Support for Economic Recovery in the Philippines

When the Aquino administration came to power in 1986, output per capita had fallen by more than 15 percent in two years. Three-fifths of the country’s population were below the poverty line, and the unemployment rate in Metro Manila was 25 percent. Infrastructure had been severely neglected, and major bottlenecks were emerging in power, transport, and water supply. A structural reform program begun by the Marcos regime, with support from the Bank and IMF, had barely begun to yield results.

The Aquino coalition represented a spectrum of views, some of them opposed to market-oriented reform. An OED audit* explores the role played by the Bank’s Economic Recovery Loan (approved 1987) in establishing a dialogue with the new government and reaching agreement among policy makers on the necessary course of reform. While its accomplishments were mixed, the loan kept the country on the path of economic liberalization and paved the way for a large-scale resumption of financial assistance from the Bank and other donors.

Background

Despite previous attempts at import liberalization, in 1986 Philippine industry remained highly protected, at the expense of agriculture and exports. A bloated government corporate sector contributed heavily to the fiscal deficit and external debt. The large foreign debt burdened public finances and the central bank. Much of the financial sector was bankrupt or in distress. The departure of many senior officials and upper and middle level technical staff had depleted the civil service.

The international community welcomed the new administration and prepared urgently to give it strong support, including debt relief and new money. Being designated as one of the Baker Initiative countries assured the Philippines full bilateral and multilateral backing, in exchange for the adoption of an approved program of structural adjustment. For its part, the Bank chaired the Consultative Group on the Philippines, began an extensive program of economic and sector work, and launched a comprehensive lending program centered on the government’s medium-term plan, the Economic Recovery Program (ERP).

The ERP aimed at alleviating poverty, improving social justice, accelerating growth with increased economic efficiency, and reducing the government’s economic role in favor of the private sector. It was supported by the Bank’s Economic Recovery Loan (ERL) and contributions from other donors.

Economic Recovery Loan

The ERL ($300 million, approved 1987, completed 1990) called for reforms in four areas:

- **Tax system:** Rationalizing the tax system, streamlining indirect taxes, replacing the sales tax with a value added tax (VAT), and improving tax administration.
- **Trade:** Implementing import liberalization measures agreed upon under earlier SALs; eliminating quantitative restrictions (QRs); reforming the tariff structure. Reforms were to be preannounced, to give clear signals to potential private investors in export-oriented activities.
- **Public expenditures:** Substantially increasing public outlays for investment—to 5-6 percent of GDP—and bringing operation and maintenance (O&M) expenditures in priority social and economic sectors back to their real 1982 levels.
- **Government financial institutions:** Reorganizing the two largest government-owned banks, the Philippines National Bank (PNB) and the Development Bank of the Philippines (DBP), which were technically bankrupt and together accounted for nearly half the assets of the Philippine banking system. Reducing the government’s direct presence in the financial system to encourage greater private ownership.

**Performance Audit Report, Philippines: Economic Recovery Program and Technical Assistance Project**, Report No. 10866, June 1992. OED reports are available to Bank Executive Directors and staff from the Internal Documents Unit and from Regional Information Services Centers.
Successful Bank Restructuring: DPB and PNB

At the start of the ERP, the two largest government-owned banks, the Philippines National Bank (PNB) and the Development Bank of the Philippines (DBP), were technically bankrupt. Eighty percent of their portfolios were nonperforming, and imposed a burden on the budget equivalent to 4 percent of GNP.

The ERL supported a phased action program for their restructuring, compliance with which was excellent:

- Actions taken before ERL was approved; approval of revised charters, rehabilitation programs, and arrangements for transfer of nonperforming assets; agreement with the Bank on programs to strengthen internal governance and performance monitoring; establishment of a committee to supervise disposal of assets, and of an Asset Privatization Trust (APT) to implement the disposal; and designation of a government committee to monitor the banks' performance.
- Conditions for release of second and third tranche: satisfactory implementation of cost reduction and branch closing programs, internal reorganization and strengthening of internal procedures, performance monitoring systems, and transfer of titles of the assets being disposed of.

