preferential treatment for selected customer) have been unduly used by the financial sector to the detriment of smaller, often more labor-intensive, firms.

#### E. Policy Directions

2.10 The Government has been conscious for some time of the need for basic changes in its industrial policies. The 1978-82 Development Plan included as one of its basic objectives an improvement in the performance of the industrial sector through increasing the processing of domestic raw materials, continuing increases in exports of nontraditional manufactures, and accelerating employment generation by small and medium-scale industries and selected large scale investments. Further impetus to industrial development policy arose from the commissioning in 1977 by the National Economic and Development Authority (NEDA) of a study of the Government's industrial promotion policies at the University of the Philippines. This study indicated that the main causes of the poor industrial performance were the high protective barriers and the capital-intensive bias of the investment policies.

2.11 The shared concern of the Government and the Bank about the performance of the industrial sector led to the subsequent undertaking of a Bank industrial sector mission in early 1979. This was followed by a financial sector mission, jointly with the International Monetary Fund (IMF), to look at interrelated questions of banking reform and industrial finance. The reports of these missions in general confirmed the findings of the Government's own studies and helped to formulate strategies for industrial and financial development. During discussions of the two reports in August 1979 there was general agreement on industrialization strategy and the reforms needed in industrial and financial policy. The Government program for industrial and financial reform are supported by the Bank's SAL I and Industrial Finance Loan (para. 1.03).

2.12 Since then the Government has outlined its industrialization strategy and policy reform program in a Statement of Industrial Policy for the 1980s. This program includes staged reforms over a five-year period to correct the import substitution and capital-intensive biases of existing industrial and trade policies. The main components of the policy reform program are: (a) tariff reform and trade liberalization; (b) export incentives and promotion measures; (c) investment incentives and their administration; and (d) industrial restructuring and subsector programming.

2.13 Tariff Reform and Trade Liberalization. In August 1980 and July 1981, the Government legislated a general reduction and evening out of the tariff system over a four-year period. This reform will reduce nominal tariff rates to the 10-50% range, and will bring most effective rates <sup>1/</sup> within a range of 10-80%. Starting on January 1, 1981, tariff rates for 14 key industry subsectors were being realigned over four years to achieve greater uniformity of protection, and current peak rates for all other industries have been reduced (in two steps on January 1, 1981 and January 1, 1982) from 100% and 70% to a ceiling rate of 50%. These reforms will reduce the average effective rate for the manufacturing sector from 44% to 29%.

2.14 In some cases, the import licensing imposed by the Central Bank is a stronger protective device than the tariff. Many of the products on which peak tariffs are being lowered, as well as 13 out of the 14 subsectors for which tariff revisions are being made, are subject to licensing. Since continued import licensing would defeat the objectives of the tariff reform, the Government has also adopted a phased formal plan for removal of import licensing restrictions that are maintained for protection of domestic industry or for balance of payments reasons. This liberalization will proceed in stages in coordination with the tariff reform to allow local industries time to adjust and to spread any balance of payments effects over the four-year period.

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1/ The nominal tariff is the rate of protection on output, whereas the effective tariff is the rate of protection on value added taking into account tariffs on tradable inputs.

2.15 Export Incentives and Promotion Measures. Since 1979, the Government has considerably improved the system of export incentives through: (i) making export industries eligible for all fiscal incentives previously available only to home industries; (ii) improving administrative procedures to simplify the duty drawback system and export documentation requirements. The Government also plans to introduce standard costings for calculating tax credits and duty drawbacks on imported inputs into export production; (iii) easing the eligibility requirements for bonded manufacturing warehouses to give wider access to duty free raw materials for processing for export; (iv) increasing the access of smaller, nontraditional exporters to the Central Bank's export rediscounting facility, and through empowering the Philippines Export and Foreign Loan Guarantee Corporation to guarantee loans to the export sector; (v) establishing 12 export trading companies which would, inter alia, extend export credit to their small-scale suppliers; and (vi) broadening the Charter of the Export Processing Zone Authority to enable it to develop 12 new export-oriented industrial estates.

2.16 Investment Incentives and their Administration. The BOI is currently working on a major reform of the industrial incentives system which would substantially correct the shortcomings of the present investment incentive system and complement the improvements in trade and industrial policy initiated in 1980. First, the number of fiscal incentives would be sharply reduced and incentives would be made neutral in terms of their effect on relative factor use. Moreover, incentives would focus more directly on achieving such specific development objectives as export promotion, regional dispersal of industry and employment creation. Also, incentives would be linked more closely to industrial performance. Second, steps would be taken to improve the administration of incentives both by streamlining and reducing administrative procedures of the BOI and the Ministry of Trade and Industry (MTI). Third, significant improvements would be made in the process of investment priority determination by the BOI. In the future, long-run comparative advantage would be the guiding principle in the selection of industrial activities for inclusion in the annual investment priority plans. Also, the BOI staff would be trained to be able to make greater use of economic analysis in industrial project evaluation.

2.17 Industrial Restructing and Subsector Programming. Comprehensive subsector development programs will be formulated and implemented in conjunction with the trade liberalization program and the reform of the industrial incentives system. Typically, these programs will set the course for the development of a particular industry over the next five years and specify government policies and the role of the private sector with respect to the direction of development, its form and its timing, and the instruments required to achieve sectoral goals, e.g., incentives, level of protection, financial and technical assistance. Subsector programs would be formulated to, inter alia, restructure problem industries and encourage nascent industries with potential comparative advantage; identify areas of comparative advantage within individual subsectors; identify subsector-specific institutional and policy constraints; formulate remedial or supporting actions to promote the growth of priority industries; and provide general information to the private sector on the likely direction of future development of important industries so that the private sector may have a better basis for planning complementary investments.

## F. Future Directions

2.18 Subsector programs aimed at industrial restructuring will be developed in the overall context of the tariff reform which will establish the price levels at which industries must be competitive and also set the time frame for the period of adjustment. Such programs will be designed to help existing industries reduce costs and improve efficiency in order to adjust to the policy changes. A restructuring program is already underway for the cement industry, and much work has been done designing a similar program for the textile sector; this is discussed in more detail in Chapter IV. General subsector development programs for foodprocessing, leather and leather products, wood and woodproducts, electronics and mechanical engineering are being formulated.

2.19 Without the policy program, these benefits would be lost. Manufacturing performance would continue along the lines of the 1970s. Increasing constraints arising from high cost production for a limited domestic market would lead to a fall in manufacturing value added growth, and the absolute number of jobs created each year in manufacturing would be an estimated 70,000 less than would occur with the policy reforms. The loss of such opportunities underlines the importance of implementing the Government's reform program.

## III. THE TEXTILE INDUSTRY

### A. Introduction

3.01 The textile industry in the Philippines which is wholly owned by the private sector is largely a creation of the import substitution policies implemented in the early 1950s. Following the introduction of import controls during this period, the domestic industry grew rapidly as traders and wholesalers previously engaged in importing turned to domestic manufacture. In fact, the industry had reached two thirds of its present size by 1965. Since then growth in the industry's capacity has slowed considerably as imports were almost completely replaced by domestic production.

3.02 The industry is an important contributor to industrial output, with a 1979 gross value added of P 3,057 million or 5.8% of total gross value added in manufacturing. Employment in textiles in 1978 was about 98,000 out of a total of about 778,000 for the manufacturing sector. Downstream production of garments was also important with value added of P 1,834 million (including footwear) and employment of 119,805.

3.03 The industry produces a comprehensive range of products, making extensive use of the whole range of man-made fibers available in both staple fiber and continuous filament form. This has resulted because the Philippines produces very little cotton (roughly 1% of total cotton usage) and the great bulk of cotton used by the industry is imported from the United States under favorable prices and credit terms, and because man-made fibers are both cheap

and durable. The processes used in the conversion of raw materials to fabric include conventional ring spinning as well as open-end spinning of man-made, natural fibers and their blends, texturing of continuous-filament yarns (principally synthetics), weaving and knitting of both spun and filament yarns, and finishing by bleaching, dyeing and printing.

B. Structure and Organization

3.04 An indication of industry structure is given in the table below taken from the report prepared in 1979 by the Inter-Agency Committee which was commissioned by the Philippine Government to investigate the industry's status.<sup>1/</sup>

Philippines - Composition of the Textile Industry a/

<u>Operation</u>	<u>Number of Plants</u>	<u>Number of Machines</u>	<u>% of Capacity in</u>		
			<u>Integrated</u>	<u>Semi-integrated</u>	<u>Specialized</u>
Spinning	32	1 million spindles	70	10	20
Weaving	42	21,000 looms	78	17	5
Finishing	53	-	15 <u>b/</u>	24 <u>b/</u>	14 <u>b/</u>
Scouring/ Bleaching	-	-	97	2	1
Dyeing	-	-	67	21	12
Printing	-	-	66	31	3
Finishing	-	-	76	14	10
Knitting					
Circular	132	4,000	34	49	17
Hoisery	12	1,300	-	-	-
Warp	23	-	9 <u>b/</u>	12 <u>b/</u>	2 <u>b/</u>
Flat	14	1,400	1	96	3
Texturizing	38	363	86	-	14

a/ Excluding cottage industries.

b/ Number of firms.

Source: Inter-Agency Committee Report, 1979.

The table indicates a severe structural problem facing the industry, namely a wide-spread pattern of integration with most mills producing a wide range of textile

<sup>1/</sup> The Inter-Agency Committee was composed of representatives from the Board of Investment, Ministry of Industry, Development Bank of the Philippines, Central Bank and the Philippines Textile Research Institute.

products, and combining yarn production, weaving and often knitting, and finishing. In fact, only 20% of spinning capacity and 5% of weaving is in specialized mills, and 74% of the mills have in-house finishing capacity. This form of organization can be highly inefficient.

3.05 The high degree of integration can be explained by the origins of the industry and in its connection with wholesalers and distributors. The textile mills were originally designed to meet the established trade of the various wholesalers, and integrated mills have continued to provide to this day an array of fabrics to meet the needs of wholesalers with whom connections were developed when the main reliance was on imports. This has meant a focus on a wide range of products from each mill in order to retain the long-established distribution channels. But it also has meant a duplication of similar efforts in most plants, even those established quite recently. As such, the scope for gaining economies by long production runs and concentration on a few main items, as is the trend in the US, Europe, Japan and Korea, has been ignored. Lack of competitive pressures either from within the domestic market or from external sources have not forced adaptation towards a greater specialization. Internally, the ties between the individual mills and the distribution networks have restricted competition. At the same time, protection from foreign competition has ensured that lower import prices arising from the gains from specialization in foreign plants have not had an impact on the domestic producers. The issues of specialization and integration are discussed further in Section C below.

3.06 Further problems arise from the large proportion of aging and ill-maintained equipment, as shown in the following table which indicates, for example, that 45% of the country's spindles and 62% of looms were installed before 1960.

Philippines: Age Structure of Spindles and Looms in 1977

	<u>Spindles</u>	<u>Looms</u>
	%	%
pre-1960	45	62
1961-65	20	12
1966-70	12	7
1971-80	<u>23</u>	<u>19</u>
	100	100

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Source: Inter-Agency Committee Report, 1979.

3.07 The lack of specialization, absence of competitive pressures and obsolete machinery have contributed to a poor performance by the industry. Capacity utilization in spinning, weaving and finishing is estimated at 56, 63 and 40% of design capacities, respectively. Labor productivity in real terms barely increased between 1973 and 1977 from P 26,811 to P 27,618 per worker, and a survey of industry profitability in 1978 found that many firms were unable to earn a significant return on investment. The low profitability is reflected in difficulties faced by a number of firms in meeting repayments of their debt on previous investments.

3.08 These problems are exacerbated in many cases by poor technical performance. Many instances arise where substantial cost savings could be made through improved technical control in operations. For example, quality control is often minimal, maintenance is disregarded with consequent increased downtime for mechanical repairs, and standard settings for machinery are ignored. In finishing, poor housekeeping in many firms impairs product quality and substantially increases cost. From a study of detailed operations in four mills, improved operating practices and energy conservation could have reduced operating costs by as much as 17%.

3.09 The textile industry structure and the protection afforded domestic producers have also led to higher cost fabric, often of inadequate quality and have resulted in the industry concentrating on the domestic market, with textile exports historically negligible. The garment industry, on the other hand, has been remarkably successful in its exports, with garment exports growing from US\$36 million in 1970 to US\$433 million in 1980, an average annual rate of 28%. These exports, however, have been based almost solely on fabric imported under consignment or into bonded manufacturing warehouses.

### C. Issues of Current Operations and Rehabilitation

#### 1. Integration vs. Specialization

3.10 The organization of the Philippines textile industry is predominantly vertically integrated with little specialization in the major sub-processes of yarn manufacture, cloth production and finishing. While integrated mills have advantages for management in terms of flexibility in production alternatives, this is generally achieved at the expense of high production cost. Improvements in efficiency with consequent reductions in production costs and, equally important, improvements in yarn and fabric quality can be gained if the industry moves in either of two directions:

- increased process specialization, with spinning, weaving and finishing as separate operations; or
- increased specialization by product, where mills may be vertically integrated, but are geared toward production of specialized products. There is considerable scope for such specialization in such diverse goods as denims and voiles, combed cotton single jersey and upholstering brocades.

3.11 In spinning, from considerations of both cost and quality, production lines should be used to produce at or near the counts for which they were designed. In contrast, the common practice in the Philippines of using machines to spin counts quite different from design is costly. Thus, many mills operate with a degree of variety inconsistent with efficient and profitable operation. It has been estimated that the cost of domestically produced yarn could be reduced by about 25% through rationalization of production, with the added attraction that yarn quality would thereby be raised to a level that

would make domestically produced cloth acceptable to the export garment industry. In addition to product specialization, mills should be of a certain size to ensure efficient operation, and there is a clearly defined economic minimum size for any given yarn count. These minima should be adhered to for efficient operation. Moreover, diseconomies of scale arising from logistic and other difficulties will normally impose a maximum size on a mill. These size limits will form part of the BOI/MTI criteria for approval of new spinning projects under the textile sector program (para. 5.24).

