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**The Philippines: Foreign Debt
and Economic Policy—
The Choices Ahead**

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An Intelligence Assessment

State Dept. review completed

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July 1982*

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The Philippines: Foreign Debt and Economic Policy— The Choices Ahead

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An Intelligence Assessment

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This assessment was prepared by [redacted]
[redacted] the Office of East Asian
Analysis. It was coordinated with the National
Intelligence Council. Comments and queries are
welcome and may be addressed to the Chief,
Southeast Asia Division, OEA, [redacted]

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**The Philippines: Foreign Debt
and Economic Policy—
The Choices Ahead** [Redacted]

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Key Judgments

Manila's 1981 foreign debt of \$15.8 billion does not pose an insurmountable immediate problem, but the government's options in formulating economic policy will narrow rapidly during the next several years because of debt management considerations. Even under favorable circumstances, debt service costs will triple by the end of President Marcos's current term in office in 1987, when they will equal about half of projected export earnings versus 30 percent at present.

Manila has managed its official foreign debt—slightly more than half the total—reasonably well, but the private sector is on precarious financial footing because of world recession, longstanding government economic policies that have discouraged industrial efficiency, and a rapidly growing short-term debt. The escalation in short-term debt concerns the international financial community because much of the borrowing has been used for projects that will not produce income for several years. Also it may be larger by \$2 billion than Manila's estimate of \$4.5 billion.

Manila has pledged a series of reforms to international creditors in return for balance-of-payments assistance, but it is giving in to pressure from the business community for short-term financial relief and long-term investment capital. The government is thus converting private-sector foreign debt problems into public-sector responsibilities. This undercutting of economic reform poses a danger that the government may commit financial resources to economic activities in which the Philippines is not internationally competitive. Under these circumstances, adjustments in economic policy required to avert debt rescheduling by mid-decade could be even more socially and politically disruptive than the current reform program, even if a recovery in the international economy begins soon.

[Redacted]

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*Information available as of 15 June 1982
has been used in the preparation of this report.*

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Contents

	<i>Page</i>
Key Judgments	iii
Growth of Foreign Debt	1
Growing Trade Deficits	2
Public and Private Borrowing	2
Deteriorating Terms on New Credits	3
The Growing Burden of Debt Service	6
Issues in Debt Management	7
Managing Repayment Capacity	7
Managing the Demand for Foreign Credit	7
Looking Down the Road	9
The Potential Debt Service Burden	10
Tests Ahead	10

Figures

1.	The Philippines: Holders of Foreign Debt	1
2.	US Bank Exposure in Selected Countries	2
3.	The Philippines: Foreign Debt by Sector	4
4.	The Philippines: Foreign Debt by Maturity	4
5.	The Philippines: Incomplete Adjustment	11
6.	The Philippines: Successful Adjustment	11
7.	Import Equivalent of Estimated Short-Term Debt for Selected Asian Countries	15

Tables

1.	The Philippines: Balance-of-Payments Summary	3
2.	The Philippines: The Burden of Debt Service	6
3.	The Philippines: The International Financial Community	8
4.	The Philippines: Estimated Short-Term Foreign Debt	14
5.	The Philippines: Is a Debt Crunch Looming?	18

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Appendixes

A.	Estimating the Size and Significance of the Philippines' Short-Term Foreign Debt	13
B.	Tests Designed To Forecast Impending Debt Problems: Applications to the Philippines	17
C.	The Philippines: Selected Private Commercial Borrowers, 1977-81	19

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The Philippines: Foreign Debt and Economic Policy— The Choices Ahead

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Growth of Foreign Debt

The Philippines has one of the most rapidly growing foreign debts and one of the most unstable balance of payments in non-Communist Asia. The official debt has nearly doubled since 1978, reaching \$15.8 billion by the end of 1981.² [redacted] in mid-1981 the Philippines owed private foreign bankers nearly \$10 billion, international financial institutions nearly \$3 billion, and foreign governments about \$2 billion on official development assistance loans (figure 1). American banks and government institutions are the leading creditors, holding claims of over \$6 billion, or slightly less than half the total loans outstanding. The Philippines, in turn, occupies a prominent position in the global loan portfolios of US commercial banks, ranking ahead of Chile, Taiwan, Indonesia, Poland, East Germany, and Yugoslavia (figure 2). [redacted]

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We believe the foreign debt is a potentially serious problem for the Philippines and for its foreign creditors because the funds borrowed have not succeeded in raising and sustaining the economy's growth rate. Moreover, the economy has slowed since 1979 while growth of the foreign debt has accelerated. Although this was initially a response to the shock of significantly higher international oil prices, the Philippine economy, unlike the economies of South Korea, Taiwan, and much of the rest of Asia, has since shown signs of sharp deterioration instead of the beginnings of recovery, [redacted]

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[redacted] Last year was especially traumatic. Some \$2.8 billion in new foreign loans and about \$500

[redacted]

² Government authorities have revised estimates of the foreign debt downward since the end of 1981. Because these revisions are not consistent with Philippine balance-of-payments statistics, we have used the government's original estimates of both the debt and the balance of payments throughout this paper. [redacted]

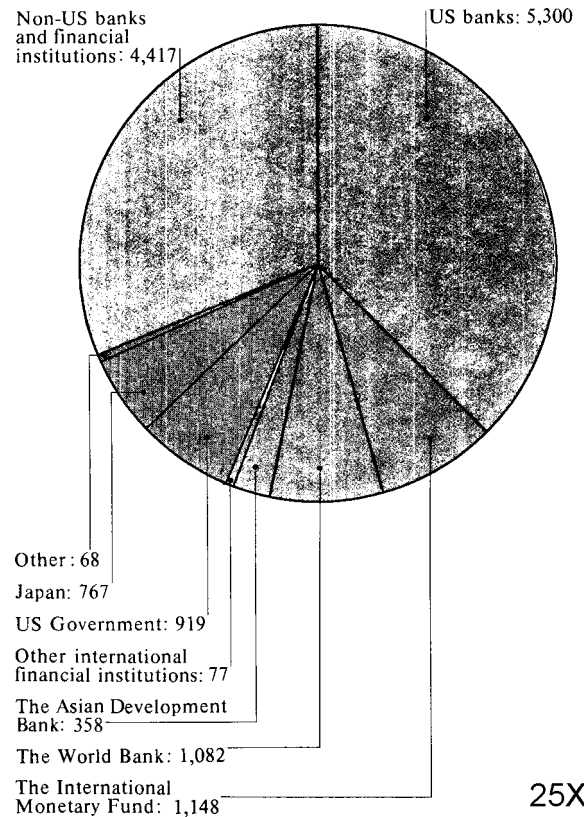
Figure 1

The Philippines: Holders of Foreign Debt 25X1

Million US \$

- Private banks; other nonofficial financial institutions
- International financial institutions
- Bilateral development assistance

