NUMBER 121

OED Précis

Operations Evaluation Department June 1996

Debt Management in the Philippines

The first debt and debt service reduction operation the World Bank financed was the Debt Management Program Loan to the Philippines, approved in 1990. Its main objective was to help restore the Philippines' creditworthiness by reducing the destabilizing pressures exerted by an excessive debt-service burden. The government, having inherited a huge debt service obligation, formulated a debt restructuring program for the country and a request for debt-relief from creditors, with assistance from the Bank and the IMF.

Several events helped improve the Philippines' creditworthiness. Three of them are particularly relevant to the operation. First, the government adopted a program of deep structural and macroeconomic reform. Second, it reduced the debt stock by about $650 million equivalent, or about 2.3 percent of its outstanding debt at the time, using Bank and IMF financing to buy back $1.46 billion of debt from commercial banks at 50 percent discount. And finally, by signaling confidence in the Philippines' commitment to sound macroeconomic reform, the Debt Management Loan opened up international financial markets for the country.

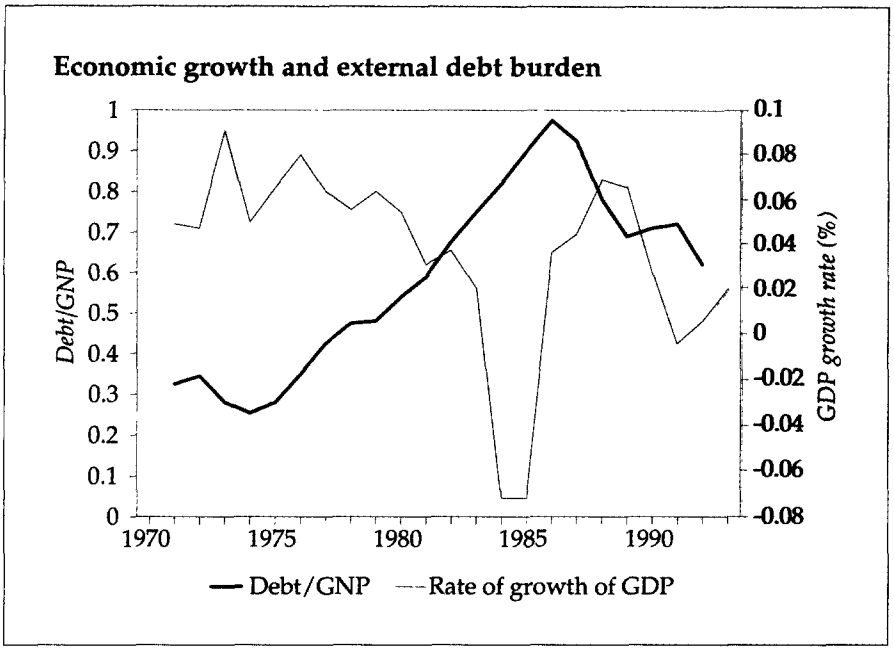
However, the program's success also led to a new problem. It encouraged new loans and other inflows of capital, which eventually became a major source of monetary problems and instability. The resulting increase in inflation forced the government to rein in the economy, suppressing growth; the currency tended to appreciate and the new loans tended to substitute for public sector savings. Clearly, in debt restructuring exercises, foreign creditors must give only enough assistance to avoid destabilizing pressures; the full benefits of debt restructuring can be captured only in a stable economic environment.

Background

In the ten years after 1986, when the Marcos regime fell, the Philippines has carried out a remarkable program of economic liberalization and modernization, initiated in the midst of a deep economic and political crisis that started in the late 1970s. The crisis had serious macroeconomic manifestations—including high inflation, large current account deficits, and huge arrears in external debt. But its source was the misallocation of resources embedded in the model of development then applied in the country, a model based on pervasive state intervention and overprotection of industry. Reaching a path of sustainable growth required both macroeconomic stabilization and deep structural reforms. By the mid-1990s, this transformation was well underway, aided by greater political stability.