At the end of 1986, the two banks transferred all nonperforming loans above $10 million ($0.5 million) to APT for workout and ultimately sale to the private sector; corresponding liabilities were transferred to the government.

The two banks now face the same constraints and incentives as private banks.

Both banks emerged profitable and financially sound. PNB by 1989 earned a profit equivalent to a yield of almost 37 percent on year-end equity; since 1986-87, its total deposit, loans and capital have all shown healthy increases. DBP, in 1989, earned a return on average equity of 18.8 percent.

Partial privatization of PNB: A major achievement has been the partial privatization of PNB, beyond the commitments made under the ERL. In 1989 the government made a secondary public offering of 30 percent of PNB's outstanding shares. As well as netting the government P1.8 billion, this had broader implications for the capital market. It added P4.7 billion to the market capitalization of listed equity, in just two months and, because it was sold to widely dispersed individual investors, added some 25,000 stockholders. It showed that properly structured equity deals involving government corporations could be successfully completed. PNB was the most actively traded stock on the Manila exchange in 1990.

The overall assets of the financial system have grown substantially. At end 1990, PNB accounted for 15 percent, and other government banks 8 percent, of Philippine banking sector assets.

Implementation

- Significant tax reforms were carried out, including the conversion—earlier than scheduled—from sales tax to a value added tax and an improvement in the income tax structure. However, the reforms did not yield the expected revenue increases: tax administration remained weak, while the shift to VAT (a more complex tax than the sales tax it replaced) was too hasty and resulted in a revenue loss. The share of import duties in total tax revenues fell somewhat, but remained high at around 20 percent.
- Trade reforms were adopted, including the removal of QRs from many products, which lowered average effective protection from 49 percent in 1985 to 36 percent in 1988. But because of strong opposition from business and Congress, import liberalization fell short of targets. Some sectors remained highly protected, and certain industrial groups received effective protection of more than 100 percent. The government repeatedly tried to introduce legislation making further progress toward liberalization, but only in July 1991 did it succeed in passing a new tariff code. (It is worth noting that because import duties were still a large share of tax revenues, earlier success in lowering them could have created serious fiscal difficulties.)
- Fiscal constraints on spending and institutional weaknesses held back the planned increases in public investment and O&M.
- Compliance was excellent in the area of government financial institutions. PNB and DBP notably improved their financial condition and began divesting nonperforming assets (see Box). At the end of 1985, government had owned 40 percent of total banking sector assets, excluding those of the central bank. Massive write-downs by PNB and DBP at the end of 1986, in compliance with the action program supported by ERL, reduced this share to 21 percent.

Conditionality: The loan was divided into three tranches, rather than the two more often used. Though many of the required actions had been taken before the first tranche was released, tranche helped program implementation by requiring Bank and borrower to assess systematically the progress made with each loan condition and the possible need for corrective action.

Monitoring and supervision missions were frequent and generally effective. On public expenditures and technical assistance, closer involvement of sector staff would have been useful. The government participated fully with periodic reporting, and the resident mission provided valuable support. After completion, the government prepared a detailed completion report which it used to derive lessons from experience.

Technical assistance loan: Bank staff had proposed a complementary $10 million Technical Assistance Loan (TAL). There were real needs for institutional strengthening, and administrative limitations were part of the reason why the public expenditure
Subsequent Bank Assistance to the Philippines

Hardly any Bank-financed operations were approved in the last years of the Marcos government, but with the economic improvements that resulted from the Economic Reform Program, Bank lending, including support for further adjustment, grew substantially. In FY87-92, 30 operations were approved, totaling $3.6 billion, in nearly all sectors. The Bank has had an active policy dialogue with the government, backed by economic and sector work.