Total June, 1981: 14,138



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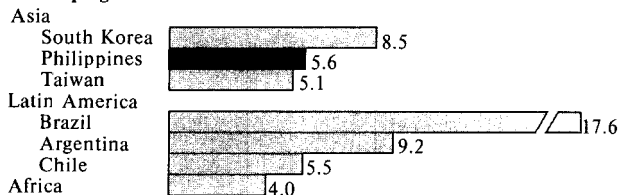
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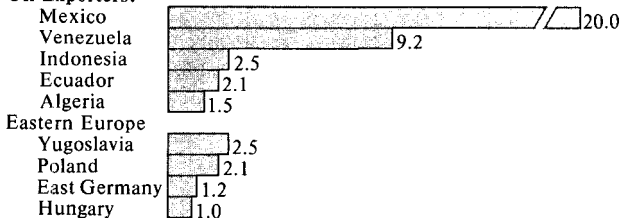
Figure 2
US Bank Exposure in Selected Countries^a

Billion US \$ Outstanding

Developing Countries:



Oil Exporters:



^aSeptember 1981.

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million in drawdowns of international reserves by the Central Bank failed to restore the 6.4-percent annual growth the economy averaged during the 1970s.

Growing Trade Deficits. Part of the external account problem is cyclical. Because manufactures constitute less than a third of export earnings, the balance of payments is highly sensitive to the vagaries of international commodity markets. The world commodity boom provided the Philippines its best economic year in 1973—a \$275 million merchandise trade surplus and 9.6-percent economic growth. OPEC oil price hikes in 1973-74 rapidly consumed the foreign exchange windfall, however, and the Philippine pay-

³ After twice revising their figures, Philippine Government authorities estimate 1981 growth at 3.8 percent. This figure is not consistent with other economic data reported by the government, however, and is questioned by the International Monetary Fund and the World Bank. On the basis of export performance and tax collections, we place 1981 real growth between -1 and 1 percent.

ments imbalance became too large for a recovery in international commodity prices to eliminate (table 1).

The economy has posted eight consecutive deficits in the current account since 1973 and we project another large one in 1982. The Philippines has chosen to finance these deficits primarily by foreign borrowing rather than by increasing exports as many of its Asian neighbors have done.⁴ In addition, import prices have increased faster than export prices since 1979, reinforcing the need for new policies to control the current account deficits. Last year the balance-of-payments deficit would have exceeded \$800 million had the Central Bank not sold gold from official reserves at over three times the usual rate. If direct foreign investment had not far exceeded previous levels—because of a significant drop in repatriated profits—the overall deficit would have been as high as \$1.1 billion. At yearend 1981, international reserves had declined about \$500 million to \$2.7 billion. This level is nearly twice the level reserves averaged in 1975-77.

Public and Private Borrowing. Philippine Government reports show that public foreign debt has grown somewhat more rapidly than private foreign debt since 1972. Still, foreign obligations at yearend 1981 were almost evenly divided between public- and private-sector borrowers. Much of the public-sector debt—which we believe remains reasonably well managed—reflects a decade of project-oriented borrowing by such government institutions as the Philippine National Oil Company, Philippine Airlines, and the National Power Corporation.

A substantial portion of public foreign debt, however, results from relending operations by government banks and investment institutions to private-sector borrowers. The Central Bank reports that since 1978 its Consolidated Foreign Borrowing Program alone has obtained \$400-600 million annually in medium- and long-term credits for relending. To this extent the

⁴ IMF statistics show that Philippine exports per capita are now exceeded by those in South Korea, Taiwan, Malaysia, Singapore, Indonesia, and even by those in Thailand.

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Table 1

Million US \$

The Philippines: Balance-of-Payments Summary

	1975	1976	1977	1978	1979	1980	1981 ^a	1982 ^b
Current account	-923	-1,101	-828	-1,172	-1,576	-2,072	-2,589	-2,600
Merchandise trade	-1,197	-1,113	-840	-1,307	-1,541	-1,939	-2,667	-2,550
Exports f.o.b.	2,262	2,519	3,075	3,425	4,601	5,788	5,733	5,650
Coconut products	468	537	729	812	965	759	756	780
Sugar	616	451	527	213	238	474	609	600
Copper concentrates	212	270	280	250	330	679	544	650
Forest products	229	268	261	324	484	433	383	400
Manufactures	374	573	770	1,076	1,520	1,135	1,294	1,400
Other	363	420	508	750	1,064	2,308	2,147	1,920
Imports f.o.b.	3,459	3,632	3,915	4,732	6,142	7,727	8,400	8,200
Oil	814	936	1,019	1,030	1,385	2,248	2,565	2,400
Services (net)	-44	-257	-248	-178	-390	-555	-392	-500
Transfers (net)	318	269	260	313	355	422	470	450
Capital account	438	937	1,379	1,086	964	1,564	1,629	1,850
Direct investment (net)	98	144	216	171	99	49	407	200
Medium and long term (net) ^c	420	1,014	670	891	1,180	1,061	1,185	1,350
Short term ^d	-80	-221	493	24	-315	454	37	300
Monetization of gold	110	214	79	32	41	127	400	150
Balance	-375	50	630	-54	-571	-381	-560	-600

^a Estimated.^b Projected.^c Includes allocation of SDRs.^d Includes errors and omissions.