The Debt Management Program Loan followed six other adjustment operations that the Bank carried out to help the country in this process. By 1986, the ratio of external debt to GNP in the Philippines had peaked at 97 percent (see Figure 1). To reduce the heavy debt-service burden—which was concentrated in the public sector—the government, the Bank, and the IMF agreed to combine general macroeconomic reform with a debt reduction agreement with the government's creditors. The Debt Management Program Loan, complemented by other IMF and bilateral funds, provided $200 million in 1989-91 toward $1.46 billion of debt buybacks at a 50-

Performance audit report. "Philippines: Debt Management Program," by Luis Landau and Manuel Hinds, Report No. 14811, June 30, 1995. Performance audit reports are available to Bank executive directors and staff from the Internal Documents Unit and from Regional Information Services Centers. Précis written by Pat McNees.



percent discount from low-exposure commercial banks.

Project goals

The main objective of the loan was to help restore the country's creditworthiness by reducing the destabilizing pressures that an excessive debt-service burden exerted on macroeconomic management. The loan was consistent with the Bank's strategy of helping the Philippines to achieve a sustainable path of growth by making investments more efficient. It complemented ongoing Bank support to improve the government's investment planning and procurement, liberalizing trade and banking, and continuing with privatization.

Implementation

The debt reduction exercise started with a 1990 pilot program, which was supported by the Bank loan. The intention was to follow with a second, larger, debt and debt service reduction operation. However, the pilot program encountered two major problems—one related to the design of the Bank support and the other to the operation's success in increasing capital inflows.

In the original design, the Bank had not intended to attach conditions to the operation, because debt reduction was meant to complement ongoing structural reforms, and those reforms were already being monitored by the preceding Bank loans. In the end, however, the Bank decided to attach similar conditions to the Debt Management Program Loan. But those conditions were unnecessary because they basically restated what was already covered elsewhere, and some of them entailed institutional changes that by definition take a long time to implement. They thus were not appropriate for an operation of a commercial type, which requires quick response to market conditions.

Added to this, the Bank applied its standard disbursement procedures, which are too slow for an operation requiring speed of action. These design flaws delayed disbursement, thus preventing the central bank from taking full advantage of rapidly changing market conditions.

The other serious problem was the effect that greatly increased capital inflows had on macroeconomic stability. The authorities could not foresee their own success when they began negotiating for additional capital as part of their debt reduction exercise. Facing uncertainty, it made sense for the government to err on the side of exaggerating the need for capital inflows. But as the debt reduction exercise coincided with falling US interest rates and a subsequent boom in private capital flows to developing countries, new loans began entering the Philippines in record volume, eventually becoming a source of financial instability. Partly for this reason, the Bank correctly decided not to participate in the second, larger, debt and debt service reduction operation. Providing even more balance-of-payments support would have increased inflationary pressures.

Outcomes

The Debt Management Loan helped improve the country's creditworthiness in two ways. First, it reduced the burden on the government from external debt, which had produced destabilizing fiscal and quasi-fiscal deficits. Second, it signaled to international markets that the Bank trusted the policies the government was pursuing and was willing to increase its exposure in the country. This opened up international financial markets for the Philippines. Although the operation's impact on institutional development was negligible, the operation was cost-effective.

The objective of reducing the debt burden was important and, on the whole, the outcome of the Philippines' debt management program was satisfactory. In particular, the program helped to make Philippine investments

more efficient, decrease the risk premium required for international financing of investments, reduce the external debt burden service to manageable levels, and attract large capital inflows. Equally important, these objectives were attained while the country was resolving serious political problems.

But the huge inflow of capital had a destabilizing effect on the economy in the 1990s. In response, monetary authorities found it necessary to adopt restrictive credit policies, which slowed economic growth. Fortunately, the government has recently taken corrective action to help stabilize the economy, thus creating a sounder basis for the resumption of foreign investment.

Lessons

- *The full benefits of a debt restructuring operation can be captured only in a stable economic environment.* Aiming to maximize the volume of new lending to the debtor country in a debt reduction exercise can result in capital inflows greater than the country can safely absorb, leading to macroeconomic instability and the substitution of foreign savings for public sector savings.