3.12 In weaving, the benefits of product specialization are high machine and labor productivity, high quality standards and minimization of costs. To a certain extent, the integrated mills, which account for the major part of the installed capacity (78% of looms), do practice some specialization in weaving. Mills tend to produce fabrics within a limited weight range with width governed by the types of looms installed, and the number of styles in each mill is not large considering the number of looms in use. If all other production factors were satisfactory, this degree of variety would not prevent an efficient weaving performance. However, because the mills are vertically integrated, the range of yarns consumed in the weaving departments is invariably produced by the spinning departments of the same mill. The range of yarn counts 1/ is often wide, leading to poor spinning performance and poor quality yarn which, in turn, causes poor weaving performance. It is not uncommon to find one mill using counts 4s to 36s, or another with counts 10s to 45s. Consequently, while most of the integrated weaving mills have a reasonably narrow product range, their single internal source of yarn is a contributory cause of low weaving productivity.

3.13 The benefits to specialization in weaving will reach a maximum when a single fabric is produced in a mill of economic size. In the Philippines, the best chance for this type of operation lies in denim, which is currently produced on some 1,300 looms. Other fabrics, which could be produced in large specialist mills in the Philippines, are grey plain weaves for industrial and commercial purposes, bed sheeting and light-weight suitings.

## 2. Rehabilitation vs. New Investment

3.14 A key question for modernizing the textile industry is whether existing equipment should be rehabilitated or replaced by new equipment. This will depend on whether the increased productivity from new spindles or looms offsets their higher net costs, taking into account both capital and operating costs. The other important factor is quality, especially for export markets.

3.15 In spinning, the rate at which textile technology is developing is such that even fully rehabilitated machinery cannot give technical performance equal to that of new machinery of modern design. The best rehabilitation will

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1/ Yarn count is a measure of yarn fineness based on the number of fixed lengths per standard weight.

not permit the spinning of yarns within the top decile of world quality today. In cases where export possibilities are concerned, the yarn quality limitations of rehabilitated machinery may be crucial particularly if the yarn is intended for high speed shuttleless weaving or for high quality fabrics.

3.16 Unit productivity of new, high performance spindles is about 40% higher than that of fully rehabilitated machinery. In addition, it has an operative productivity advantage of from 20 to 50%. Thus, although the capital cost per spindle is from two to three times greater for new high performance machinery, this is substantially offset by higher unit productivity so that the capital cost per unit of production differential is only about 2:1 for rehabilitation of pre-1960 machinery, to 1.4:1 for rehabilitation of more recent mills. With regard to operating costs, the advantage is wholly with the new machinery and, in many cases, overall rehabilitation will be less profitable than buying new machinery. As a broad generalization, it may be said that rehabilitation is worthwhile for post-1960 installations but not worthwhile for older plants unless the latter have been meticulously maintained. While this is broadly true, the replacement vs. rehabilitation decision should be made on a mill-by-mill basis, taking into account capital and operating costs. Some poorly maintained mills may not be worth rehabilitation even with relatively modern machinery.

3.17 In weaving, machine and labor productivity as well as product quality mainly depend on woven yarn quality. With the anticipated upgrading in the spinning operations as a result of the restructuring program and with the planned liberalization of imports of good quality yarn, the weaving sector would be capable of substantially improving its performance (in quantity, quality, and cost reduction) as well as meeting part of the fabric demand for garment exporters. As in spinning, the capital cost per unit of production differential for new equipment vs. rehabilitation is about 1.8:1 for pre-1960 rehabilitation to 1.3:1 for rehabilitation of recent mills. Unless needed for specific products requiring particular types of looms or for exports to highly competitive markets, most of the other fabric varieties can be successfully woven on the existing looms. Looms older than 1951 are too slow and narrow, and should be replaced by wider looms. The other looms in place can operate quite efficiently at adequate quality without replacement. After rehabilitation, these looms would be able to increase their productivity and reduce total operating costs by around 6%.

3.18 In finishing, there are many cases where replacement of equipment is necessary on economic grounds because of low machine productivity, high consumption of energy, water, dyes and chemicals or to allow fabrics to reach their quality potential. In particular, outmoded technology, such as the processing of woven fabric in rope form through the preparation stages, can be detrimental to the uniformity of preparation and to the final appearance of the fabric. This is particularly important in fabrics containing polyester fiber. With certain exceptions, much of the installed finishing equipment in the Philippines is reasonably modern and rehabilitation should be considered, again on a case-by-case basis. Undoubtedly, improvements in performance and quality can be achieved by rehabilitation of such items as bearings, pad bowls, singe burners and fabric guiding equipment. This upgrading is something which should, however, be part of the normal operation of a good finishing mill.

### 3. Manpower Skills and Development

3.19 The quality of labor and management plays a major role in determining the industry's operating efficiency. Overall, the quality of top management is generally good. The quality of technical management, however, varies significantly. The best technical managers are good by international standards, and operate well-run mills. Other managers, however, operate poorly-run mills with inferior working conditions and a lack of good house-keeping and maintenance.

3.20 With respect to labor, the staff of a modern mill may be divided into three categories: technologists, direct operators and technicians (mechanics, electricians, etc.). Technologists' skills are crucial to operating efficiency in running a mill. Technological management is currently provided mainly by expatriates, often from Hong Kong, Taiwan, Japan and India, and there is a strong case for training of more Filipino technologists in overseas technical institutions specializing in textile technology.

3.21 Operating labor for the industry is generally adequate and, subject to technological supervision, is competent. However, weaknesses arise in the general use of slipshod methods for carrying out routine tasks. This has resulted mainly from a lack of training and supervision. Basic training of all operators for routine tasks should, as a matter of course, be given in a training room, outside the production area, by specialized instructors. This would result in raising both machine and operator productivity and the incidence of fabric faults would be reduced.

3.22 Severe problems exist with respect to technicians. Modern textile machinery can only work well when in first class condition and, although technologists can define setting requirements, they are dependent on the services of technicians for achieving and maintaining those settings. There is clearly a shortage of adequately trained technicians, with consequent adverse impact on industry efficiency. Appropriate training courses in local technical colleges need to be developed to cater for this lack of skills.

3.23 The importance of training for the industry cannot be overstressed. There is a clear need for training at all levels - technologists, operators and technicians. The training component proposed under the project will address this need through provision of foreign scholarships for technologists and hiring of textile experts skilled in training (para. 5.12).

### 4. Garment and Textile Industry Links

3.24 The dependence of the export garment industry almost entirely on imported fabric means that domestic value added is low and that opportunities for indirect exports of domestic fabric are missed. Imported woven fabrics are preferred to the domestically produced fabrics because the price is lower, the quality is higher and there are fewer problems in obtaining orders in small quantities. While quality standards of domestically produced fabrics are often inferior to those of imported fabrics, the main obstacle to the use of domestic woven fabric is price, with domestic fabrics up to 70% more expensive than equivalent imported fabrics.

3.25 Under the present system of high tariffs and import restrictions, there is little incentive for the textile industry to improve its technical performance and lower its costs and prices to the point where it becomes competitive internationally. The planned tariff reductions and the easing of import restrictions will increase the competitive pressures on the domestic market, and make it possible for higher import substitution of fabrics to the garment industry. Moreover, organizational improvements referred to above, including increased specialization by product and process, the rehabilitation of old equipment, the purchase of new equipment, and improved operating and management performance, will all contribute to quality improvement and thus an increased input of fabric to the export garment industries. Garment manufacturers would be more than willing to use domestic fabrics of competitive price and quality to avoid the costs and delays associated with imports. Yarn quality and price will be especially important in determining the competitiveness of domestic fabric, and improvements in overall standards of dyeing and finishing will also be necessary to improve consistency of quality.

3.26 Provided the appropriate policy and technical changes are made, the textile industry should be capable of supplying by 1985 a substantial proportion of the fabric requirements of the export garment manufacturers. Typical fabrics in which substitution will be possible include denims, piece-dyed and yarn-dyed lightweight shirtings, yarn-dyed ginghams, knitted shirting fabrics, and lightweight continuous filament taffetas and crepes.

#### 5. Geographic Dispersal

3.27 Like most of the Philippines manufacturing sector, the textile industry is heavily concentrated in and around Metro Manila as shown below:

Philippines - Regional Dispersal -- Textiles and Garments  
Proportion of Output and Employment in Manila Area - 1977

	<u>Output</u> (%)	<u>Employment</u> (%)
Textiles	97	90
Garments	83	67
All Manufacturing	79	69

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Source: National Census and Statistics Office (NCSO).

In 1977, 97% of gross output and 90% of employment in textiles originated in Metro Manila and adjacent provinces. The garment industry is more dispersed with 83% of output and 67% of employment in Metro Manila and the surrounding areas. A combination of Manila as the most important market and an almost complete lack of adequate infrastructure in most of the provinces has meant that virtually no nonresource based industry of any size has located outside Manila.

3.28 These same factors lie behind the concentration of the textile industry in Manila. Efficient spinning and weaving requires factories of reasonable size with a reliable power supply and access to imported materials and spare parts. These factors have all influenced the decisions to locate textile factories in and around Manila. For garment manufacture, which is less capital-using and can be based in smaller units, some decentralization has taken place, especially in Cebu where there is a flourishing export garment industry.

3.29 In the face of the lack of infrastructure in the regions, a substantial move of the textile industry outside Manila cannot be expected in the near future. The BOI is now offering greater incentives to firms locating in selected regions outside Manila and is prepared to consider favorably applications supporting the dispersal of the textile and garment industries (one of the large textile groups has in fact been encouraged to build a factory, mainly for garments, in Mindanao), but manufacturers will still prefer to site in Manila with its services. The Government proposes to tackle the regional problem through the preparation of Export Processing Zones at Cebu and Baguio and the development of infrastructure in the regions through Industrial Estate Projects. These projects will lead to a greater investment in the provinces, but such estates are still some way from being developed.

#### D. The Textile Market

3.30 As noted earlier, textile production in the Philippines has traditionally been oriented towards the domestic market, and comprised mainly fabrics for making up, with ready-to-wear garments forming a small, but growing segment of the market. Assessment of the textile market has been hampered by a lack of up-to-date reliable figures on the quantity of yarns and fabrics produced. However, reasonable estimates were made using raw material imports together with domestic production of synthetic fibers and ramie (Annex 3-1). Total yarn available in 1979 is estimated at 119,200 metric tons (mt), of which 75,000 mt was woven, 30,000 mt knitted, 2,600 mt exported directly, and 11,600 mt used as sewing thread. Some 9,700 mt were exported, either as yarn, fabric, or in garments, leaving a domestic market of 109,500 mt. In per capita terms, this domestic consumption amounted to 2.4 kg/head. This is lower than other countries with a similar climate and income, such as Thailand, which has a per capita consumption of 2.8 kg. However, part of this discrepancy may be explained by the widely acknowledged technical smuggling through unrecorded imports, as well as outright smuggling in the barter trade in Mindanao. Informal estimates put the degree of smuggling at 25% of the market.

3.31 Exports of textiles have not traditionally been important, although the 1979 figure of 9,700 mt of direct exports of yarn, fabric and garments mainly to associated firms in Hong Kong is encouraging. The generally inferior quality and high cost of Philippine textiles are the main reasons for the poor export performance. As noted in para. 2.06, the garment industry has shown a dynamic export performance, based on imported fabrics, and linkages with this industry represent a large potential market for textile manufacturers.

3.32 The future domestic demand for textile products has been projected by using a textile demand elasticity of 0.62 estimated on basis of per capita consumptions in 1970 and 1979, an estimated growth of GNP per capita in 1979-1985 of 3.7% per annum, and a population growth rate of 2.4%, resulting in an annual average increase in textile demand of 5%. On this basis, the domestic demand for textile products is estimated to reach 148,000 mt in 1985.

3.33 The export market is much less certain. Direct exports of yarn and fabric into the highly competitive markets are unlikely to increase rapidly in the near future and are assumed, for planning purposes, to remain at their present level of around 10,000 mt per year. The best opportunities for substitution for imported fabrics into the export garment industry lie in denim where replacement of 7,000 mt of the expected 10,000 mt of export by 1985 is feasible. Of the remaining fabric imports, estimated at about 300 million square meters, around one third could not be made on domestic equipment, but the other two thirds, consisting mainly of woven fabrics for shirts and blouses, and knitted fabrics for T-shirts and tops could be manufactured in the Philippines. Although a target of 50% substitution in these products by 1985 is technically possible, in practice the industry is unlikely to attain a target of more than 25% substitution because of financial, organizational and marketing reasons. And, allowing for increased garment exports, this would require some further 16,000 mt of fabric per year.

3.34 On the basis of the assumptions in paras. 3.32 and 3.33, including a 5% annual growth rate and 25% substitution of domestic fabrics into export garment industry, the estimated demand for 1985 is summarized as follows:

Philippines - Textile Demand Estimates, 1985  
(<sup>000</sup> mt)

	<u>Spun</u>	<u>Continuous Filament</u>	<u>Total</u>
<u>Domestic Market</u>	122	26	148
<u>Export Market</u>			
Direct Exports	8	2	10
Substitution in export garment market			
- denim	7	-	7
- other	<u>15</u>	<u>1</u>	<u>16</u>
Total	<u>152</u>	<u>29</u>	<u>181</u>

The above estimates are necessarily ballpark figures due to lack of reliable data (para. 3.30) and the difficulty of assessing the impact of the textile sector restructuring efforts on possible increase in fabric imports, reduction in smuggling and price elasticity.

E. Investment Requirements

3.35 Projected investments for the sector are based on the above market forecasts and on a strategy which calls for selective rehabilitation of equipment, where appropriate, accompanied by replacement of obsolete machines with new equipment, and further new investment to meet the additional demand through 1985 (Annex 3-2). To meet the estimated demand of 181,000 mt in 1985, (assuming about 15% of additional yarn requirements met by direct imports) it will require rehabilitation of around 241,000 spindles and 16,000 looms, together with the purchase of 404,000 new spindles and 2,350 looms mainly to replace 500,000 spindles and 1,000 looms which will be phased out. The additional looms over the existing installed capacity will be required to meet the increased demand for fabrics for the export oriented garment industry. Additional investment will also be required in the knitting, texturizing and finishing sectors.