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government, rather than the private sector, bears a major share of the financial risk imbedded in Philippine foreign liabilities. [redacted]

Philippines' top 20 companies by sales. Government loan guarantees have helped these and other private-sector borrowers secure foreign credit on substantially more favorable terms than otherwise would have been available. [redacted]

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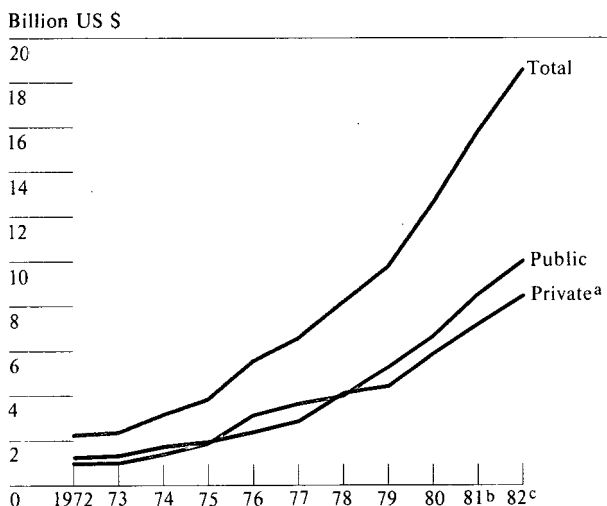
Major Philippine private corporations also have been active direct foreign borrowers in the last several years. [redacted] since 1976 such firms as San Miguel, Construction and Development Corporation of the Philippines, Marinduque Mining and Manufacturing, and Atlas Consolidated Mines all have secured large medium- and long-term syndicated loans (appendix C). Each of these firms ranks in the

Deteriorating Terms on New Credits. Even with adroit use of loan guarantees and the Central Bank's monitoring of foreign borrowing, Philippine commercial borrowers have secured credits on increasingly

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Figure 3

The Philippines: Foreign Debt by Sector

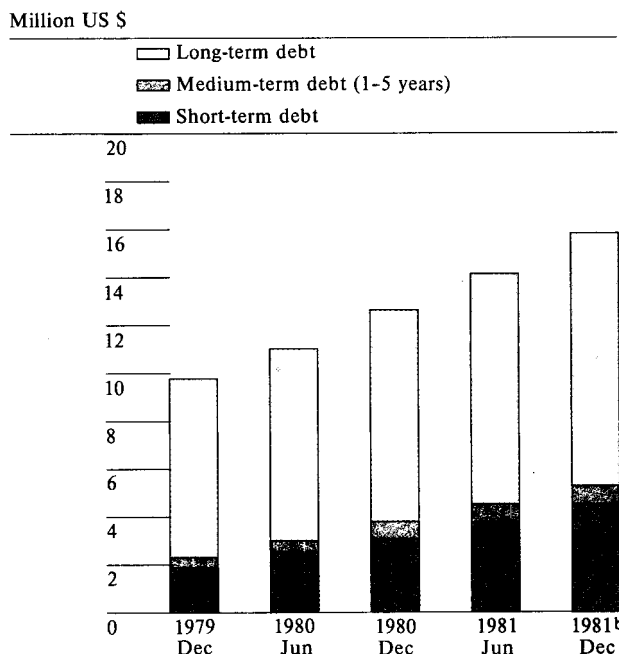


^aEstimated.
^bProjected.
^cPrivate sector debt includes government guaranteed private debt.

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Figure 4

The Philippines: Foreign Debt by Maturity^a



^aEnd of period.
^bEstimated; revised downward in April 1982 by Philippine authorities.

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less attractive terms since late 1980, [redacted] Maturities on new loans have shortened while other measures of bankers' risk assessments—spreads and management fees—have increased.⁵ *Euromoney*, an international financial industry magazine, early this year rated the Philippines as one of the developing world's most rapidly deteriorating credit risks on the basis of maturities and spreads obtained on foreign loans during 1981. [redacted]

At the same time, rapidly expanding private credit needs and reduced creditworthiness have combined to force private borrowers into the short-term market since mid-1979 (figure 4). During the first six months of 1981, short-term debt grew at an alarming annual rate of over 46 percent; by yearend it reached nearly

⁵ Spreads and fees have risen recently for several other LDCs in financial trouble, such as Mexico and Argentina, but have remained steady for most East Asian countries except South Korea. [redacted]

\$4.5 billion, according to official government statistics.⁶ Had Philippine borrowers used short-term and revolving credits to finance foreign trade (as is usually the case), we estimate that the short-term debt would have been about \$2.9 billion. [redacted]

The Central Bank traditionally has paved the way for other Philippine borrowers by securing highly publicized syndications on premium terms early in each calendar year. Early in 1982 Manufacturers Hanover—which has led the first Central Bank syndication

⁶ The actual size of the short-term foreign debt is in doubt and could exceed government estimates by as much as one and a half times (see appendix A). [redacted]

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International Lending: A Primer on Terms

<i>Term</i>	<i>Definition</i>	<i>Term</i>	<i>Definition</i>
<i>Syndication</i>	<i>The process by which a leading bank recruits other banks to contribute funds to the amount pledged to the borrower.</i>	<i>Risk</i>	<i>The banker's subjective assessment of the unexpected, expressed via the interest rate or other terms of the loan.</i>
<i>Lead bank</i>	<i>The bank selected by the borrower to market a loan. The lead bank receives a syndication or marketing fee—a percentage of the loan's total value—in addition to earning interest on the portion of the loan amount it supplies.</i>	<i>Maturity</i>	<i>Length of a loan commitment. Shorter maturities can indicate bankers' lack of faith in a country's longer term economic or political prospects.</i>
<i>Comanagers</i>	<i>Other banks that agree to provide a portion of the loan amount in return for sharing the syndication fees. Comanagers in turn hope to recruit other banks as syndication participants.</i>	<i>Short-term loans</i>	<i>Loans with an original maturity of one year or less.</i>
<i>Syndication participants</i>	<i>Banks that provide a smaller share of a syndicated loan.</i>	<i>Reschedule</i>	<i>An agreement between borrower and lender to place repayment on more manageable terms.</i>
<i>LIBOR</i>	<i>London Interbank Offered Rate. The interest rate London banks pay for US dollar deposits. Most syndicated loans are made at a contracted spread over LIBOR. The spread remains fixed over the life of the loan, but LIBOR is free to vary as market conditions dictate.</i>	<i>Country limit</i>	<i>The maximum value of outstanding loans to all borrowers in a given country that a banker is willing to accept. Self-imposed.</i>
<i>Spread</i>	<i>The percentage interest rate above LIBOR that borrowers pay.</i>	<i>Debt service ratio</i>	<i>A ratio intended to measure the burden on the economy of foreign debt repayment (principal and interest). Variously defined as: (a) Medium- and long-term repayments as a share of merchandise exports. (b) Medium- and long-term repayments as a share of the previous year's balance-of-payments earnings (the definition used by the Philippines). Philippine law limits the ratio to 20 percent, but it will rise to at least 22 percent for 1982.</i>

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Table 2

Million US \$

The Philippines: The Burden of Debt Service

	1978	1979	1980	1981 ^a	1982 ^b
Medium- and long-term debt service	1,007	1,252	1,418	1,703	2,241
Principal	730	760	804	850	950
Interest	277	492	614	853	1,291
Interest on official short-term debt^c	93	172	363	620	630

^a Estimated.