- *Increases in capital inflows should not be used as a measure of the benefits from a debt reduction exercise, for three reasons.* (1) The new resources are liabilities on the country's balance sheet. Increasing indebtedness is a neutral activity; its value to the country depends on the use to which the new loans are put. In the Philippines in the 1990s, excessive capital inflows brought about serious macroeconomic problems. (2) The dynamic benefits the new loans are supposed to measure—improved access to international financing—are captured by the reduc-

Box: The causes of the declining risk premium on Philippine debt

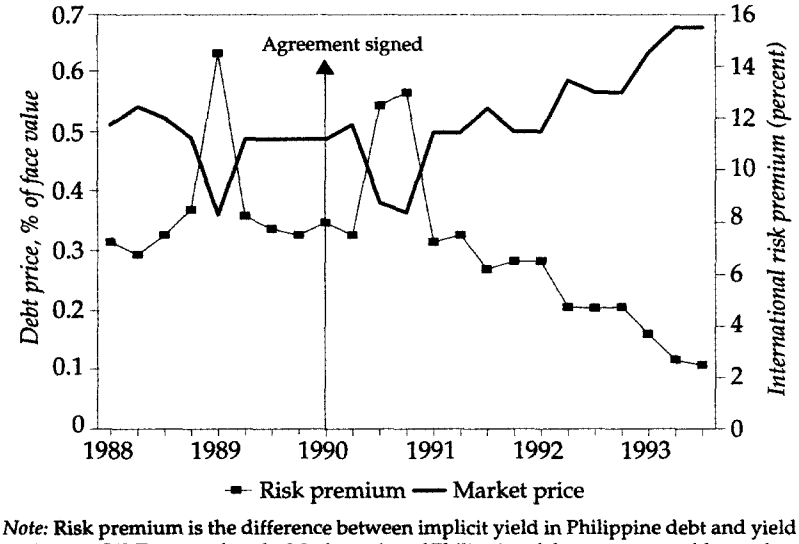
The path of the decline in the risk premium on Philippine debt paralleled the decline in interest rates on the US dollar, which meant that the yield international investors required on Philippine debt fell from 17.2 percent in the first quarter of 1989 to 8.3 percent in the third quarter of 1993. There is no doubt that falling US interest rates had an important, positive effect on the outcome of the Philippine reform program. But two points must be kept in mind in analyzing cause and effect.

First, the risk premium fell only after the second, larger debt reduction exercise took place, in 1992. After the first debt reduction loan, the premium actually increased substantially, probably because of the slowdown in the nation's growth rate and the outburst of macroeconomic instability in 1991-92.

Second, the decline in the risk premium coincided with a general increase in demand for investments in developing countries, largely associated with the decline in US dollar interest rates.

That is not to say that government action in the Philippines was no factor in the success of the country's debt reduction program. For one thing, only countries that carried out credible efforts to stabilize their economies and made them more efficient shared in the boom of investment in developing countries. And changes in the discount applied to Philippine debt mirrored the country's macroeconomic performance, increasing initially as performance deteriorated and then declining as the government established a credible stabilization program and began the second stage of its debt reduction program.

The declining risk premium of Philippine debt



Note: Risk premium is the difference between implicit yield in Philippine debt and yield on 10-year US Treasury bonds. Market price of Philippine debt, as percent of face value.

tion in the international risk premium (see box). The instability of the 1990s threatened the Philippine program's sustainability, so domestic financial markets did not immediately benefit from the reduction in the risk premium imposed on the country in international markets. (3) Excessive capital inflows can become destabilizing. The Bank should make sure that capital inflows are monitored and should suggest restricting those attracted by government negotiations when they become a source of instability.

- *The Bank should adopt streamlined procedures for debt reduction operations.* In debt relief and debt swaps, speed is important. Bank procedures caused delays, which prevented the Central Bank from taking full advantage of rapidly changing market conditions.

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