3.36 The estimated investment requirements for imported equipment, engineering costs and contingencies are shown below.

Philippines - Textile Industry Foreign Exchange Investment  
Requirements, 1982-85  
(US\$ million)

	New Investment (Replacement + Addtl. capacity)	Rehabilitation (Modernization/ Renovation)	Total Investment
<u>Equipment</u>			
Spinning (incl. air cond.)	133	24	157
Weaving (incl. air cond.)	42	75	117
Knitting	28	-	28
Texturizing	-	3	3
Finishing	<u>15</u>	<u>5</u>	<u>20</u>
	218	107	325
<u>Engineering Services and</u>			
<u>Erection (10%)</u>	<u>22</u>	<u>11</u>	<u>33</u>
Base Cost Estimate	240	118	358
Physical Contingencies (10%)	24	12	36
Price Escalation a/	<u>73</u>	<u>36</u>	<u>109</u>
Total	<u>337</u>	<u>166</u>	<u>503</u>

a/ Assuming 10% p.a. inflation for textile equipment. For new investment 30% are assumed to be committed in 1982, 40% in 1983, and 30% in 1984, and for rehabilitation 50% in 1982, 40% in 1983 and 10% in 1984.

The above figures are only indicative and actual investment would depend on the projects carried out by the industry.

3.37 The above estimates of about US\$500 million of foreign expenditures are only for equipment including the costs of technical installations (air conditioning, electric supply and distribution, steam, water supply and treatment, effluent treatment and workshop facilities). Local cost requirements for civil works and working capital are difficult to estimate due to the nature of these investments. A rough estimate would be about 25-30% of the cost of new investment, i.e., of the order of US\$80-100 million. Although the largest part of this investment program is in spinning, the number of installed spindles will be practically the same as that prior to the program. New investment will be intended primarily to replace outdated and inefficient equipment, to balance existing facilities and expand them to economic size. At this stage the Government is planning its textile development program on the above investment estimates. Administration of the program, however, will be flexible depending on the investments which eventually materialize and to ensure that such investments will be adapted to any future changes in demand.

#### F. Priorities for Investment

3.38 In the event that funds available for investment fall short of the financial requirements of the textile sector program described above, certain priorities should be established in allocating such investment funds among the various subsectors as well as within each subsector of the industry. In principle, investment funds should be allocated to projects in those subsectors that have better prospects for producing at internationally competitive levels. Such projects would be competitive in the domestic market and would be in a position to substitute imports to garment manufacturers.

3.39 In general, since the returns from rehabilitation are usually faster and higher than those from new projects (since no additional cost of civil works is necessary and a large part of capital equipment is already in place), selective rehabilitation of spinning, weaving and knitting should be given top priority. A second priority is the expansion of the existing spinning and weaving plants to efficient size. Such expansion will reduce the operating cost of existing manufacturers and is essential for any firm to become competitive with imports or to be able to export profitably.

3.40 Among "greenfield" investments, weaving may have some priority over investment in new spinning capacity. Compared to downstream operations, spinning is a low value added, capital and energy intensive activity with relatively low returns except for very efficient operations. Also, only if yarn is of good quality and competitively priced can the use of domestic fabrics by the export garment industry be increased. Weaving, on the other hand, uses less capital and is less technically complex than spinning and, given good quality yarn, there is no reason for the Philippines not to be able to weave fabrics as efficiently as other countries. For these reasons, some priority is indicated for new weaving projects over new spinning projects, with spinning approved only for those applicants with a proven track record and technical skills in spinning. If this strategy results in any shortfall in yarn, good quality and cheap yarns are readily available from elsewhere in the region, e.g., South Korea and Taiwan.

- 3.41 A sequence of priorities for investment would thus be:
- (i) Selective rehabilitation investment in spinning, weaving and knitting;
  - (ii) Expansion in existing spinning and weaving operations to an efficient size;
  - (iii) New weaving and knitting investment; and
  - (iv) New spinning investment.

Investment in finishing will typically depend on other investments and on the demands of the market and would be undertaken as required. This set of priorities was discussed in detail and agreed to with the Government.

3.42 The consultants under the technical assistance program for the Structural Adjustment Loan are in the process of assisting the BOI in the formulation of an overall system of investment priority determination. The principles arising from this study will apply equally to the textile sector as well as to other industrial sectors. The economist to be hired as part of the technical assistance under the Textile Sector Restructuring Project (para. 5.20) will work in conjunction with the SAL Consultants in further refining, if necessary, the priorities set out in para. 3.41.

#### IV. POLICY AND STRATEGY FOR THE SECTOR

4.01 Along with the rest of the industrial sector, the textile industry is both assisted and controlled by the wide-ranging and complex system of tariffs, import restrictions and investment incentives discussed in Chapter II. The proposed changes in Government policy will have a substantial impact on the textile and garment industries of the Philippines, and this impact is discussed in this Chapter.

##### A. Tariffs

4.02 As described in Chapter II, tariff levels in the Philippines vary widely, ranging from 10 to 100% before the first stage reduction that took effect in January 1981. Tariff rates as a whole are high, with an overall (unweighted) average nominal rate in 1980 of 46%. In general, tariffs are lower on producer goods and raw material inputs, and escalate with subsequent stages of processing to final products. Consumer goods, such as motor vehicles, appliances, footwear and garments, have the highest protective tariffs.

4.03 Textile and garment tariffs follow this escalating pattern, with 1980 tariffs on cotton set at the minimum 10% rates, staple fibers 30%, yarn 30-50%, fabrics usually 70%, and garments 100% (Annex 4-1). These increasing

rates mean that each process in the textile and garment production chain (spinning, weaving, finishing and garment making) receives increasing protection, i.e., that the effective rates of protection are even higher than the nominal rates, with effective protection on spinning and weaving of the order of 150%, and garment manufacture, 170%. This contrasts with the estimated average 1980 effective protection for the manufacturing sector of 44%.

4.04 These high levels of protection afforded textile and garment manufacturers in the domestic market have had several adverse effects:

- (a) they have enabled domestic manufacturers to sell their products at high prices, with most domestic fabric prices some 30-50% higher than the prices of comparable imports (before import duties);
- (b) they have allowed efficient firms to make high profits, while at the same time allowing badly run and marginal firms to survive;
- (c) they have led manufacturers to concentrate on the domestic market and the potential of supplying the export garment industry as a user of domestically manufactured fabrics has been missed. Exports continue to be based on less expensive, better quality imported fabrics; and
- (d) they have permitted high cost organizational structures in the industry, for example, excessive vertical integration and overcapacity, as discussed in Chapter III. Because of the lack of competition such inefficient organizations can still operate profitably.

4.05 The Government is well aware of the problem arising from excessive tariff protection, and in August 1980 and July 1981, legislated the comprehensive tariff reform covering all line items in the Tariff Code mentioned in para. 2.13. All peak tariff rates of 100% and 70% will be lowered to 50% by 1985, and tariff rates in selected subsectors will also be substantially reduced over the four-year period beginning in January 1981. This will result in a reduction in protective levels, with average effective protection for the manufacturing sector dropping from 44% to 29%.

4.06 Textiles and garments are included in these tariff reductions and will be lowered by between 30% and 50% (Annex 4-2). The reductions are phased over three to four years to give the domestic industries time to adjust to more competitive production levels. The longest phase is for garments, where the reductions are greatest, from 100% to 50%.

4.07 These moves will mean a considerable reduction in both nominal and effective levels of protection for the textile industry. However, effective

rates for the textile industry would still reach 70-80% after completion of the 1981-85 tariff reform program (Annex 4-2). The Government in a policy statement prepared for the textile sector has indicated its intention to consider further tariff changes (para. 4.23).

4.08 These ongoing tariff decreases are an essential prerequisite to a more competitive and efficient textile industry. Without them, marginal, high cost firms will continue to operate, more efficient firms will make excess profits, and there will be no pressure on the industry to improve its operations. Furthermore, tariff cuts would make smuggling, currently an extensive practice in the Philippines, less attractive and, therefore, could result in increased scope for local production.

4.09 While the cuts will increase competitive pressures on the industry, efficient well managed firms will have little trouble in coping with them, especially if they increase product-line specialization, and trim fat off their operations. Based on representative costings for spinning and weaving operations, the proposed tariff reduction, when fully implemented and assuming they are fully reflected in price decreases, would reduce a profit of 13% of sales in spinning to zero and 14% to 2% for weaving. Such decreases in profit, however, could be recovered through cost reductions or improvements in unit productivity of 15% in spinning and 13% in weaving. Such improvements are feasible. Similarly in finishing, it is estimated that cost savings of 12-17% are readily achievable through improved technology, more efficient use of dyestuff and energy conservation programs.

4.10 The phasing of the tariff reductions over four years will give ample time for firms to make these necessary adjustments. The concomitant availability of finance for rehabilitation of equipment and new investment and the provision of technical assistance to help firms to adapt to the new environment will be an important prerequisite. Even then, some firms will be forced to cease production. In these cases the tariff cuts will be forcing what is, in any event, an inevitable outcome, as these firms would not, in the longer term, be able to compete against the other more efficient, domestic producers.

4.11 It is unlikely that there will be any long term reduction in employment resulting from the tariff cuts. The tariffs, even after the changes, will still give a significant amount of protection to the industry, and imports are unlikely to increase to any marked extent. This is especially so in garments where the Philippines' low labor costs will give it a significant advantage over other producers. In fact, the experience of countries that have adopted this approach clearly shows that employment will even increase as a more efficient textile industry moves into the export garment sector. A further spur to employment from lower tariffs will arise because smuggling will become less attractive encouraging increased domestic production and hence employment.

4.12 Although aggregate employment is unlikely to be affected to any significant extent, some dislocation of workers will occur when marginal mills are forced to close. These jobs will be replaced as other mills expand output as the market grows. Nevertheless, the new jobs are likely to be in different parts of Metro Manila or elsewhere in the Philippines, and this will be a disadvantage to displaced workers. Such disruption, however, will be alleviated as other firms are likely to use any vacated factories. Moreover, experienced textile workers are in demand and will be able to obtain jobs, even if some additional travel or relocation is involved.

#### B. Import Restrictions

4.13 In addition to tariffs, textile and garment imports are restricted by the Central Bank. Garments are included on the Central Bank's Unclassified Consumer Goods (UC) and Non-Essential Consumer Goods (NEC) lists, which in essence means that imports are prohibited, except in special cases. Banks are not permitted to issue letters of credit for fabric imports as instructed in a Central Bank Memorandum to Authorized Agent Banks (MAAB). Exceptions are fabrics imported under bond for re-export as garments. Synthetic fibers and yarns are also regulated through a MAAB, with imports permitted if supplies are short. Substantial quantities of polyester fiber and yarn were imported in the latter half of 1979, but such imports were suspended in February 1980 on the petition of domestic polyester manufacturers.

4.14 These restrictions have an important protective impact in addition to tariffs. Tariff reductions will not be effective if imports continue to be severely restricted, and continuation of import licensing would certainly frustrate the objectives of the tariff reductions. Therefore, it is essential that the restrictions are phased out at the same time as tariffs are reduced.

4.15 As mentioned in para. 2.14, the Government has drawn up a plan for removing most of the import restrictions over the next few years. Restrictions on imports of garments will be removed over the next three years, on fabrics by 1984, and on synthetic fibers and yarn by 1986. An assessment of the impact of removing these restrictions is difficult, since the prohibition of imports has constrained information on actual and potential import competition. However, items that are expected to face import competition include polyester staple fiber and polyester yarn, polyester/cotton shirtings and denim. Garment imports are unlikely to become unduly high because of the eventual 50% tariff on garments and the Philippines' advantages in labor costs. Imports of sensitive items would be monitored following the removal of restrictions to ensure that disruptive importation does not occur. This will mean that the local industry is given as much chance as possible to adapt to the more competitive situation.

4.16 As in the case of textile products, the import of textile machinery is regulated by the BOI. To allow the sector to operate freely, the Government intends to remove the restriction on imports of textile machinery by the end of the restructuring program.

C. Investment and Export Incentives

4.17 Industry in the Philippines is also assisted by a wide range of investment incentives, referred to in para. 2.08. These incentives are offered to firms registered with BOI, which prepares annual "Priorities Plans" to indicate the preferred areas of investment which will be considered for the granting of incentives. Priority areas included in these plans are selected on the basis of objectives, including employment generation, regional dispersal, increased utilization of indigenous raw materials, increased foreign exchange earnings or savings, strengthening of industrial linkages, and promotion of manufactured exports.

4.18 The textile industry has been an important recipient of the incentives, particularly through the Export Incentives Act. In 1979, for example, approved textile and garment investments (excluding synthetic fiber) reached P 604 million under the Investment Incentives Act (R.A. 5186) and P 696 million under the Export Incentive Act (R.A. 6135), or 16.9% and 23.1%, respectively, of total approved investments in manufacturing. In 1979, tax deductions, credits and exemptions for textiles totalled P 17 million out of an all-industry total of P 683 million under the Investment Incentives Act, and a much larger P 46 million out of P 453 million under the Export Incentives Act (Annex 4-3). At the firm level, these incentives are worth around 11-12% of annual sales in the textile and garment industries.

4.19 The sectoral program for the textile industry will be one of the first comprehensive subsector development programs, and the existing incentives will be offered (as new incentive system will not become effective until late 1982), both for new investment and rehabilitation investments, only to firms that meet the criteria outlined in the program's guidelines, including satisfactory economic rates of return and improved competitiveness.

D. Textile Sector Restructuring Program

4.20 The textile industry has been selected by the Ministry of Trade and Industry and the Board of Investment as a high priority target for a coordinated sector development program. This priority is dictated by the industry's urgent need for rehabilitation and rationalization, its importance in supplying a basic need of the population, and its considerable potential for export, particularly through the garment industry. Within the sector, particular priority will be given to rehabilitation investment and expansion to an efficient size as described in paras. 3.38 - 3.40.

4.21 The program for the sector rationalization will involve a three-pronged strategy, encompassing the key areas highlighted in the previous sections - policy changes, technical and structural improvements in operations and manpower, and financing of investment requirements.