^b Projected.

^c Estimated using the average London Eurodollar rate.

[Redacted]

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each year since 1978—managed a \$325 million syndication on the most favorable terms the Central Bank had obtained since the late 1970s—a split spread of five-eighths and three-fourths percentage points over the London Interbank Offered Rate for the duration of the 10-year term of the loan. Even so, Manufacturers Hanover had to share management fees with 14 comanagers before filling out the syndication, according to the financial press. The Central Bank, moreover, had to promise syndication participants for the first time in writing to stay out of the market for new loans until late in the year. [Redacted]

export earnings, interest payments are rising even more rapidly. The Philippine Central Bank reports that for the first quarter of 1982, interest payments amounted to 27 percent of exports, compared with 16 percent in the first quarter of 1981. We believe this trend is both the most accurate and the most alarming measure of the net resource drain that debt service imposes on the economy. [Redacted]

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The Growing Burden of Debt Service. The annual cost of debt service has nearly tripled since 1977. Even though Manila took advantage of relatively low world interest rates during 1978 and 1979 to engage in substantial refinancing, [Redacted] medium- and long-term debt service consumed 30 percent of merchandise export earnings last year—the largest share in a decade (table 2). If short-term debt service were included, the share of export earnings would reach 40 percent. [Redacted]

Philippine law limits the burden of medium- and long-term debt service by requiring that repayment obligations on loans not exceed 20 percent of the previous year's balance-of-payments earnings. Even using this definition, however, the debt service burden is rising. Medium- and long-term repayment obligations in 1981 reached 19.4 percent of 1980 balance-of-payments earnings. We expect the statutory limit will be breached in 1982 because medium- and long-term debt service will increase by more than \$500 million,⁹ as grace periods on old loans expire and interest costs rise; in addition, export earnings fell last year. [Redacted]

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Interest payment obligations made up one-third of total debt service in 1978 but will constitute two-thirds of total debt service in 1982. As a share of

⁸ As a share of national income, interest payments were less than 2 percent of GNP in 1978 but will reach 5 percent of GNP this year. [Redacted]

⁹ Either of two amendments to the law would prevent this by keeping 1982 debt service under 20 percent: the denominator of the fraction could be increased by changing the balance-of-payments calculation to the current year, or the numerator could be reduced by excluding certain kinds of debt service. Both approaches have been considered in the past. [Redacted]

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⁷ The large short-term debt is cause for concern because we believe much of it was used to finance investment projects that will not produce income for several years. [Redacted]

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Issues in Debt Management

Managing Repayment Capacity. We believe the recent record of economic growth in the Philippines is one of the most anemic in East Asia and results from industrial and trade policies since the 1960s that have kept resources from their most efficient uses. Our analysis indicates that Manila has indirectly subsidized capital-intensive manufacturing industries in which the economy could not compete internationally.¹⁰ The government has discriminated against exporters and subsidized importers of capital goods and raw materials with exchange rate policies that overvalued the peso.¹¹ At the same time, high tariffs and foreign exchange controls have protected inefficient local manufacturers of such products as cement, steel, textiles, paper, chemicals, and processed foodstuffs. Combined with underdeveloped local financial markets, these policies ensured the continuing presence of a private sector prone to repayment difficulties in international capital markets. [redacted]

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In exchange for balance-of-payments assistance, the International Monetary Fund and the World Bank have extracted promises from Manila for far-reaching economic reforms to solve these problems (table 3). An IMF Extended Fund Facility credit of \$400 million covering 1978-79 and a Supplementary Financing Facility loan covering 1980-81 required Manila to pursue an exchange rate policy that does not seriously overvalue the peso and to protect export competitiveness from the effects of domestic inflation by restraining growth of the money supply. Manila also agreed to promote development of the local capital market by deregulating interest rates and to limit foreign commercial borrowing to keep debt service manageable. Last year a World Bank Structural Adjustment loan of \$200 million further required that Manila reduce

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¹⁰ Political allies of President Marcos's have been among the principal beneficiaries of these policies [redacted]

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¹¹ An overvalued currency discriminates against exporters by reducing the amount of domestic currency earned per dollar of exports. For example, an overvalued exchange rate of 5 pesos per dollar provides an exporter with 5 pesos for each dollar of export earnings while a lower exchange rate of 10 pesos per dollar gives him twice as many pesos for the same dollar's worth of exports. The importer prefers the overvalued exchange rate because he can buy twice as much in imports than with the lower rate of 10 pesos per dollar [redacted]

tariffs and liberalize foreign exchange controls. Accompanying tax reform is to replace funds lost to import duty reductions. These measures represent a sharp departure in Philippine policy because they favor enterprises and activities that do not depend on political connections. [redacted]

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Even with the restrictions on its policymaking, the government will receive a substantial dividend from Bank and Fund balance-of-payments assistance. Private foreign banks—which say they provide the Philippines two-thirds of its foreign credit—will be much more receptive to making new Philippine loans if Philippine economic policies continue to bear the imprimatur of international financial institutions. The Bank and the Fund have taken steps to ensure this occurs by providing financial assistance in stages. The Bank's 1981 Structural Adjustment Loan was the first installment of \$600 million in such credits. Manila is currently negotiating another IMF standby loan and will remain dependent on IMF assistance throughout the early 1980s. Further balance-of-payments support will depend on whether Manila implements the reforms and meets the targets the IMF and World Bank have set. [redacted]

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Managing the Demand for Foreign Credit. The Private Sector. Manila is making slow progress correcting the policy excesses that lie at the root of its balance-of-payments problems. The Central Bank allowed the exchange rate to depreciate fairly rapidly against the US dollar during the second half of 1981, but a strong dollar meant that the peso appreciated—by over 3 percent on average—against the currencies of most of the Philippines' other trading partners. According to public statements by government officials, Manila is reluctant to allow rapid depreciation because it would reverse the effects of the government's primary policymaking victory in the last two years—cutting the inflation rate by half to 12 percent in 1981. The Philippine Chamber of Commerce and Industry has protested the depreciation that has occurred because of the profits squeeze experienced by large private firms that buy imported raw materials and capital goods. Early this year the government

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Table 3

The Philippines: The International Financial Community

The Lenders	Comments
The International Monetary Fund	Provides medium-term balance-of-payments assistance in exchange for pledges by Philippine authorities to make corrective changes in economic policy. Now negotiating \$500 million credit with Manila. Its 1982 review of the Philippine economy gave Manila the equivalent of a C for economic management.
The World Bank	Largest Philippine aid donor. Chairs Consultative Group—the Philippines' consortium of aid donors meeting in June 1982. Also provides balance-of-payments loans in exchange for adjustments in economic policy. Its \$200 million structural adjustment loan will require that Manila cut domestic energy subsidies and continue reform of industrial policy. Private bankers believe it essential that Manila follow World Bank and IMF advice.
The private international banking community ^a	Lends on medium- and long-term basis to various Philippine borrowers. Lends on short-term basis to finance international trade. Places informal pressure on Manila's formulation of economic policy. Private banks provide about two-thirds of the flow of credit to the Philippines.