Today's lending program emphasizes infrastructure, poverty alleviation, and sustainable environment issues. The infrastructure program emphasizes power, transport, water supply and sewerage, and other initiatives including Mount Pinatubo-related rehabilitation. Lending in education and training and in health—especially targeting women and children—will help alleviate poverty. Environmental issues are being addressed through assistance in agriculture, natural resource management, and industrial pollution control.

and tax reform components of the ERL did not succeed. But lack of borrower participation in the design and preparation of the TAL conspired against its success. There is no evidence that the borrower participated much in the decision to include the TAL in the ERL package, or in choosing the areas of focus. The activities were not well defined in advance, and mid-level staff who would have received the assistance were not consulted. The government eventually requested cancellation of the TAL, undisbursed.

Outcome

Economic performance improved markedly during the implementation of ERL (1987-89). Renewed capital inflows and a return of confidence—prompted by the strong international support and by the reforms begun under the ERP—stimulated imports, exports, and some private investment. With considerable excess capacity in the system, exports surged and economic growth picked up (see table). Tax revenues increased somewhat, and the public sector deficit was reduced. Using the official poverty line, poverty incidence of families and of individuals declined by 3 percentage points between 1985 and 1988.

The ERL contributed to these improvements by:

- Being part of a comprehensive package that included the IMF standby arrangement, strong aid coordination, and debt relief activities in which the Bank played a key role. These efforts helped to relieve the foreign exchange constraint and reinforce the return of private sector confidence.
- Directly addressing some critical problem areas, such as the distressed financial sector and the need for public spending to maintain infrastructure.

But, as events showed, the underlying macroeconomic weaknesses had not yet been corrected. In 1990, unable to withstand the effects of a major drought, an earthquake, the Gulf war, and terms-of-trade losses, growth declined, inflation accelerated, and the export drive slowed down.

The precarious financial condition of the central bank compromised the conduct of monetary and exchange-rate policy, making trade reform more difficult (see below). Adjustment to higher energy prices was delayed, and growing energy subsidies, uncompensated by the low-yielding tax reform, added to the fiscal deficit and crowded out development-oriented public expenditures. Infrastructure bottlenecks worsened, particularly in power, transport, and other utilities, further discouraging private investment.

Assessment

The ERL initiated a productive dialogue between the Bank and the new administration that helped to forge agreement within the administration on the need to continue with economic liberalization. Though the achievements under the ERL itself were mixed, and further progress on structural reform has been uneven, the process of change in the Philippines has been sustained and deepened, and supported by follow-on loans from the Bank (see Box).

The ERL helped to rescue the two largest government-owned banks, to begin a far-reaching process of divestiture, to start the rationalization of the tax system, and to make progress toward trade liberalization. The country's physical infrastructure would probably have deteriorated even further without the ERL.

Selected Indicators, 1986-90

(annual growth rates)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>-7.3</td>
<td>3.4</td>
<td>4.8</td>
<td>6.3</td>
<td>6.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Private consumption per capita</td>
<td>-3.5</td>
<td>0.9</td>
<td>1.6</td>
<td>3.8</td>
<td>2.6</td>
<td>3.0</td>
</tr>
<tr>
<td>Imports GNFS (US$)</td>
<td>-14.2</td>
<td>10.2</td>
<td>28.6</td>
<td>19.6</td>
<td>15.2</td>
<td>10.0</td>
</tr>
<tr>
<td>Exports GNFS (US$)</td>
<td>-16.6</td>
<td>17.1</td>
<td>6.5</td>
<td>14.7</td>
<td>10.7</td>
<td>1.3</td>
</tr>
<tr>
<td>Inflation (CPI)</td>
<td>23.1</td>
<td>0.8</td>
<td>3.8</td>
<td>8.8</td>
<td>10.6</td>
<td>12.7</td>
</tr>
</tbody>
</table>