- (a) Policy Changes. These will include primarily the tariff reductions and import liberalization discussed above. These changes will ensure that the industry operates in a more competitive environment that will encourage it to improve its efficiency. The industry will still have adequate protection against imports in line with the protection afforded other key sectors. This protection, however, will not be excessive and the potential competition from imports will be the main incentives to improve efficiency. The relaxation of import controls will also be of vital importance in developing a competitive environment.
- (b) Technical and Structural Improvements As discussed in Chapter III, there is wide scope for the industry to adjust to the new environment, relating in particular to improvements in technical operations, greater product and process specialization, and rehabilitation/replacement of aging equipment. The MTI/BOI will encourage these changes by granting incentives only to those firms meeting guidelines for industry restructuring (para. 5.24). Adjustment will also be assisted through technical assistance in selection and purchase of equipment, and in productivity and operational improvements. In addition, the identified weaknesses in manpower skills at all levels will be addressed through a comprehensive training program for managers, supervisors and workers. This technical assistance and training which will be an integral part of the Bank Project, is described in Chapter V.
- (c) Financing. The third element of the Government's sector program is the provision of finance for projects meeting the proposed guidelines. Such finance will help industry to adjust to lower tariff levels through rehabilitation and new investment, and will be available as an integral part of the program to projects that are financially and economically viable. The finance will come from both the Bank line of credit under the proposed Loan and bilateral sources notably suppliers and buyers' credits. Irrespective of the source of funds, however, finance and incentives will not be made available unless projects meet the sectoral guidelines and have satisfactory financial and economic rates of return.

4.22 The BOI and MTI will be the key agencies in implementing the sector program, with the Development Bank of the Philippines (DBP) as the main financing agency. This will involve setting the guidelines for the program, evaluating proposals submitted, monitoring the effect on the industry of tariff reductions and the easing of import restrictions, and developing a system and data base for assessing the overall impact of the program and refining and adjusting it where necessary. The scope and implementation of the proposed Project which is part of the restructuring program are elaborated in the following Chapter.

4.23 The MTI/BOI have finalized a Statement of Development Policy (Annex 4-4), which defines the objectives, scope and implementation, as well as the policy framework of the textile sector restructuring program. According to this statement, the Government intends to further adjust nominal tariff rates for the 1986-90 period for the textile and garment industries to bring the effective rates of protection in line with the average for the manufacturing sector as a whole. To this end, the Government intends to formulate and adopt such tariff adjustments by the end of the restructuring program, i.e., by January 1, 1986.

## V. THE PROJECT

### A. Objectives and Scope

#### 1. General Framework

5.01 The Government, through its program of structural adjustment discussed in Chapter II, has set the directions for industrial development and change through the 1980s. The policy changes in that program, namely tariff reductions, import liberalization, and increased export assistance, will be the key instruments in improving the competitiveness of industry and moving towards the Government's prime objectives for an increased growth role of industry, continued large increases in exports of nontraditional manufactures, more rapid expansion in employment, more productive use of capital, and greater development of industry outside the Metropolitan Manila area.

5.02 The Bank has supported the structural adjustment program through the first SAL in August 1980, which included technical assistance to help the Government in implementing its program. The subsequent Industrial Finance Loan to financial intermediaries made in May 1981 and channeled through the Central Bank is also directed towards industry and will help broaden access to longer term finance. The proposed SAL II, currently under preparation, would support, inter alia, Government's efforts to reform the industrial incentives system and its administration; develop a new approach to investment priority determination; and further develop the concept of subsector development programs.

## 2. Textile Restructuring Program

5.03 Within this wider framework, the proposed Project will assist the Government in the implementation of the textile restructuring program, which involves policy changes, improvements of the structure and technical operations of the industry, and financing of investment requirements as elaborated in para. 3.36. Measures related to policy changes, particularly with regard to tariff reductions and import liberalization for textiles, will establish the price levels at which the industry must be competitive and their phasing over a period of three-four years will set the time frame for the sector's restructuring. These measures are being implemented in connection with the SAL I.

5.04 With regard to the improvement of the structure and performance of the textile industry, the proposed Project will provide finance for:

- (a) the physical rehabilitation, modernization and expansion of the various subsectors, including spinning, weaving, knitting, finishing, etc., which meet the guidelines of the restructuring program;
- (b) training of technologists, technicians, operators and management, and technical assistance requirements of individual firms with a view to improving their technical operations and reducing costs;
- (c) setting up of training facilities/programs, which will benefit the entire textile industry; and
- (d) consulting services to assist the Government (i) in the evaluation and supervision of the projects and firms which participate in the restructuring program; (ii) in monitoring the impact of the sector program and in developing a textile technology information service; and (iii) in carrying out studies for improving sector performance, such as in the areas of energy conservation, effluent treatment, local manufacture of accessories, etc.

## B. Proposed Bank Loan and Lending Arrangements

5.05 Bank financing will help the textile industry to adjust more smoothly to the new competitive situation. Without such assistance, the measures necessary to adjust, including equipment rehabilitation and replacement and efficiency improvements, would take place more slowly, often only as a last resort, with consequent greater disruption on the resources employed in the industry--both labor and capital. It is proposed, therefore, that a Bank loan of US\$157.4 million (including provision for a front end fee of US\$2.4 million on the Bank loan) be made to the Government to assist in the implementation of the textile sector restructuring program. The proposed loan amount

would cover about one third of the foreign exchange requirement of about US\$500 million of the US\$600 million program being planned by the Government for the 1981-85 period (para. 3.36).

5.06 While the industry is expected to put up or borrow funds from domestic financial institutions for the local cost of the program, the remaining foreign exchange cost of the order of US\$350 million would come from other external sources. In this connection, the Government has been seeking financing from bilateral sources including suppliers' credits. During loan negotiations, the Government, through BOI and DBP, provided the Bank with details of these sources of financing which include suppliers' and buyers' credits from the US, Europe, Japan, India and others.

5.07 Of the proposed Bank loan of US\$157.4 million to the Government, US\$150 million would be onlent to DBP and US\$5 million would be made available to BOI/MTI. The onlent funds to DBP would finance individual textile sub-projects as follows:

	<u>US\$ Million</u>
(a) <u>equipment</u> required for the rehabilitation, modernization and expansion of the various subsectors, including spinning, weaving and finishing for selected subprojects; and	140
(b) <u>training</u> of technologists, technicians, operators and management, and <u>technical assistance</u> to individual firms to assist in upgrading their technical operations and reducing costs.	<u>10</u>
Total	<u>150</u>

5.08 The funds (US\$5 million) made available to BOI/MTI would be used to finance the following:

	<u>US\$ million</u>
(a) <u>setting up of sectorwide training facilities/</u> <u>programs</u> )	
(b) <u>training of BOI and MTI staff; and</u> )	3
(c) <u>consulting services to BOI/MTI to assist</u> <u>in implementing the sector restructuring</u> <u>program and specific technical studies to</u> <u>benefit the entire industry.</u>	<u>2</u>
Total	<u>5</u>

Training required for DBP staff involved in evaluation, and supervision of subprojects, will be financed from DBP's own resources.

5.09 The allocations of the proposed loan shown in paras. 5.07 and 5.08 have been agreed with BOI and DBP.

5.10 The US\$150 million onlent to DBP, which would finance about one third of the total sector requirements through 1985 (para. 5.05) during a three-to-four-year period, would cover approved investment in the textile industry that meet the BOI's general sectoral restructuring criteria (para. 5.24). In accordance with the set of investment priorities agreed with the Government (para. 3.41), and in consideration of equipment for which bilateral financing will not be available, this loan component is expected to be utilized by the various subsectors as shown below. These figures are indicative only and will not be treated as rigid categories.

Expected Utilization by the Subsector  
(US\$ Million)

	<u>Rehabilitation</u>	<u>New Investment</u>	<u>Total</u>
Spinning	35	13	48
Weaving	60	12	72
Knitting	-	-	-
Texturizing	-	-	-
Finishing	<u>5</u>	<u>25</u>	<u>30</u>
	<u>100</u>	<u>50</u>	<u>150 a/</u>

a/ Including technical assistance and training requirements.

5.11 The BOI with the assistance of a training consultant has prepared a manpower development study. 1/ This study was based on information received from textile mills in response to detailed questionnaires circulated by the consultant, from field visits and from discussions with a large number of mills and local and foreign educational/training institutions. It contains recommendations regarding the training needs of the sector; suitable programs for training textile manpower (managers, technologists, supervisors, technicians, and operators) at both industry and firm levels; facilities required for carrying out such programs; and related detailed cost estimates. Training requirements and technical assistance at firm level (para. 5.07 (b)) will be evaluated for each subproject and will address not only requirements for the new investment, but also for upgrading current operations. It is estimated that these requirements will cost about US\$10 million and will be financed from Bank funds onlent to DBP (para. 5.07). Sectorwide training (para. 5.08 (a)) will be basically directed towards training officers, trainers for mechanics and operators, loom mechanics as well as refresher courses for inpost technologists, supervisors, and technicians. The Philippine Textile Research Institute (PTRI) and its facilities, which lately came under the supervision of MTI, will play an important role in sectoral training. To supervise the implementation of all sectoral training activities, a textile training foundation has been established and is supported jointly by PTRI and the Textile Association of the Philippines. Additionally, the foundation will assist textile mills in the planning of their own training programs identification of potential sources for technical assistance, and placement of

1/ The study, "Manpower Development Plan for the Textile Industry 1981-86", is included in the Project File.

trainees in foreign training institutions. The duration of this activity will be about three years and is estimated to cost about US\$3 million. The manpower development study was reviewed and discussed with BOI and found to be satisfactory. With respect to the training of BOI and MTI staff (para. 5.08 (b)), the BOI has prepared a proposal for training of its staff responsible for implementing the sector program; this was reviewed by the Bank and found reasonable.

5.12 The Consulting Services to BOI/MTI (para. 5.08(c)) mainly consists of two separate categories of consulting services: (a) consultants who will be employed by BOI to assist both BOI and DBP in continuing their sector planning, evaluating projects for inclusion in the sector program, project supervision and monitoring the impact of the program, as further discussed in para. 5.20; and (b) those who would be hired to carry out specific studies intended for improving the overall performance of the industry. These studies will include, but not be limited to energy conservation, possibilities of local manufacture of textile machinery accessories and effluent treatment. It is estimated that the above technical assistance will provide for about 200 man-months of consulting services for a total cost of about US\$2 million at an average cost of US\$10,000 per man-month including travel and lodging expenses.

### C. Implementation

#### 1. Project Organization

5.13 The proposed Project will be implemented jointly by the BOI and DBP. The BOI will be responsible for approving subprojects for incorporation in the sector program and for eligibility for investment incentives. DBP will approve and provide finance to the subprojects provided that normal credit conditions are met by the subproject sponsors and that the subprojects are financially and economically viable. The MTI will also be involved in coordinating the associated policy changes in tariffs and import liberalization.

5.14 The BOI, as the Government agency in charge of the implementation of investment laws, has extensive experience in dealing with the industry through approving projects for eligibility for incentives and in monitoring the performance of projects for which incentive privileges have been awarded. However, because of the complexity of the restructuring program, BOI decided to strengthen its technical and market analysis capabilities in project evaluation, project supervision and program monitoring through the use of expatriate consultants (para. 5.12 and 5.20). As detailed in paras. 5.16-5.18, DBP is by far the most important lender of long-term finance to the Philippines textile industry, and has long been associated with the Bank through a number of loans for industry, shipping, agriculture and fisheries.

5.15 As elaborated in paragraphs 5.23 to 5.27, the evaluation of the subprojects included in the sector program will be carried out in two phases. The first phase will cover all technical, managerial, marketing and economic aspects of the proposed subprojects and will be carried out jointly by BOI and DBP. The second phase which will involve detailed financial and economic evaluation of these subprojects, as well as the financial position and performance of the sponsors, will be carried out by DBP only. Final decision on

subproject finance will rest with DBP (para. 5.27). The joint evaluation arrangement will ensure that both BOI and DBP personnel involved will benefit from the consulting services (to BOI) in those aspects where they both need substantial assistance, and that approved subprojects meeting the sectoral restructuring criteria will have ready access to finance. A joint DBP/BOI evaluation unit has been set up for this purpose. Details of the working procedures of the unit have been reviewed with the BOI and DBP and are satisfactory.

## 2. DBP and its Involvement in the Textile Sector

5.16 DBP was established in 1958 as an autonomous Government-owned development bank whose financing operations (loans, equity and guarantees) cover almost all segments of the economy. The bulk of its financing, however, has gone to the private industrial sector, ranging from small to large-scale enterprises. DBP is by far the largest supplier of long-term credit. At the end of 1979, its total assets of P 22 billion (about US\$2.7 billion equivalent) represented about 11% of the total assets of the financial sector, and its long-term portfolio of P 12.8 billion accounted for about half of the total outstanding long-term credit of the financial sector.

5.17 DBP has been associated with the Bank for more than a decade, through a number of loans for agriculture, industry, and transportation including three DFC loans totalling US\$205 million. DBP is also the most important recipient of the US\$150 million Industrial Finance Loan approved by the Bank's Executive Directors in May 1981. Although DBP has made substantial progress in strengthening its institutional capabilities and financial position, it continues to have a number of organizational, operational and financial problems. These were discussed in the SAR on the Industrial Finance Project and a "Program of Action" was formulated to address them. <sup>1/</sup> DBP was required to carry out certain elements of this "Action Program" prior to its accreditation under the Industrial Finance Loan. As of August 1981, these requirements have been fulfilled. Other elements of the "Action Program" are being implemented under close supervision of the Central Bank. Implementation progress of these elements is satisfactory.

5.18 DBP is a major lender to the textile and garment industry. As of February 29, 1980, DBP had made loans or guarantees to 101 textile/garment firms for a total amount (net of repayment) of P 1,943 million (about US\$240 million). Of these projects, 48 were loans above P 3 million each (about US\$0.4 million) and handled by the Industrial Projects Department I (IPD-I), with the remainder handled by the Industrial Projects Department II. DBP currently has 25 projects for the textile and garment industry in its pipeline (excluding those awaiting approval by the BOI), namely, 18 for garments, 6 for textiles, and one integrated project.

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<sup>1/</sup> Staff Appraisal Report on the Industrial Finance Loan to the Republic of the Philippines. Report No. 3331-PH, April 7, 1981.