^a US banks usually lead syndications, but Japanese and Middle Eastern banks are increasingly prominent participants.

[Redacted]

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began lowering tariffs and liberalizing foreign exchange controls in an effort to force manufacturers to cut costs, but local opposition to these measures is substantial. According to the Manila press and to embassy reports, domestic producers of durable consumer goods recently obtained the Central Bank's pledge that foreign exchange licensing would be reimposed on household appliances, and the garment and textile industries are pressing for similar relief. [Redacted]

rates on savings deposits to 9 percent. The Philippine press has pronounced financial reform a failure, but the government-owned Philippine National Bank is trying to encourage higher rates for depositors by raising its own rates. [Redacted]

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Progress promoting the development of local financial markets—the most obvious alternative to foreign financing for the private sector—also is slow despite vigorous government efforts. Last year, following a domestic financial crisis, Manila deregulated domestic interest rates and adopted a series of financial reforms designed to place corporate finances on a sounder footing.¹² Although the reforms have restored order in the local financial community, the new interest rate regulations have yet to generate an increase in the supply of loanable funds because private banks in a cartel-like action have held interest

The Public Sector. To trim its foreign borrowings, Manila has sharply scaled back a controversial heavy industry program for the 1980s. Planned outlays of \$6 billion have been reduced to \$4 billion as a result of cuts in an overly ambitious gasohol program and the size of a proposed \$1 billion integrated steel mill. A proposed \$320 million petrochemical complex and a \$450 million aluminum smelter probably will not be built. [Redacted]

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Nonetheless, Manila's growing budget deficits remain a cause for concern in the international financial community. In 1981 the government's operating deficit ballooned in the face of declining tax collections, reaching 3.9 percent of GNP—the highest since the mid-1970s, and budget performance continued to deteriorate early in 1982. The deficit soaked up 15 percent of domestic savings last year, three times the level

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[Redacted]

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recorded in 1980. This has largely offset the effects of financial reform aimed at promoting local sources of credit. Moreover, near-term tax collection is unlikely to dramatically improve in view of World Bank-mandated reductions in foreign trade taxes. [redacted]

continuing world recession.¹³ Manila is moving ahead with management reorganization and financial restructuring of several major firms. One result of its corporate rescue program, however, is growing exposure to the private-sector's financial problems. [redacted]

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According to reports provided by Philippine technocrats to the IMF and the World Bank, Manila is counting on eventual reductions in government food and energy subsidies to help cut the budget and the deficit. These moves will pit the technocrats, led by Prime Minister Virata, against a variety of important political constituencies. To keep prices down Virata has reduced fertilizer subsidies and even threatened local producers with import competition. He has also announced reductions in domestic sugar and rice subsidies, even though these moves will raise prices for urban consumers. Manila was to have pledged reductions in electricity subsidies this summer in exchange for a second \$200 million World Bank Structural Adjustment Loan, but local business interests successfully lobbied against the move, and a planned increase in electricity rates has been postponed indefinitely according to Philippine press reports. [redacted]

The outlook is bleak for the balance of payments this year. Philippine Central Bank reports show the first-quarter payments deficit reached \$539 million—nearly equal the deficit for all of 1981, one of the worst years in the country's postwar economic history. Interest payments on the foreign debt this year will rise by about \$450 million, but the decline in international oil prices will not offer much relief because most of the Philippines' oil import contracts are long-term deals unaffected by international oil price reductions. The Central Bank, moreover, probably will not want to sell gold at anywhere near last year's rate because of the diminished world price. [redacted]

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One means of reducing the financial burden of foreign borrowing would be increased direct foreign investment. Although Manila is reviewing its investment regulations, the process is unlikely-

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[redacted]-to result in significant streamlining. Tariff reductions on raw materials, however, promise to enhance the profitability of investing in the Philippines. Government plans envisage \$400 million in foreign direct investment this year, but we believe Manila will have to resolve increasingly unsettled labor relations before attracting anywhere near that amount. [redacted]

For its part, the IMF is calling for immediate reductions in the current account and in the overall payments deficit because of the mid-decade cost in added debt service that will result from heavy current borrowing. To this end, Prime Minister Virata has announced a \$2.4 billion foreign borrowing limit for 1982, with only \$1.4 billion reserved for the private sector. If the new limits are adhered to, they would stabilize the trade deficit, but at the cost of denying the private sector needed financing in the face of weak domestic and international sales. Central Bank Governor Jaime Laya admitted as much in a speech earlier this year. We believe, moreover, that the loan limits may be too low to accommodate borrowing planned by government banks for private corporations. Manila hopes the 12-percent cut in government expenditures it announced in April 1982 will ease the problem by reducing public-sector competition with the private sector for scarce investment funds. [redacted]

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Looking Down the Road

We believe that recent developments at home and abroad have increased the urgency of placing the country's external accounts on a sound footing. The embassy reports that the financial positions of the top firms in the private sector—and thus its prominent private foreign borrowers—remain precarious in the wake of last year's domestic financial crisis and the

¹³ Philippine corporations experiencing severe financial distress in 1981 and early 1982 include six of the country's top 25 firms according to sales. Using this criterion, a somewhat analogous situation in the United States would be for Gulf Oil, Atlantic Richfield, General Electric, DuPont, Tenneco, and Getty Oil to teeter simultaneously on the verge of insolvency, avoiding bankruptcy only by transferring existing equity to federal government ownership. [redacted]

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The Potential Debt Service Burden.¹⁴ Much of the Philippines' debt service burden later in the decade will depend on variables we cannot forecast with any precision. A strong economic recovery in the United States—the Philippines' leading trade partner—would help ease short-term financial problems, for example. International interest rates and other terms available to Philippine commercial borrowers also will be important determinants of Philippine borrowing activity and subsequent repayment obligations. [redacted]