Source: Audit report, op.cit., page 12.
Recommendations

- Close coordination with IMF is indispensable. This calls for rigorous efforts to ensure that structural adjustment programs to be supported by Bank lending are compatible with government stabilization programs.
- Borrowers' institutional capacity to carry out the program should be ascertained during preparation. Arrangements for technical assistance or institutional strengthening should be made jointly, before Board presentation.
- Technical assistance projects need the borrower's full involvement and participation not only at the highest levels but also at the middle levels where the TA will be delivered. Precisely formulated work programs, terms of reference, budgetary provisions, and supervision arrangements should be worked out jointly. Bank sectoral staff should participate.
- Close cooperation between sector and country operations Bank staff in the design and supervision of adjustment operations can be most valuable, regardless of which Bank unit has primary responsibility.
- Coordination of cofinancing requires careful planning. Conditions for tranche release should be clearly spelled out in advance, and a financing program drawn up early on, to ensure that the available financing is consistent with the reform program and that one donor's disbursement decisions do not undermine the implementation of reforms supported by another.
- Multiple tranching can effectively influence compliance with the conditions and objectives of adjustment operations.

Issues

Public expenditures

Part of the reason why the targets for public investment and for O&Ms were not met was that they were too abstract. The loan conditions specified the targets as percentages of GDP, and not enough attention had been given to the realities of governmental jurisdictions, the kinds of expenditures to geographic distribution. Also missing was an adequate assessment of the institutional capacity needed to meet the targets—even though they represented a large increase over prevailing levels and Bank staff were aware of the country's serious administrative constraints in general.

Macroeconomic management

Reforms were made more difficult by not tackling earlier the deteriorating position of the Central Bank. Monetary and exchange rate policy, shaped by CBP's financial distress, conflicted with the ERL's goals.

By 1986, CBP was experiencing heavy losses because of the extraordinary obligations it had taken on earlier. (These had included assuming the foreign currency liabilities of certain public and private enterprises, advancing the payment of foreign interest on publicly guaranteed debt, and making forced loans to failing firms.) To absorb the excessive liquidity caused by these losses—which were not addressed by the ERL or by the IMF program—CBP borrowed domestically, pushing up interest rates and crowding out private investment. CBP's external debt position made it vulnerable to devaluations, leading it to maintain an overvalued exchange rate, which in turn hindered further reductions in industrial protection.

Aid coordination

Other donors, notably the IMF and Japan, contributed substantially to the ERP. The IMF extended an 18-month standby and a Compensatory Facility arrangement, for a total of SDR 422 million. Bank staff relied on the macroeconomic framework provided by the IMF, which contemplated an expansionary fiscal policy to be financed with increased foreign aid. While this program included wide-ranging structural reforms which had been coordinated with the Bank, it did not address the worsening financial situation of the CBP, or call for a real devaluation which could have stimulated export-oriented private investment.

Japan's Overseas Economic Cooperation Fund (OECF) contributed $240 million equivalent of cofinancing, and the Japanese Eximbank $300 million equivalent. Disbursements under the latter loan were linked to progress in executing the country's public investment program, rather than to fulfillment of tranche-release conditionality. This arrangement involved the potential risk of conflicts when the timing of bilateral disbursements did not coincide with that of Bank tranche releases.

Institutional capacity

Especially when dealing with a young administration, the Bank should make every effort to ensure that the institutional capacity exists to carry out the program. For example, it can be risky to plan the elimination of a proven—even if suboptimal—tax before installing adequate training and institutional arrangements for administering the new tax.

OED Précis is produced by the Operations Evaluation Department of the World Bank to help disseminate recent evaluation findings to development professionals within and outside the World Bank. The views here are those of the Operations Evaluation staff and should not be attributed to the World Bank or its affiliated organizations. Please address comments or enquiries to the managing editor, Rachel Weaving, E-1204, World Bank, telephone 473-1719.

May 1993