DBP Textile/Garment Portfolio as of February 29, 1980  
(P million)

	<u>Textiles/Garment a/</u>	<u>All Industry</u>	<u>Proportion (%)</u>
Loans and Advance	1,852.5	7,687	24.1
Guarantees	90	3,233	16.3

a/ Including synthetic fibers  
Source: DBP

5.19 IPD-I, which now handles DBP's textile projects, has some 65 professional staff (40 financial analysts and 25 engineers) directly involved in project evaluation and supervision. Although IPD-I does not have any textile engineer, most of its technical staff have gained on-the-job experience in processing textile projects. Nevertheless, for a program of this magnitude and complexity, substantial technical assistance will be required, particularly with regard to market analysis, project design, capital cost estimate and assumptions on realistic production buildup and sales. The consultants to be employed to assist the BOI/DBP project evaluation unit (para. 5.12) are expected to strengthen IPD-I in these areas. The proposed Project will help improve the capability of DBP staff responsible for textile projects through training, including on-the-job training with textile consultants in project evaluation as well as supervision. Additionally, DBP staff will keep up with developments in the industry through overseas visits to textile mills, machinery manufacturers, trade fairs as well as potential markets. DBP has prepared a training program for its staff and this was reviewed with the Bank and is satisfactory. The quality of IPD-I's appraisal reports on textile projects have improved steadily, but there is room for further improvement in the methodology used for financial and economic evaluation. Possible improvements have been discussed with IPD-I and will be followed up during project supervision.

3. Technical Assistance to BOI/DBP

5.20 As discussed in para. 5.12, consulting services will be required to (a) assist in the evaluation of projects under the sector program for approval by the BOI and DBP, with particular regard to technical, market and economic aspects; (b) assess the manpower requirements and formulate a suitable training program to meet the needs of the industry; (c) identify areas for further study, where significant improvement in the overall performance of the industry could be realized, and prepare detailed terms of reference for and supervise the implementation of these studies; and (d) develop and implement an information system to assess the state of the textile and garment industry, monitor its development and evaluate the impact of Government policy actions undertaken as part of the sector restructuring program. Details of these

Terms of Reference (TOR) are shown in Annex 5. The TOR specify that a professionally qualified textile consulting firm, with textile company operating experience or with close association with manufacturing companies, is required for the above service.

5.21 Since the consultants will play a vital role in the implementation of the sector program, it is essential that BOI employ a consulting firm with textile operating and engineering experience or in close association with manufacturing companies and that the consultancy services must include five specialists (spinning, weaving, finishing, training and marketing) and a financial/economic consultant. It is envisaged that the services of the spinning, weaving, finishing, and training specialists will be required until project completion. The marketing specialist would be required for an initial period (about 6 months) mainly to assess the overall market for textile products and to assist in the market evaluation of subprojects, and thereafter, employed on a retainer basis to advise on market aspects of subprojects under evaluation. The financial/economic consultant would be needed to assist and train BOI/DBP staff in the evaluation of subprojects under the program, and to set up systems to monitor the impact of the textile restructuring program (para. 5.20). The team leader of the consulting team would be responsible for the coordination of all individual consultants' work under the overall supervision of BOI.

5.22 It has been agreed that the Government will employ, until project completion, consultants whose composition, selection, qualifications, experience and terms and conditions of employment are satisfactory to the Bank in accordance with the Guidelines for the Use of Consultants by World Bank Borrowers and by the World Bank as Executing Agency, August 1981. The BOI has recently appointed Tootal International of the U.K. as consultants on terms and conditions acceptable to the Bank.

#### 4. Processing of Subloans

5.23 The processing of subloans will involve two main phases of evaluations: (i) in the first phase, which will be handled jointly by BOI and DBP, it will be determined if the proposal is consistent with sectoral restructuring criteria and technically and economically sound. Once projects have passed this stage and are approved by the Board of Governors of BOI, they will be eligible for the BOI investment incentives and (ii) in the second phase which will be handled by DBP, projects will mainly be subject to complete financial and economic evaluation with an emphasis on risk analysis by DBP on a case-by-case basis. Once projects are approved by DBP Board of Directors, they will be eligible for finance. Certain projects which may pass the first phase of evaluation may not necessarily be eligible for DBP finance. Projects could be financed from other sources, but they will still have to be approved by the BOI if they wish to receive incentives.

(a) First Phase Evaluation

5.24 In this phase, preliminary screening of individual projects will be carried out with emphasis on (i) compliance of proposal with evaluation requirements of BOI/DBP under the program and for which a checklist is available for project sponsors; and (ii) conformity of proposal with the objectives under the technical and structural changes of the program. The General Guidelines for these changes which were established following the Inter-Agency Committee Report and discussions with the Bank and BOI are:

Spinning

- priority will be given to projects resulting in greater specialization by product or process;
- spindles for rehabilitation should be no older than 1960;
- projects should reach a specified economic size, taking into account spindle numbers, average counts and ring diameters.

Weaving

- priority will be given to projects resulting in greater product specialization;
- looms of pre-1951 vintage will not be rehabilitated. New/modernized looms should have a minimum width of 60" and at least 200 picks per minute;
- projects should reach a specified economic size dependent on nature of product mix, loom width and geographical location.

Knitting

- new knitting machines will be of gauges 24 and above geared to export of full fashioned knitwear.

The BOI has also drawn up guidelines for capacities needed in producing the types of yarn and fabric estimated to meet the 1985 demand pattern (Project File). These guidelines are intended not to restrict entry of viable firms into the industry but rather to ensure that unduly excessive capacity does not develop in the industry.

5.25 As well as meeting the above guidelines, each mill will be asked to submit a detailed plan to ensure efficient operations. This plan will include actions to be taken to increase productivity and reduce cost, and where appropriate to achieve targets for exports, both directly and indirectly through garment exporters. It will also include facilities for staff training, and requirements for expatriate technical assistance for plant operations.

5.26 Once a proposal for rehabilitation or new investment has passed the screening process, it will be subjected to further evaluation which will involve study of markets for project output, organizational structure, technical details and a preliminary financial and economic analysis of the project, as well as an evaluation of financial position and prospects of the project sponsor. The consultants hired to assist the BOI will help in this evaluation. Particular areas where the consultants's expertise will be most useful include market analysis, assessing the technical aspects of project design, assistance in choice of equipment for the projects, and reviewing capital costs, especially equipment prices. Special attention will be paid to the choice of technology for new projects to ensure that excessive capital-intensity is avoided. Where possible, project sponsors will be encouraged through additional incentives offered by the BOI for decentralization to locate outside Manila. An appraisal report will then be prepared for consideration by BOI (para. 5.23). Approved projects will subsequently be evaluated by DBP.

(b) Second Phase Evaluation

5.27 As stated in para. 5.23, DBP will be responsible for subsequent detailed project evaluation. DBP already has the skills to calculate economic and financial rates of return, and these will be computed for each project to serve as indicators of economic and financial viability. As a guideline, subprojects yielding ERR of less than 15% will not be eligible for finance under this program. Also, sub-borrowers will be required to contribute a minimum of 25% in equity towards subproject cost. Furthermore, DBP will assess the financial viability of sub-projects based on a maximum nominal tariff of 30%. The BOI/DBP Unit will also review the status of approved projects, both during construction and operation. This will help to ensure that projects are operating smoothly and will assist in identifying and overcoming problems that might arise. Experience gained during supervision could be also useful in improving the evaluation process itself.

5. Procurement and Disbursement

5.28 For items to be financed from the proposed Bank loan, DBP would require sub-borrowers to follow International Competitive Bidding (ICB) procedures consistent with the World Bank procurement guidelines for contracts exceeding US\$1.5 million equivalent; contracts below US\$1.5 million equivalent would be awarded following competitive bidding from suppliers registered with BOI and from at least three Bank member countries, Switzerland and from Taiwan. DBP has recently revised its procurement guidelines in light of the new Presidential Decree No. 1764 (dated January 11, 1981, on Regulations and Instructions on International Competitive Bidding for Major Industrial Projects), setting out regulations and instructions on ICB, as well as its internal reorganizations which would directly affect its administration of procurement. The Bank has reviewed these new guidelines which are not in conflict with Bank procurement procedures or the monetary limits shown above. Consultants for special studies (para. 5.12) will be employed in accordance with Bank Guidelines for the Use of Consultants, August 1981. For items to be financed from bilateral sources--mainly new spinning and weaving equipment, procurement is restricted to a small number of suppliers for standardization and bulk purchase purposes.

5.29 The proceeds of the proposed loan will be used to finance 100% of CIF costs of imported equipment; and 100% of foreign exchange cost of erection, consulting services and training. An indicative disbursement schedule of the proposed loan is shown in Annex 5-2. This schedule is estimated on the basis of the disbursement profile of previous Banks loans to industry in the Philippines. The closing date will be December 31, 1988.

D. Features of the Proposed Loan

1. Relending Terms

5.30 Under the ongoing Industrial Finance Loan, the Central Bank on-lends the proceeds of the Bank Loan to the participating financial institutions (PFIs), such as DBP, at an interest rate at least equivalent to the interest rate charged by the Bank plus a service fee of not less than 0.75% per annum. The PFIs in turn on-lend the proceeds of the Bank funds to end-users with a maximum spread of 4.5%. Under that loan it was also agreed that the Central Bank would review every six months the lending rates of the PFIs and, if necessary, revise its own on-lending rate on uncommitted Bank funds so as to allow the PFIs to charge lending rates more closely in line with market rates.

5.31 With regard to the proposed loan, DBP will charge the end-users the prevailing market rate in line with the lending criteria adopted under the Industrial Finance Project. Also, to conform with the general lending terms under that project, the Government will on-lend the Bank funds to DBP at an interest rate that will allow DBP a spread not exceeding 4.5% but not less than 2.5% to cover its overhead expenses and credit risk. This on-lending rate which would not be less than the interest rate charged by the Bank on the proposed loan will be subject to periodic reviews by the Government and will be adjusted, if necessary, in tandem with the interest rate to end-users, so that the latter would closely reflect market rates (para. 5.30). The margin between this on-lending rate and the Bank rate would accrue to the Government for the recovery of the costs of training and technical assistance to be provided by the Government through BOI/MTI (para. 5.08). The DBP, in addition, will be charged a front end fee of 1.5% on the onlent amount and a commitment fee of 0.75% on the undisbursed portion of the onlent amount. These fees will be passed on to DBP sub-borrowers. The subproject funds (para. 5.10) will be onlent from the Government to DBP under a subsidiary loan agreement acceptable to the Bank and its signing will be a condition of effectiveness.

2. Amortization Schedule

5.32 The Government would repay the proposed loan to the Bank in accordance with standard country terms, i.e., over 20 years including a grace period of 5 years. Such repayment is justified in view of the country's needs for substantial long-term funds to blend with shorter term borrowings for the restructuring of the textile sector. DBP, however, will repay to the Government the onlent amount in accordance with a flexible amortization schedule, which will correspond to the aggregate amortization schedule of its subloans to end-users. It is expected that such subloans will have a maximum maturity

of 15 years, with most having maturities ranging from 6 to 12 years. A flexible grace period will be allowed so that DBP can blend these subloans with funds from other sources, such as suppliers' and buyers' credits and commercial loans, which can generally be expected to have shorter maturities and grace periods. Funds repaid by DBP to the Government in conformity with the subsidiary loan agreement would be credited to a special account that would be established in the Central Bank. Pending repayment to the Bank, these funds would be used to finance expenditures on rehabilitation and restructuring of industry. Quarterly reports will be submitted to the Bank on the utilization of these funds.

### 3. Free Limit

5.33 Subloans above the proposed free limit of US\$4 million will be reviewed by the Bank before approval. Subloans below this free limit will be reviewed ex-post. The proposed free limit would be higher than the existing free limit of US\$2 million for DBP under the Industrial Finance Project Loan, but justifiably so since (i) expert consultants will assist in appraising subprojects to ensure that they are viable and that they fit in well with the restructuring program already agreed with the Bank; and (ii) the Bank will review closely the work of the consultants particularly during initial stages. To acquaint the DBP/BOI team and its consultants with the Bank's review method as quickly as possible, the first three subprojects requiring loans over US\$2 million each will be reviewed by the Bank in Washington. Additionally, in consultation with DBP the Bank would revise, if necessary, the free limit in light of BOI/DBP's performance in evaluating subprojects.

### 4. Subloan Size

5.34 To ensure that the proceeds of the proposed loan are spread among an adequately large number of subprojects, it was agreed with the Government that subloans will have a ceiling of US\$8 million. However, Bank financing could exceed this ceiling in cases where a subproject installed cost is at least US\$25 million and has been reviewed in detail by the Bank and in such case the Bank may conduct its review of this project in the field.

### 5. Foreign Exchange Risk

5.35 The foreign exchange risk on the proceeds of the Bank funds on-lent to DBP will be borne by sub-borrowers. The Government will bear the foreign exchange risk on the balance of the Bank loan (US\$5 million) made available to BOI/MTI for technical assistance purposes.

### E. Environmental Impact

5.36 The Philippine Pollution Control Commission has set environmental guidelines for the textile industry. However, the existing powers to control effluent flows are not always applied and at times discharges are taking place, particularly in dyeing and finishing. The BOI and DBP are aware of

these problems and have undertaken to ensure that adequate pollution controls, in conformance with the national code, are installed and adhered to in approved projects. Mills will also be required to control emission of fibers and dust into the atmosphere to reduce workers' exposure to risk of respiratory disease. Technical assistance, which will be financed under the proposed Project (para. 5.08), will greatly assist the BOI, DBP and the industry itself in pinpointing areas of concern and devising measures to reduce pollution from textile operations. DBP has agreed that implementation of subprojects approved under this program will be carried out with due regard to ecological considerations and health hazards.

F. Benefits and Risk

5.37 This is the first Bank project of its type in the Philippines. It is being proposed because the textile sector, which is an important contributor to industrial output and employment, is in urgent need of substantial structural change. Bank financing will help the industry to adjust more smoothly to the new competitive situation. Through the proposed project, the major portion of the industry's production capacity would be modern and substantially more efficient: In spinning 75% of the installed capacity could become internationally competitive (from the present level of less than 25%), and in weaving 25% import substitution to garment exporters could also be possible (from the present negligible level). Nevertheless, the extent of efficiency and competitiveness that can be realized by the textile industry will depend on a number of other factors, such as the management capability of the millers and the improvement of the skill level of the workers. Further, the success of the project is not relying solely on the performance of individual entrepreneurs and their projects, but on a combination of significant policy changes, the administrative effort by the BOI, MTI, and DBP, and the efforts of the textile industry as a whole. This increased complexity adds to the difficulty of the Project.

5.38 The likely impact of the Project is difficult to evaluate because of the uncertain response of the industry. It is indeed hard to predict exactly how the industry will react to the project objectives during the current depressed state of the textile sector and the economy as a whole. Probably the biggest risk in the Project is that the proposed policy changes are not carried through in the face of increasing pressure from groups that are adversely affected. As the policy changes start to impact on the industry, such pressure will certainly increase, particularly from the least efficient firms. If the policy changes do not eventuate, the Project objectives will not be fully realized, to the extent that the industry would not strive to be as competitive as it possibly could and that some of the funds would act to bolster marginal firms, with no broader economic benefits.