Nevertheless, a major portion of the debt service burden through the mid-1980s will be determined by repayment obligations on loans Philippine borrowers have already secured. Furthermore, Manila is pursuing a wide range of policies that will shape its borrowing needs regardless of the performance of the international economy. Not the least of these is exchange rate policy—which will determine the economy's near-term balance-of-payments prospects—and ongoing industrial restructuring—which will shape the balance-of-payments prospects by mid-decade. [redacted]

If Manila responds to the current international economic environment by placing economic reform on hold, we believe the effects on the current account deficit and on borrowing requirements could be devastating (figure 5). We project that the trade deficit under these circumstances could rise from \$2.6 billion in 1982 to over \$4 billion by 1985; debt service on medium- and long-term loans, even assuming some easing in international interest rates, would reach \$4.9 billion, with over half the total outflow used for repaying loans obtained after 1981. The outstanding medium- and long-term foreign debt would reach nearly \$25 billion, with debt service rising to about 70 percent of merchandise export earnings. To the extent that the current short-term debt is refinanced with new medium- and long-term borrowing, debt service and the debt would be even larger. [redacted]

¹⁴ The discussion in this section should not be interpreted as a formal forecast of the growth of foreign debt, debt service, or current account balances through 1985. As developments in the international economy in the 1970s show, unexpected events can play havoc with any forecast, no matter how sophisticated the economic modeling. The discussion is intended to illustrate potential repayment problems in the next few years that are built into existing foreign loan agreements and into Philippine current industrial restructuring policies. [redacted]

If the international economy rebounds sharply, if interest rates moderate further, and if Manila continues economic reform through 1985, we believe there will be an opportunity to stabilize the slide in the country's external accounts. For example, assuming the current account deficit stabilizes this year and improves dramatically after 1984, debt service could reach \$4.2 billion in 1985 (figure 6). Because of the repayment burden on loans contracted prior to January 1982 and the lack of immediate improvement in the trade deficit, the foreign debt and the debt service burden would continue to rise through the mid-1980s but at a slower pace. Debt service would peak at roughly 50 percent of merchandise export earnings in 1984. The burden would drop thereafter, but would remain above current levels through 1987—the end of President Marcos's current term in office. [redacted]

Tests Ahead. We believe Marcos's complete domination of Philippine politics probably will enable him to continue economic reform through its most painful period in the next two years. He has displayed a flexibility in formulating economic policy—at the behest of his technocrats—that should enable the Philippines to cope with growing financial strains. Indeed, Marcos announced in March 1982 that chief technocrat Cesar Virata will keep the post of Prime Minister, rather than rotate out, as had been scheduled, in July. [redacted]

The world recession may nevertheless have forced Manila into a preoccupation with short-term economic problems that will compromise long-term debt management. We believe the government could negate the benefits of overhauling tariff policy and of foreign exchange liberalization if it chooses to bail out firms that cannot survive on their own. Bailouts are proving an expensive proposition for the government, and the financial drain could grow rapidly in the next few years. [redacted]

Marcos thus will have to choose more carefully during the 1980s than he did in the 1970s between heavy foreign borrowing, corporate bailouts, indulging inefficient state enterprises and powerful private monopolies, on the one hand, and reform and the forces of the

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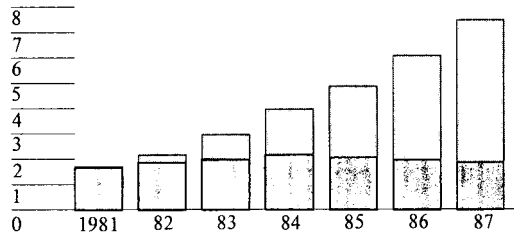
Figure 5

The Philippines: Incomplete Adjustment

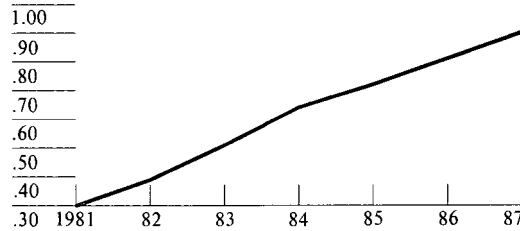
Current Account Million US \$	Note change in scales						
	1981	1982	1983	1984	1985	1986	1987
Exports	5,733	5,650	5,932	6,229	6,852	7,537	8,290
Imports	8,400	8,200	9,020	9,922	10,914	12,006	13,206
Services (net)	-392	-500	-550	-605	-666	-732	-805
Transfers (net)	470	450	495	544	599	659	725
Current Account	-2,589	-2,600	-3,143	-3,754	-4,129	-4,542	-4,996

Service on probable borrowings, 1982-87
 Service on debt contracted as of 31 December 1981

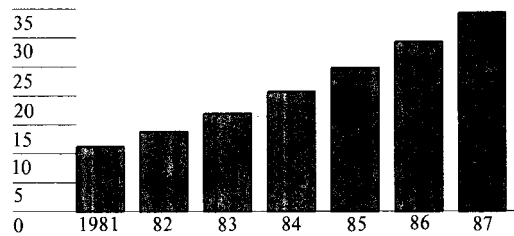
Debt Service on Medium- and Long-term Loans
Billion US \$



Debt Service Ratio
Share of Export Earnings



Medium- and Long-Term External Debt
Billion US \$



Assumptions:
In projecting the current account, we assume a slow recovery from world recession, stable terms of trade, and incomplete adjustment of the Philippine economy. Export growth is 5% in 1983-84 (from a 1982 base) and 10% thereafter. Imports, services, and transfers all grow by 10% a year. All new borrowings have 8 year maturities, an average interest rate of 10%, and a one year grace period for repayment of principal.

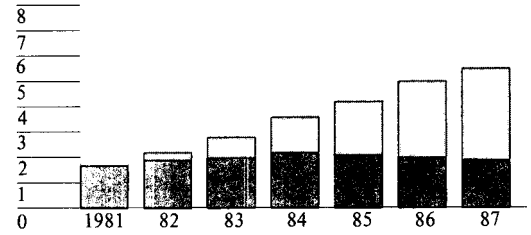
Figure 6

The Philippines: Successful Adjustment

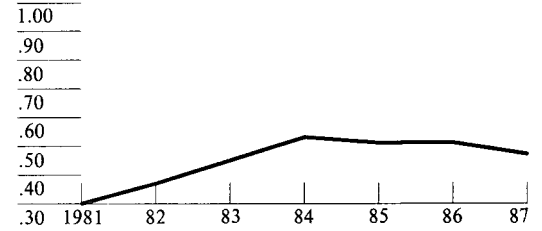
Current Account Million US \$	Note change in scales						
	1981	1982	1983	1984	1985	1986	1987
Exports	5,733	5,650	6,215	6,836	8,204	9,844	11,813
Imports	8,400	8,200	8,610	9,471	10,418	11,460	12,606
Services (net)	-392	-500	-525	-551	-579	-608	-638
Transfers (net)	470	450	495	544	599	659	725
Current Account	-2,589	-2,600	-2,425	-2,642	-2,194	-1,565	-706

Service on probable borrowings, 1982-87
 Service on debt contracted as of 31 December 1981

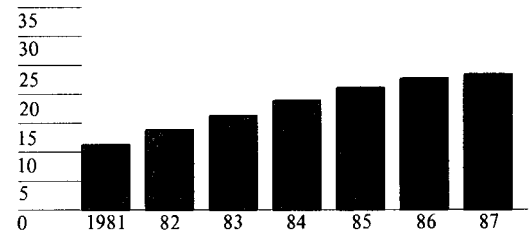
Debt Service on Medium- and Long-term Loans
Billion US \$



Debt Service Ratio
Share of export earnings



Medium- and Long-Term External Debt
Billion US \$



Assumptions:
In projecting the current account, we assume a moderate recovery from world recession, a slight improvement in the terms of trade, and successful adjustment. Export growth is 10% in 1983-84 (from a 1982 base) and 20% thereafter. Import growth is 5% in 1983 and 10% thereafter. Services grow at 5% and transfers at 10%. New borrowings have 8 year maturities in 1982-84 and 10 years thereafter; the average interest rate is 7% and there is a one year grace period on repayment of principal.

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free market on the other. The President and his technocrats, moreover, will have to maneuver among an increasingly restrictive set of options to make these choices. High world interest rates, for example, make it impractical for the Philippines to refinance its current foreign debt. We believe retarding import growth by deliberately slowing the economy is an option that Marcos wants to avoid because of its prohibitive political costs. Among other considerations, we believe the resulting high unemployment would probably increase the attractiveness of the Communist Party and affiliated labor and student front groups in urban areas where heretofore their success has been limited. In addition, growing imports of capital will be necessary for restructuring the manufacturing sector to increase international competitiveness and for continuing the major industrial projects in which Marcos's cronies have large stakes. Largely for these reasons, we believe it likely that Marcos will decide to take a middle path—initiating enough reform to maintain support from the international financial institutions, but not enough to upset his political base—and hope to muddle through. If short-term economic or political problems lead Marcos to either defer reform or to assume responsibility for all private foreign debt problems, however, we believe that by mid-decade he could find a socially disruptive slowdown in development his only alternative.

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**Appendix A
Estimating the Size and Significance
of the Philippines'
Short-Term Foreign Debt**

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The Philippine Central Bank puts the short-term foreign debt at \$4.5 billion at the end of 1981. Our estimate—based on Bank for International Settlements data—has the short-term debt significantly higher, probably as high as \$6.8 billion. [redacted]

The BIS provides data on short-term bank claims against the Philippines from mid-1978 to mid-1981. The data must be adjusted in a number of ways to estimate the Philippines' short-term debt:

- The most important problem is the omission of claims against the Philippines held by non-BIS (mostly Middle Eastern) banks. We adjusted the BIS numbers for short-term claims upward by our estimates of 10 percent in 1978-79 and 30 percent in 1980-81. The higher adjustment for 1980-81 reflects increased financing of higher priced oil imports.
- The BIS data do not include suppliers' credits provided by private firms. Our best estimate is that these credits are equal to one month's imports, and we make this adjustment to the BIS short-term claims.
- BIS data on short-term claims include claims with a residual maturity of one year or less. Some of these claims reflect maturing medium- and long-term loans. Therefore, we adjusted the BIS data downward by an estimate of longer term claims maturing that year. This estimate was derived from the BIS category of claims with residual maturity of between one and two years from the report of the preceding year. [redacted]

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¹ The Bank for International Settlements in Switzerland—a clearinghouse for Central Banks—reports bank claims against as well as liabilities to the Philippines. Reporting banks include those from most of the industrialized Western countries. The data include claims and liabilities of all affiliates of US banks, no matter where located, and affiliates of other reporting banks located in major offshore banking centers. [redacted]

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Our adjustments and final estimate of the Philippine short-term debt from mid-1978 to mid-1981 are shown in table 4.² To obtain the estimate of the short-term debt for the end of 1981, before adjusting for offshore banking arrangements, we increased the mid-1981 figure by 14 percent, a conservative estimate based on the growth of the official short-term debt by 28 percent during the preceding year. [redacted]

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Our estimate, however, may need to be adjusted slightly up or slightly down because of the existence of various offshore banking arrangements, which may produce some BIS claims on the Philippines that do not arise from Philippine foreign borrowing:

- Offshore banking units (OBUs) are affiliates or subsidiaries of foreign banks that are given special incentives to locate in the Philippines.
- Foreign currency deposit units (FCDUs) are banks, both foreign and Philippine, that are allowed to accept foreign currency deposits and make foreign currency loans up to the amount of their deposits.
- Deposit-taking corporations (DTCs) are Philippine companies located primarily in Hong Kong that accept deposits and then lend the funds to both Philippine and non-Philippine borrowers. [redacted]

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The existence of these arrangements creates the possibility that some of the BIS-reported claims may be interbank deposits that reflect Philippine deposits being lent ultimately to Philippine borrowers. It is also possible that some of the BIS-reported data are interbank deposits that reflect foreign deposits ultimately being lent abroad. Our best guess, based on other data, is that the magnitude of these transactions was no larger than \$2 billion in 1981. [redacted]

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² Even with these adjustments, our estimate could still be off because of incomplete data and financial transactions such as prepayments and rescheduling that we are not aware of. [redacted]

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Table 4

Billion US \$

The Philippines: Estimated Short-Term Foreign Debt

	Mid-1978	End 1978	Mid-1979	End 1979	Mid-1980	End 1980	Mid-1981	End 1981
Official short-term debt		1.2		1.7		3.0		4.5
Estimation procedure								
BIS reporting banks' short-term claims against the Philippines	2.2	NA	2.9	3.9	4.4	5.4	5.7	
Adjustment for non-BIS bank claims	0.2	NA	0.3	0.4	1.3	1.6	1.7	
Adjustment for nonbank suppliers' credits	0.4	NA	0.5	0.5	0.6	0.6	0.7	
Adjustment for longer term claims maturing this year	-0.4	NA	-0.4	-0.4	-0.3	-0.3	-0.4	
Subtotal	2.4	NA	3.4	4.5	6.1	7.4	7.7	8.8
Adjustment for BIS short-term claims that reflect either domestic intermediation of lending by Philippine institutions to foreigners	-0.1		-0.5	-0.5	-1.0	-1.0	-2.0	-2.0
Estimated short-term debt	2.3	2.8	2.8	3.9	5.0	6.3	5.7	6.8