5.39 The Project will impose a heavy administrative burden on the BOI, DBP and the MTI. They must coordinate the use of consultants to help the industry improve its efficiency. If such improvements are not forthcoming, disruptions in project implementation may occur which, in addition to social problems with displaced workers, could also jeopardize the textile industry restructuring program. Clearly defined working arrangement and procedures between BOI, DBP and the consultants (para. 5.15) will minimize this risk.

5.40 The protectionist trends towards textile exports from developing countries is not expected to pose a serious threat to the restructuring program. These trends are mainly directed to dominant exporters. Under the recently concluded Multi Fiber Agreement (MFA) for 1981-86 period, exporters from other developing countries are treated more favourably with regard to quota restrictions including growth rates. <sup>1/</sup> The Philippines is not a major textile exporter. In fact, the Philippine textile industry's direct exports of yarn and fabric are small and are unlikely to increase rapidly in the near future (para. 3.33), and accordingly there are no restrictions to their entry into developed countries' markets. By contrast, the garment industry has been growing at a rate of about 25% per year from 1970 to 1978, though from a very low base, but this growth rate has slowed down to about 15% per year since. Despite the fact that export quotas are envisaged to grow at only 4-6% per year between 1982-86, the export growth could grow at a significantly faster rate as the available quotas are still underutilized. Furthermore, there is considerable possibility for increasing the value added of exports by increasing the backward linkage to the domestic textile industry. As mentioned in para. 2.06, garment exports are largely based on imported fabrics with little value added and little backward linkage to the domestic textile industry. One of the objectives of the restructuring program is to induce this backward linkage. Although up to 50% should be technically feasible (para. 3.33) if the restructuring program achieves its objective of improving quality and reducing cost of domestic production, it is assumed that only about 25% of the fabrics imported in 1979 will be replaced by domestic production by 1985. For this reason, the limited growth in garment quotas is not, therefore, expected to affect the growth of these indirect textile exports.

#### G. Project Monitoring

5.41 Besides substantial inputs by Bank staff during subproject reviews at headquarters and periodic field supervision, consultants employed under the proposed loan will also be required to monitor the implementation of the sector restructuring program. Their services will include the development of an information system to periodically assess the state of the textile and garment industry and monitor its developments including markets, industry structure and performance, and price and cost structures. This information will be used to evaluate the impact of government policies and programs. Consultants will prepare monthly reports on the program's progress and their recommendations for submission to BOI/DBP and the Bank. Upon project completion, BOI/DBP with the assistance of the consultants, will prepare a final report detailing overall results achieved under this program.

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<sup>1/</sup> Article 6 of the new MFA states that: "In recognition of the obligation of the participating countries to pay special attention to the needs of the developing countries, it shall be considered appropriate and consistent with equity obligations for those importing countries which apply restrictions under this Arrangement affecting the trade of developing countries to provide more favorable terms with regard to such restrictions, including elements such as base level and growth rates, than for other countries".

VI. AGREEMENTS

6.01 Agreements were reached with the Government on the following points:

- (i) that the restructuring of the textile sector will be in accordance with its Statements of the Development Policy for the sector restructuring program (para. 4.23);
- (ii) that BOI shall retain, until project completion qualified and experienced consultants on terms and conditions satisfactory to the Bank (para. 5.22);
- (iii) that consultants required for special studies will be employed in accordance with the Bank Guidelines for the use of Consultants, August 1981 (para. 5.28).

6.02 Agreements were reached with the Development Bank of the Philippines that:

- (i) subprojects eligible for financing would have a minimum ERR of 15% (para. 5.27);
- (ii) sub-borrowers will be required to contribute a minimum of 25% in equity towards subproject costs (para. 5.27);
- (iii) assessment of the financial viability of subprojects will be based on a maximum nominal tariff of 30% (para. 5.27);
- (iv) interest rate charged to sub-borrowers to be based on prevailing market rate (para. 5.31);
- (v) approved projects will be implemented with due regard to ecological considerations and occupational hazards (para. 5.36);
- (vi) it will submit progress and completion reports on the project in a timely manner (para. 5.41).

6.03 Signing of the subsidiary loan agreement between the Government and DBP, on terms and conditions satisfactory to the Bank, would be a condition of effectiveness of the loan (para. 5.31).

6.04 Based on the abovementioned agreements, the Project provides a satisfactory basis for a Bank loan of US\$157.4 million to the Government (including front end fee of about US\$2.4 million), of which US\$150 million to be onlent through DBP to textile companies fulfilling the requirements of the textile sector restructuring program, and US\$5 million to be utilized by the Government (BOI-MTI) to finance sectoral training programs and technical assistance and studies, which would benefit the entire sector.

## PHILIPPINES - TEXTILE SECTOR RESTRUCTURING PROJECT

 SECTORAL COMPOSITION OF MANUFACTURING  
 (Value Added in P Million at Constant 1972 Prices)

	1970		1973		1978		1979	
	Value Added	%						
<u>Consumer Goods</u>	<u>6,379</u>	<u>53.9</u>	<u>7,669</u>	<u>50.3</u>	<u>10,200</u>	<u>50.8</u>	<u>10,651</u>	<u>50.5</u>
Food	3,552	30.0	3,871	25.4	5,032	25.1	5,263	24.8
Beverages and Tobacco	1,393	11.8	2,049	13.4	2,701	13.5	2,763	13.1
Textiles	695	5.9	852	5.6	1,249	6.2	1,329	6.3
Apparel and Leather	477	4.0	538	3.7	783	3.9	870	4.1
Printing and Publishing	262	2.2	339	2.2	435	2.2	456	2.2
<u>Intermediate Goods</u>	<u>4,159</u>	<u>35.2</u>	<u>6,174</u>	<u>40.4</u>	<u>7,776</u>	<u>38.8</u>	<u>8,262</u>	<u>39.1</u>
Paper and Paper Products	341	2.9	420	2.8	547	2.7	560	2.6
Wood and Cork Products	497	4.2	627	4.1	715	3.6	804	3.8
Chemicals and Rubber Products	1,096	9.3	2,232	14.6	3,434	17.2	3,639	17.3
Petroleum Nonmetallic Mineral Products	858	7.3	1,358	8.9	1,108	5.5	1,141	5.4
Basic Metals and Metal Products	394	3.2	597	3.9	665	3.3	717	3.4
Metal Products	872	7.3	940	6.1	1,307	6.5	1,401	6.6
<u>Durable and Capital Goods</u>	<u>1,029</u>	<u>8.7</u>	<u>1,143</u>	<u>7.6</u>	<u>1,806</u>	<u>9.0</u>	<u>1,912</u>	<u>9.0</u>
Machinery	532	4.5	582	3.9	809	4.0	912	4.3
Transport Equipment	497	4.2	561	3.7	997	5.0	1,000	4.7
<u>Miscellaneous</u>	<u>256</u>	<u>2.2</u>	<u>266</u>	<u>1.7</u>	<u>284</u>	<u>1.4</u>	<u>291</u>	<u>1.4</u>
TOTAL	<u>11,823</u>	<u>100.0</u>	<u>15,252</u>	<u>100.0</u>	<u>20,066</u>	<u>100.0</u>	<u>21,146</u>	<u>100.0</u>

Source: NEDA

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TEXTILE SECTOR RESTRUCTURING PROJECT

INVESTMENT REQUIREMENTS FOR THE TEXTILE INDUSTRY

The investment requirements up to 1985 were determined by taking into account the estimated demand for the various types of textile yarns and fabric. Assumptions were then made about the rehabilitation and expansion needs of the existing industry to meet that demand. These were then used as a base for the investment requirement estimates, assuming reasonable productivity increases forthcoming from the sector program and operating practices common in other countries in the region, such as Taiwan. Spindles/looms requirements to meet 1985 demand are shown below:

SPINDLES AND LOOMS REQUIREMENTS TO MEET DEMAND IN 1985

	<u>Status in 1979</u>		<u>Requirements by 1985</u>	
	<u>No. of Spindles/Looms</u>	<u>Production ('000 ton)</u>	<u>No. of Spindles/Looms</u>	<u>Capacity ('000 ton)</u>
<b>A. Spinning</b>				
Pre-1960	504,000 spindles)		-	
1960-1970	241,000 )	90.3	241,000 spindles	35.5
1971-1978	218,000 )		218,000	27.5
1979-1980	170,000 )		170,000	23.1
Additional			<u>404,000</u>	<u>54.9</u>
Total	1,133,000	90.3	1,033,000	141.0
<b>B. Weaving</b>				
Pre-1951	916 looms )		-	-
1951-1960	12,006 )	75.0	12,006 looms )	74.7
1961-1970	4,052 )		4,052 )	
1971-1980	3,880 )		3,880	18.0
Additional			<u>2,350</u>	<u>17.8</u>
Total	20,854	75.0	22,288	110.5

For spinning, it was assumed that most pre-1960 spindles would be scrapped by 1985, and that most spindles installed between 1960 and 1970 would be rehabilitated. Costs of US\$300 per new spindle and US\$100 for rehabilitation were used in determining investment costs.

For weaving, pre-1951 looms were regarded as too slow and narrow. The 16,000 pre-1970 looms should be rehabilitated at a cost of US\$2-5,000 per loom. Additional costs were estimated for weaving preparation equipment and for air conditioning.

For texturizing, some investment is needed to produce pre-oriented yarns, but existing excess capacity means that other investment requirements are negligible.

In finishing, capacity is already underutilized, but product specialization in the industry will require some balancing changes in dyeing, printing and finishing capacity.

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SCHEDULE TARIFF REDUCTIONS ON SELECTED TEXTILE ITEMS<sup>a/</sup>

Tariff Heading 20	Item	Rate of Duty (%)					
		1980	1981	1982	1983	1984	1985
55.01	Cotton	10	10	10	10	10	10
56.01	Discontinuous staple fiber Yarn of man-made fiber (not put up for retail sale)	30	30	30	20	20	20
55.05	Cotton Yarn (not put up for retail sale)	50	40	30	30	30	30
55.09	Cotton Woven Fabrics	70	60	50	40	40	40
56.07	Man-made Fiber Fabrics	70	60	50	40	40	40
60.01	Knitted Fabrics	50	40	40	40	40	40
61.63	Garments (most types)	100	90	80	70	60	50

<sup>a/</sup> In addition, there is a slight additional protective effect through a 10% sales tax which applies to both domestic production and imports, but which is charged to imports including a 25% mark up.

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NOMINAL AND EFFECTIVE RATES OF PROTECTION<sup>a/</sup> UNDER INITIAL AND PROPOSED TARIFF RATES (%)

Product	Initial 1980 Tariff	Eventual Reduced Tariff	Effective Protection	
			Now	After Reduction
Fiber - man-made	30	20	90	50
Yarn	50	30	150	75
Fabric	70	40	157	83
Garments	100	50	170	73

a/ Estimated by the mission from returns of actual firms.

These rates are indicative only and show the differences resulting from proposed tariff reductions. They are for the domestic market only. If exports were taken into account, industry effective protection would be lower.

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VALUE OF INCENTIVES TO THE TEXTILE AND GARMENT INDUSTRIES  
1976-1979 (P million)

	<u>Investment Incentives Act</u>		<u>Export Incentives Act</u>		
	<u>Textiles</u>	<u>Total</u>	<u>Textiles</u>	<u>Garments</u>	<u>Total</u>
<u>Deduction from taxable income</u>					
1979	14.7	483.4	8.0	17.0	387.6
1978	11.4	469.9	11.7	29.9	283.7
1977	23.8	323.8	11.7	33.1	263.8
1976	16.8	379.6	4.0	17.2	112.7
<u>Tax exemptions</u>					
1979	1.4	120.0	1.5	3.3	36.7
1978	0.5	173.9	11.2	2.9	111.4
1977	4.9	181.4	1.8	4.2	28.5
1976	9.4	170.0	0.8	11.1	20.8
<u>Tax credits</u>					
1979	0.7	79.8	0.1	16.3	28.2
1978	0.5	48.0	21.8	9.8	47.4
1977	0.5	42.4	na	na	na
1976	0.5	11.8	na	na	na

Source: BOI

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TEXTILE SECTOR RESTRUCTURING PROJECT

STATEMENT OF THE DEVELOPMENT POLICY

I. Industrial Development Policy

The Philippine holds industrialization as one of the main tools for economic development. Since the adoption of an industrial policy geared towards self-reliance during the post war years, industry has gradually emerged and developed to its present state. Latest statistics show that for 1979, industry contributed 35.0 percent of the GDP. 25.2 percent of this was from manufacturing which also accounted for 30 percent of the fixed investment and 12 percent of the total employment. In spite of these achievements, however, there is still much to be desired of industry if it will have to be evaluated in the context of the new industrial thrust of competitiveness in the international market.

Previous Industrial Policy

The industrial policy that was adopted during the post war period emphasized the manufacture of import substitute products and consisted of tariffs, import regulations and a system of fiscal and financial incentives directed towards the industry. The nominal tariff rates adopted ranged from 10-100% with highest rates for consumer goods. On the contrary, the export industries receive a lower effective protection rate of only 4%.

This tariff protection of the domestic market has been further reinforced by an extensive system of import licensing administered by the Central Bank. Under this system, import of certain commodities classified as luxuries are prohibited. Imports of a number of intermediate goods which are used primarily as inputs to local industry are also regulated to protect the local manufacturer.

The combination of tariffs and import restrictions led to inefficient use and allocation of resources. Emphasis was on the production of consumer goods previously being imported at the expense of producer goods and exports. The lack of competition from imports together with restrictions on entry into many important industries, allowed inefficient high cost producers to survive and added a substantial cost burden to the economy and the consumer.

Thrust of the New Industrial Policy

Aware of the shortcomings of the import substitution policy, the Government felt it necessary to redirect its present policies to emphasize export and world competitive orientation for industry. Although difficult,

it is an imperative move in order to improve the existing conditions of the industry. Particular attention will be paid to ensuring that industries, based on the country's comparative advantages of a relatively inexpensive, efficient sizeable work force and a substantial raw material base, operate at scales both efficient and competitive by world standards.

In order to effect this new thrust of industrialization, the Government has adopted the following policies that will induce development and likewise, support industry during the re-orientation period:

- Tariff reforms and deregulation of import restrictions to allow international and domestic market forces to play a greater role in the resource allocation of industry;
- Institution of industry management/development/modernization/rationalization programs to assist industries towards the adoption of technologies and scales of operations which are efficient and appropriate to the country's comparative advantage;
- Incentive reforms to encourage increased investments into priority areas, consistent with the overall national development objectives.

The textile industry is one of the first sectors where an industry restructuring program is being implemented. Attention has been drawn to this industry because of its important contributions to the industrial output and employment generation. This is further reinforced by its excellent potential as an export industry if it can be linked with the garment manufacturers which have been well on their way in export.

Industry statistics show that in 1978, gross value added was P2.7 billion for textile and P1.7 billion for apparel or about 9.8% of total gross value added in manufacturing. Employment levels reach 98,000 for textile and for garments, 120,000 out of a total of 778,000 for the manufacturing sector in 1978.

## II. Objectives of the Textile Restructuring Program

### Basic Problems of the Philippine Textile Industry

Over the past 25 years, the industry's level of performance indicated the lack of direction and the need to take definite steps to modernize the industry.

The present textile industry is faced with severe structural and operating problems. Production is concentrated in vertically integrated mills producing a wide range of products. This organization has been highly inefficient contributing to increased production costs and underutilized capacities of existing textile mills. Another major problem is the use of old and ill-maintained machineries and equipment by a big portion of the industry. This case is true specifically for the spinning and weaving subsectors wherein a number of the machineries were produced during the 50's. The run down state of the equipment results into higher fabric production cost.

Poor technical performance has cost the industry much in terms of increased operating costs. Quality control is often minimal and maintenance usually disregarded with consequent increase in downtime for repairs. There is also a shortage of qualified textile technologists and technicians, particularly mechanics and electricians. Such could be traced to the lack of adequate training which has resulted in the degradation of skills among the industry workers.

The structural problems in the industry could be traced to the industry's orientation immediately after the war. The institution of import controls have forced traders and importers to become manufacturers in order to stay in business. Integrated mills producing a variety of products were set up to meet the capricious market demand developed when main reliance was on imports. Very limited competition among domestic producers, in combination with import controls, reinforced the tendency towards vertical integration as firms could not be sure of obtaining inputs at reasonable prices and quality from either the domestic or international markets.

Resulting from these is an industry which can only exist in a highly protected domestic market. Tariff rates for yarn before 1981 were 30-50 percent, fabrics 50-70 percent and garments 100 percent. Aside from the tariffs, import restrictions are being implemented by the Central Bank together with other Government agencies dealing with textiles and garments. The restrictions cover imports of raw materials, intermediate inputs such as spun yarn, fabrics and garments.

This situation has suited the domestic industry. Inefficient firms have survived while the more efficient ones are getting higher profits, without any fear of competition, because of restrictions on both expansion and entry. Quality has suffered considerably to the detriment of the consumers.

#### Program's Objectives

Against this industry background, the Government has formulated the Textile Restructuring Program which aims to achieve the following objectives:

- Transform, by 1985, the existing textile industry into a competitive and efficient industry able to produce at prices and quality comparable to imported textile products, in an environment of free entry into the industry and minimum protection.
- Achieve a greater degree of specialization, product and process wise for the industry's mills.
- To the extent possible, meet the requirements of the export market both direct and indirect, through the garment manufacturers.

The program will have components dealing explicitly with each of the industry's subsectors of spinning, weaving, knitting and finishing.

#### Program Priorities

Because of the substantial investments involved in the modernization of the identified subsectors, it is necessary to give priority to investments where returns are immediate and comparative advantage exists. Ranking of these priority areas are:

- (i) rehabilitation investment in both spinning and weaving;
- (ii) expansion in both existing spinning and weaving plants to an efficient size where economically feasible;
- (iii) new weaving investment;
- (iv) new spinning investments.

Finishing and knitting investments will be evaluated on a case to case basis depending on the requirement for the said subsectors. The BOI will allocate new capacities to successful proponents based on its Investments Priorities Plan. Existing firms who did not apply under the program will in general have to await the program's evaluation in 1985 before they can be allowed to participate in the program. However, in special cases, proposals which are consistent with the program will be considered.

In line with the 5-year tariff restructuring and trade liberalization policies currently being implemented, the time frame for the modernization program will be based on a five-year period starting 1981 and culminating in 1985. Awards for the supply of equipment from bids conducted last quarter of 1981 are expected to be made by mid 1982. Equipment deliveries and erection are expected by end-1982 and start-up operations in 1983. With the new equipment, increased efficiency and lower tariff rates for raw materials, it is envisioned that the industry will be competitive by 1985 in view of the conditions existing by that time.

### III. Policy Framework

#### Broad Policy Parameters

To allow a more competitive market condition for the local textile industry, the following policies are adopted:

1. Increased import competition through a reduction of tariffs for textile and garment.

In line with the overall tariff reforms, adjustments in rates of textile items are being effected in a 3-5 year period starting 1981. Coverage includes fibers, yarns, fabrics, garments and supplies. New rates are 50 percent for garments, 30 percent for yarns, 40 for fabrics and 20 for staple fibers by 1983.

These tariff reductions are being phased over a 3-5 year period to allow the industry to adjust gradually to a more competitive environment. The Government intends, for the period 1986-90, to further adjust the nominal tariff rates for the textile and garment industry in order to bring the effective rates of protection for this industry in line with the average for the manufacturing sector as a whole. To this end, the Government intends to formulate and adopt such tariff adjustments by the end of the restructuring program, i.e., by January 1, 1986.

2. Phased liberalization of import licensing on textile products.

Concomitant with the tariff adjustments, phased liberalization of import licensing is to be undertaken for the regulated textile items. Fabrics and textiles will be freely importable by 1984 while the same will be true for synthetic yarn and fiber come 1986.

The objective of the restructuring program is to allow the sector to eventually operate freely with only the protection afforded by tariffs.

3. Incentives and measure capacity.

Firms participating in the restructuring program will register with the BOI and become eligible for the investment incentives administered under Omnibus Investments Code. Modernization and rehabilitation projects will be entitled to the same set

of incentives as new textile investments. As part of its priority determination for the sector, the BOI has set a measured capacity for each subsector (i.e., spinning, weaving, etc.) to discourage over-investment. Incentives and financing under the program will not be awarded to additional projects when such capacity is reached. As the restructuring program is completed and the sector operating on a more competitive footing, "measured capacity" will be used only to limit the granting of fiscal incentives. Accordingly it is intended that the present regulation of the imports of textile machinery, equipment and spare parts will be removed by the end of the restructuring program, i.e., by January 1, 1986.

### Specific Policy Elements

Aside from these general industrial policies, specific ones have also been formulated for the textile mill proponents under the Textile Restructuring Program:

1. Increased production efficiency through proper use and conservation of energy.

With energy costs sharing 10-20% of the production costs specially for textile finishing, emphasis for its proper use will be given in existing mills and new undertakings related to rehabilitation and/or capacity expansion.

2. Emphasis on quality control measures will be required of program proponents to better product quality.

With the objective to penetrate the export market, more careful consideration will be placed on product quality comparative to those available in the world market. Strict adherence to product standards will be required of mills for their textile products.

3. Standardization of machinery equipment and spare parts to be used by the industry.

Standardization will result in cost savings through bulk purchases of spare parts and will deter the practice of misdeclaring the prices of equipment/parts purchases. Depending on the level attained, local production of equipment and/or accessories/parts may also become viable to the industry's benefit.

4. Training of industry personnel will be provided to increase productivity and efficiency.

A comprehensive training program formulated by the MTI/BOI and the DBP will serve as guide to the program proponents on what is expected of them to undertake in line with the policy of increased productivity.

For the Government institutions involved in the program, technical assistance will be given to make them more effective in implementing the said program. Further training will be given the MTI/BOI and DBP personnel on the aspects related to program supervision and monitoring. Consultants will be hired to render assistance on these areas as needed.

#### IV. Program Implementation

To maintain a closer supervision of textile mills included in the program, it is requisite that prospective participants register with the BOI under its priorities program. Incentives under the Omnibus Investment Code will be accorded all program participants in view of their BOI registration. Modernization and rehabilitation activities will be accorded similar BOI incentives as those of new investments.

Criteria covering management competence, financial standing, production and export performances will be used to screen program participants as these are deemed vital in gauging a proponent's ability.

Program applicants will submit for evaluation their project proposals which include action programs on increased productivity and reduction of costs. The applicants should also have plans for the specialization either by product or by processes and the standardization of equipment and spare parts. Program for man-power training to increase labor efficiency, energy conservation and pollution control are also additional requirements. These specific requirements will be detailed in the Specific Terms and Conditions requirement of the BOI registration.

To further promote and achieve product and/or process specialization, the BOI will set indicative optimum plant sizes for the spinning and weaving subsectors.

Since funding will be provided by the DBP and to avoid the duplication of evaluating the proposals, a joint BOI-DBP team will evaluate projects for inclusion in the program. The MTI/BOI will provide for the analysis of the technical, marketing and management aspect of individual proposals. Financial and economic aspects including credit worthiness will be handled by the DBP. Reports will be made to the respective BOI and DBP Boards for their individual approval of the applications. A full economic evaluation will be prepared for each proposal.

For purposes of facilitating the standardization of capital equipment and spare parts, the acquisition of such will be made to the extent possible through bulk purchases limiting sources to either 3 to 5 suppliers. The MTI/BOI/DBP, assisted by the hired consultants will identify the needed spare parts/equipment after which an international bidding will be arranged for their purchase.

On project supervision and program monitoring, the joint team of the MTI/BOI and DBP will also be involved, with assistance from the SAL consultants of the MOI. Eventually the MTI/BOI/DBP staff will handle fully the supervision and monitoring activities. Results of monitoring the program will be periodically evaluated to adjust the program features as needed.

The capabilities of the MTI/BOI/DBP as regards to their involvement in the program will be further augmented by additional training, not to mention increase in manpower. It is envisioned that a portion of the textile loan will be allocated for technical assistance to the institutions concerned and will involve personnel training in project analysis, supervision and monitoring. Portion of the funds would also be used to finance consultancy services to assist/train the BOI/MTI/DBP staff.

On the industry training, part of the technical assistance component could also be used to implement the training of industry operatives technicians, supervisors, technologists.

PHILIPPINES

TEXTILE SECTOR RESTRUCTURING PROJECT

TERMS OF REFERENCE FOR TECHNICAL AND ECONOMIC CONSULTING SERVICES  
TO THE BOARD OF INVESTMENTS (BOI) AND MINISTRY OF TRADE AND INDUSTRY (MTI)

Background

The Philippine Government, through the Ministry of Trade and Industry (MTI) and the Board of Investments (BOI), has been drawing up plans for implementing a sector program for the textile industry. The primary objective of this program is to assist the industry in rehabilitating/modernizing existing equipment and investing in new machinery and improving its operating efficiency, so as to meet competitively the future demands of both the domestic and export markets for fabric and garments. The program will involve policy changes, including reductions in tariffs and easing of import regulations; assistance to help the industry upgrade its technical operations; and finance for projects approved by the BOI, through financial institutions designated by the Government.

Due to the complexity of the program, the BOI and MTI intend to strengthen their capabilities in sectoral planning and assessing project proposals through additional assistance from consultants with suitable background and expertise, including whenever possible and desirable, joint ventures with local consultants. The completed textile industry development program would be made available to the consultants, as would the results of sector studies that have been conducted by the Philippine Government and the World Bank. A counterpart team of BOI/MTI and financial institution representatives will be appointed to work closely with the consultants.

Scope of Consultancy Work Required

Consulting assistance is required in four key areas:

1. In accordance with the guidelines set forth in the sector program, evaluation of project proposals for approval by the BOI, with special regard to the technical aspects, including building up the capabilities of the institutions involved with sector program implementation.
2. Assessment of the manpower requirements and formulation of a suitable training program to meet the needs of the
3. Identification of areas, where significant improvement in the overall performance of the industry could be realized,

for detailed study and preparation of detailed terms of reference for and supervision of the implementation of these studies. 1/

4. Monitoring the implementation of the sector program.

A. Evaluation of Projects

The BOI currently has on hand, for its consideration, some \_\_\_\_\_ project proposals from the industry and expects to receive further applications from time to time. The BOI intends to process the pending proposals as rapidly as practicable.

To assist the BOI in the evaluation of these proposals, the consultants will:

1. review and update annually the supply and demand projections for textiles for a moving period of at least five years, based on, among other considerations, past statistics; new investments planned in the sector; realistic forecasts of population growth and increase in per capita GNP; elasticity of demand for textiles products; and potential exports to EEC, North America, etc.;
2. determine the appropriateness of the proposed projects in the light of the above market study and the overall development strategy of the industry;
3. assess the viability of the plant designs (capacity, balancing, technology, layout infrastructures, services, etc.) and the suitability of the equipment chosen for the proposed projects, considering their employment generation capabilities and other factors;
4. review capital cost estimates with special regard to the price of equipment to ensure that prices quoted are appropriate;
5. investigate opportunities for cost savings in bulk purchasing of equipment, where similar equipment is required by a number of mills;
6. assist in the economic/financial analyses of the proposed projects, particularly with regard to assumptions on product mix, production buildups, prices of inputs and outputs as well as breakdown of operating costs;

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1/ Examples of such areas and guidelines for the terms of reference for these are shown in Attachment 1.

7. review the technical operations of the project sponsors' existing mills and, where appropriate, recommend the technical assistance and other steps necessary to improve the efficiency of the existing mills and to ensure that the proposed projects will be properly run upon completion. Special attention will be given to assessing the adequacy of the companies' programs and facilities for training and maintenance;
8. review the environmental and related health aspects of the proposed projects and evaluate/recommend measures for treatment or protection;
9. review the product mix, including in particular the desirability of specialized vs. integrated production facilities, and marketing arrangements of project sponsors;
10. review the raw material supply availability and the possibility of encouraging the development of industries supplying raw materials; and
11. considering the industrial dispersal objectives of the Government, review the decision of project sponsors regarding the location of new projects.

In addition, the consultants will:

1. draw up and help implement a training program in the project evaluation and supervision for the counterpart team composed of the staffs of the BOI and financial institutions to improve their technical evaluation capabilities; and
2. set up a system to enable the BOI and Philippine financial institutions to have access to information on changes in equipment availability, technology and cost, in coordination with the technology information system to be set up as part of the technical assistance component of the proposed World Bank structural adjustment loan.

B. Manpower Requirement and Training

Upgrading of manpower available to the industry, at all levels, through suitable training programs is vital for the industry to improve its efficiency. In this connection, a study is required to review the manpower situation, identify gaps and recommend specific training programs to meet the needs of the industry, particularly with regard to technologists, technicians, operators, and supervisors. It is envisaged that such training programs would be carried out at the sector level as well as in individual mills.

In carrying out the training study, the consultants will:

1. survey the present performance of operators, technicians, technologists, and supervisors;
2. identify areas of major weaknesses;
3. estimate the value of the effect of improved training in productivity and product quality;
4. appraise the training facilities currently or potentially available and, in particular, the contribution which might be made by the Philippines Textile Research Institute;
5. make detailed recommendations as to how adequate provision for training and further education may best be made both in the Philippines and abroad;
6. make detailed cost estimates of the various components for the program; and
7. draw up an implementation program.

Once the study has been reviewed and the recommendations accepted by the BOI/MTI, the consultants will be required to assist in the implementation of such recommendations, monitoring the results and recommending improvements in the program.

C. Other Studies for Improving Sector Performance

To improve the overall performance of the industry, the consultants will identify areas for further study. These areas will include, but not be limited to energy conservation, possibilities for local manufacture of accessories, and effluent treatment for which the consultants will prepare terms of reference based on the knowledge which they will acquire from plant visits (as part of their work on projects evaluation in Section A). Subsequently, they will assist the BOI/MTI in the supervision of these studies. (See Attachment 1.)

D. Monitoring the Implementation of the Sector Program

The consultants will assist the BOI and MTI to:

1. develop and help institute an information system to assess the state of the textile and garments industry, monitor its developments and evaluate the impact of government policies and programs. Taking into account the current status of the statistical system in the Philippines and the efforts currently being made to improve it in the longer term, the system will include information on:

- i. structure of the industry such as number, size and degree of integration of firms;
- ii. age and technology of machinery;
- iii. manpower;
- iv. demand and supply projection for both domestic and export prices;
- v. price trend and cost structure of major products and areas of likely cost reduction;
- vi. raw material requirements, as well as sources and prices of raw materials;
- vii. investment requirements for the various segments of the industry;
- viii. financial structure and performance of the industry;
- ix. sources and costs of financing for working and fixed capital and export financing.

This information should cover both firms registered with the BOI, and other nonregistered firms;

2. analyze and use this information base to monitor the impact of the policy actions undertaken as part of the sector program. This will include periodic studies of the cost structure of a number of major products produced by different firms and the potential for cost reductions and/or productivity improvements. These studies will be used to monitor the impact of tariff reductions on industry; and
3. review the financing needs of the industry particularly for export and suggest ways to improve access to finance in coordination with the general export finance study planned by the Government.

#### Consulting Team

Since the scope of work requires a wide range of consulting expertise, MTI/BOI intends to employ a professionally qualified textile consulting firm or institution with textile company operating experience or with close association with manufacturing companies as consultants. Such consulting firm should have extensive experience (preferably in developing countries) and with sufficient backup resources to cover all segments of the industry.

It is envisaged that the firm would provide the services of a number of technical experts, and industrial economists experienced in industrial planning and analysis of the impact of Government policy changes, an information system specialist, and training specialists. Some of these consultants will assist on a full time basis; others may work on a part-time basis as dictated by the need of their services. On the whole, the contract with the firm will be for a period of about three years. Consultancy services may involve collaboration with local consultants (as in the case of training specialists) both to hold down costs and to take advantage of locally available expertise. Consultants are encouraged, before submitting their proposals, to visit MTI/BOI to familiarize themselves with the nature and the scope of the required services.

#### Proposals of Consultants

Proposals should include the following information:

1. A brief description of the firm and outline of recent experience on studies of similar nature.
2. Any comments or suggestions of the consultants on the Terms of Reference, and a description of the manner in which the consultants would plan to execute the work.
3. The composition of the team of consultants which the firm would propose to provide and the tasks which would be assigned to each team member.
4. Curriculum vitae of each individual staff member to be assigned to the study and of staff in the home office who would be responsible for the supervision of the team.
5. Estimate of the time-effort required for the consulting services, supported by a bar-chart diagram showing the man-months for each expert.
6. The consultants' comments, if any, on the data, services and facilities to be provided by BOI/MTI.

The cost estimate for carrying out the consultants proposal should cover all foreign and local costs of consulting services for this study, including costs of experts in the field and home office. It should also indicate cost to be borne by the Government for international travel, office space, secretarial and other support staff, equipment, insurance, office supplies, housing and subsistence allowance and local transportation. Cost of preparing a proposal and of negotiating a contract including trips to the Philippines is not reimbursable for firms submitting proposals.

PHILIPPINES

BROAD GUIDELINES FOR STUDIES FOR IMPROVING  
TEXTILE SECTOR PERFORMANCE

The following areas are given as examples of where studies might usefully be conducted to improve sector performance. The guidelines are presented as suggestions as to the format for Terms of Reference for these studies.

1. Energy Conservation

Introduction

Textile manufacture involves a great deal of energy consumption. Mechanical energy (particularly in spinning) for the driving of machinery and direct thermal energy in dyeing and finishing are very important cost components. Escalation of the prices of oil in recent years have caused a great deal of attention to be directed to energy conservation. As a result, there are many new techniques and devices coming into use by means of which energy costs in manufacturing are being reduced. Consultants will be engaged to assess the situation and prepare action plans for improvement.

Term of Reference

The broad guidelines for the Terms of Reference for the study on the scope for energy conservation in the Philippines textile industry are as follows:

- a. Appraise the situation regarding energy conservation in relation to that being obtained in other countries;
- b. outline actions which might be taken to improve the situation and the likely outcome of such actions. It is expected that these will include the installation of heat-exchange devices wherever appropriate and also the use of integrated mechanical energy/thermal energy systems in which waste heat from mechanical and electrical power generation is used to meet thermal energy needs, particularly in dyeing and finishing. The value of supplementary instrumentation for the more precise monitoring of

energy usage in the various subprocesses of individual mills should also be appraised and guidelines established for the determination of realistic conservation targets in specific processes;

- c. carry out detailed cost benefit studies on an agreed list of actions which BOI regard as being both appropriate and practical in relation to industry views;
- d. resolve energy conservation issues that have to be faced, and prepare comprehensive plans for implementation of selected actions.

## 2. Local Manufacturers of Accessories

### Introduction:

Accessories are required in significant quantities. The cost of these is typically of the order of 10% of the replacement cost of the machinery of a mill and their nature is variable. Bobbins, pirns, and weavers' beams are not machine-specific, but over the whole of the industry the range of sizes used is wide. Drafting rollers, loom shuttles, and printing screens are highly machine-specific. To minimize the dependence of the industry on imported accessories and to the extent to which it is practical and economically worthwhile to produce these various categories of accessories within the Philippines depends on a number of factors of which quantity required, complexity of the component and the availability of suitable raw materials are the most important. Consultants would be engaged to study the situation, determine the extent to which accessories could profitably be locally produced.

### Terms of Reference

The broad Terms of Reference for such a consultancy are:

- a. Prepare an inventory of all important accessories used by the industry, quantities used and prices. Estimate the cost of delays and of stockholding to individual millers. Categorize these items in terms of cost to the industry;

- b. examine the feasibility of domestic manufacturing including assessment of existing local production capabilities for all items for which there is a prima facie case based on such factors as low material cost, noncriticality of technical performance and high total value;
- c. after reporting to BOI and industry representatives on the finding under (a) and (b) above and agreeing on a list of those items, the domestic manufacture of which should be considered in greater detail, prepare detailed costings for the manufacture and distribution of all items on the agreed list and relate these costs to present import prices and cost to the user. Arising out of this work, recommend which items should be made domestically and estimate the fixed capital and the working capital which would be needed, and possibly that they be included in the textile industry development program by BOI.

3. Effluent Treatment

Introduction

Operation of textile industry gives, in varying degrees, noise, air and water pollution. Of these, the latter two are the most far reaching in their consequences and the most dangerous from the health point of view. In both cases, the major source of pollution is effluent discharge - air from gaseous effluents, such as flue gases and rejected air, and water from the spent dye liquors and other discharges from chemical operations. Much research and development effort has been expended on these matters in recent years and there is now a considerable bank of experience on which developing countries may draw. Consultant advise is sought to determine the extent to which it may be worthwhile to control and limit environmental pollution by the industry.

Term of Reference

The broad Terms of Reference for such consultancy are:

- a. Survey the extent and importance of pollution resulting from effluent discharges by the textile industry. The survey should include both gaseous and liquid effluents, and a cost/benefit analysis of proposed pollution controls;

- b. report to BOI/MTI and discuss the situation with the appropriate officials with the object of determining the extent to which it is desirable that the regulations relating to effluent discharges be made more stringent;
- c. help formulate draft regulations;
- d. make recommendations as to how these regulations may be met. Equipment needs should be specified and both fixed capital and operating costs which enforcement of the regulation will incur should be estimated;
- e. prepare informative literature for the guidance of mill personnel who will be responsible for compliance with new regulations; and
- f. assist in the setting up/strengthening of the National Pollution Control Commission with particular concern for the technical problems which will be encountered.

PHILIPPINES

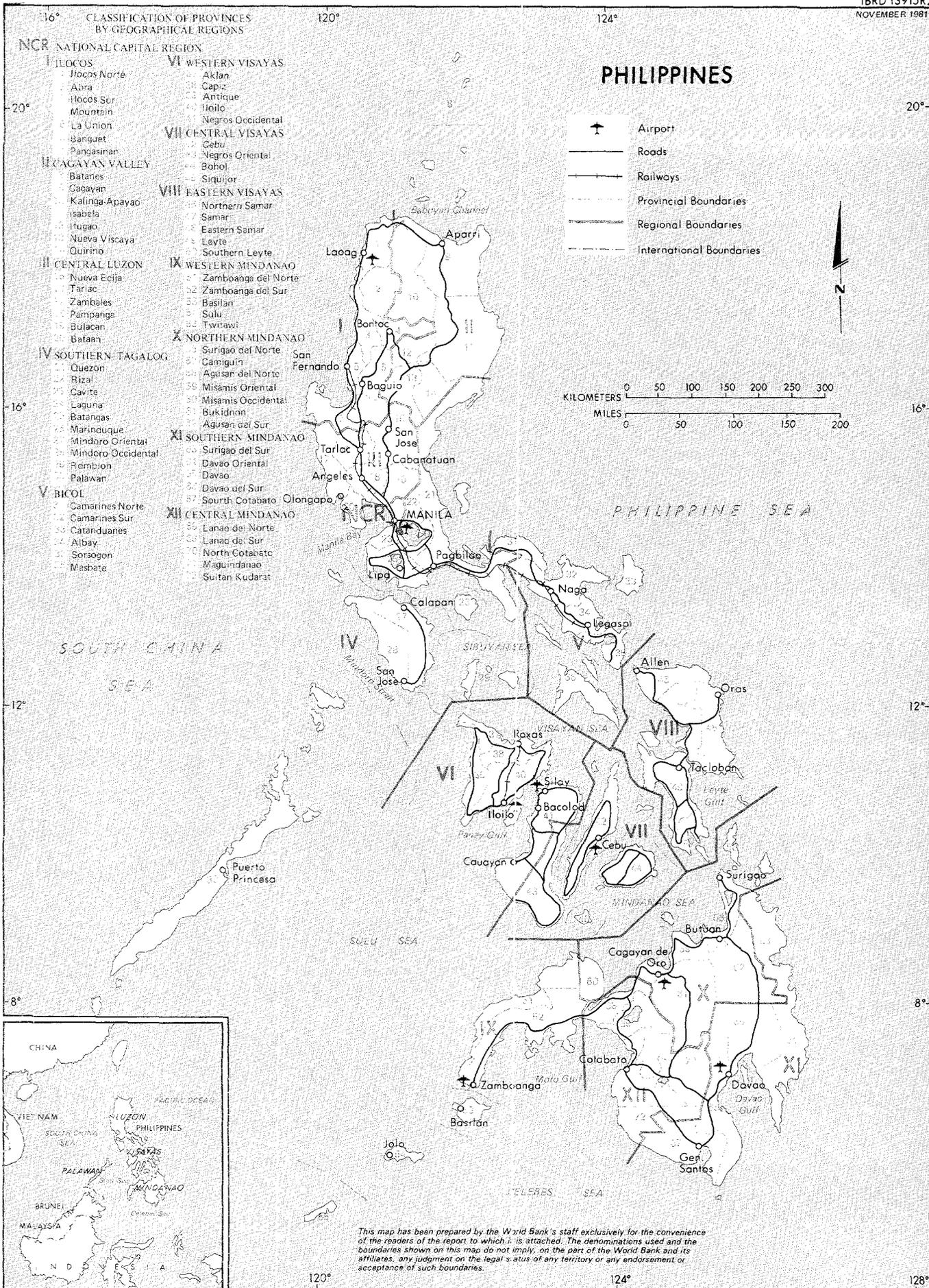
TEXTILE SECTOR RESTRUCTURING PROJECT

PROJECTED DISBURSEMENT SCHEDULE

(Excluding front end fee of about US\$2.4 million on Bank loan)

<u>Fiscal Year</u>	<u>Quarter</u>	<u>Disbursements (US\$ million)</u>	
		<u>Quarterly</u>	<u>Cumulative</u>
1983	I	-	-
	II	3	3
	III	3	6
	IV	3	9
1984	I	8	17
	II	10	27
	III	11	38
	IV	11	49
1985	I	11	60
	II	12	72
	III	11	83
	IV	11	94
1986	I	10	104
	II	10	114
	III	8	122
	IV	7	129
1987	I	5	134
	II	5	139
	III	4	143
	IV	3	146
1988	I	3	149
	II	2	151
	III	2	153
	IV	2	155

NOTE: The above schedule is in accordance with disbursement profile for the industry sector in the Philippines. Actual disbursements will depend on the industry's response to the sectoral program. Furthermore, the schedule is based on the assumption that the Project will be considered by the Bank's Executive Directors in April 1982.



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