[Redacted]

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Significance of Short-Term Debt

Debt analysts do not treat an economy's short-term foreign debt the way they treat medium- and long-term debt for two reasons: statistics on short-term foreign debt are notoriously unreliable, and short-term loans are usually considered self-financing. Banks feel secure in extending short-term credits because such loans consist almost entirely of revolving or trade credits used to finance imports. These credits are considered self-liquidating; that is, they are to be repaid out of the proceeds of the sale of the imports they were used to finance. [Redacted]

By any of the conventional measures, the Philippine short-term debt is much larger than would be expected if the debt consisted primarily of revolving credits used to finance imports. The usual rule of thumb is that a country requires trade financing equal to approximately four months' imports. By our estimates the Philippine 1981 short-term foreign debt is equal to about 10 months' imports. (Even the official short-term debt is equal to over six months' imports.) In any case, the ratio of short-term debt to imports is much higher for the Philippines than for other Asian countries (see figure 7). [Redacted]

There are several reasons why the short-term debt has grown so rapidly. Part of the Philippines' high demand for short-term credit springs from the inability or unwillingness of private companies to borrow long term at current high rates. More worrisome is the possibility that the demand for short-term credit is the result of distress borrowing by firms whose working capital is being depleted, or even the result of distress lending by banks unwilling to push Philippine customers into bankruptcy by withdrawing loans. In the latter event, banks are advancing money to troubled companies to pay interest obligations on outstanding loans. Such abnormally heavy short-term borrowing over the long run adds to the already severe financial problems of many firms. If this is the case, much of the short-term foreign debt—probably about \$4 billion—is not self-liquidating and adds to the basic current debt service burden. [Redacted]

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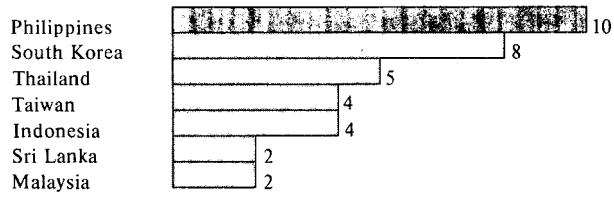
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Figure 7
Import Equivalent of Estimated Short-Term
Debt for Selected Asian Countries^a

Number of Month's Imports



^aEnd of 1980. Based on Bank for International Settlements data.

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**Appendix B
Tests Designed To Forecast
Impending Debt Problems:
Applications to the Philippines**

In 1975-80, 11 developing countries experienced multilateral debt renegotiation, involving both public and private creditors. Although it is difficult to identify leading indicators that can be used to forecast an impending debt crisis with any degree of confidence, IMF analysts have isolated several characteristics exhibited by most of the developing countries that underwent debt rescheduling.¹ We apply these criteria to the Philippines in the following table. [redacted]

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A summing up of the factors in the table suggests that the Philippines will face serious balance-of-payments problems within the next few years but will not encounter a debt crunch. Compared to most of the countries that rescheduled in this period, the Philippines has a more diversified economic base and is trying, with some success, to broaden its exports. Philippine imports have not grown as rapidly as

imports of the rescheduled group, nor have inflows of capital been as variable. In addition, Manila has asked for and has received IMF and World Bank financial assistance and technical advice—in time, perhaps, to implement the necessary structural reform of the economy. The government has already shown both the willingness and the ability to intervene to prevent widespread financial collapse—in the wake of the 1981 domestic financial scandal. Most importantly, Manila possesses a set of highly competent economic managers, technocrats who realize the implications of the large foreign debt and who—in the right political climate—can design measures to manage it.

[redacted]

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¹ Bahram Nowzad, Richard C. Williams and others, *External Indebtedness of Developing Countries*. International Monetary Fund, Washington, D.C., May 1981. [redacted]

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Indicator	Remarks on Philippines' Status
<p>Deteriorating balance of payments:</p> <ul style="list-style-type: none"> • Expansionary monetary and fiscal policies producing rapid import growth • Sharp rise in imported oil prices • Slow growth in output and exports • Fluctuations in workers' remittances and tourist earnings • Decline in official long-term capital inflows • Slower growth or decline in private capital inflows 	<p>The Philippines has run increasingly large balance-of-payments deficits since 1979:</p> <ul style="list-style-type: none"> • Expansionary fiscal policies were in evidence in 1981, but monetary policy was restrictive and imports grew less than 10 percent • OPEC price hikes have accounted for the bulk of the trade deficit since 1979. • Exports fell in 1981 and output grew at most 1 percent. Export revenue is highly variable because it consists heavily of primary commodity earnings • Workers' remittances are buoyant and tourist receipts reasonably steady • Official long-term inflows are steady at \$1.1 billion a year • Private medium- and long-term capital flows are holding steady. Short-term capital inflows are rising.
<p>Rapid expansion of private bank borrowing:</p> <ul style="list-style-type: none"> • Large increase in share of external debt held by private banks • Rapid expansion of medium-term syndicated loans at terms slightly less favorable than those accepted by other non-oil-developing countries • Bank lending tended to be procyclical and move with the commodity price cycle • Periods of peak borrowing associated with rapid increases in government expenditure and a decline in the domestic savings rate • Marked shortening of maturities • Banks tended to react to payments difficulties by running down trade credits 	<p>Private banks hold about 70 percent of the Philippines' external debt:</p> <ul style="list-style-type: none"> • Terms on Philippine loans are not as good as those of 1980, but remain better than those for many LDCs • Medium- and long-term lending increased in 1980 and held steady in 1981. The Philippine Central Bank is trying to limit borrowing in 1982, but may not be able to do so. • Borrowing is procyclical and corresponds to rise of government budget deficits, which is due to poor tax performance • Government expenditure held steady in 1981, and President Marcos has announced efforts to trim outlays in 1982: • Maturities have shortened considerably since 1980, and short-term debt is growing rapidly • Philippines is still an excellent short-term risk
<p>Borrowed funds generally invested in projects not productive enough to generate sufficient foreign currency earnings to repay the loans</p>	<p>Investment in the Philippines for a decade has been inefficient in generating output. Foreign borrowing has also been inefficient. The country is in the middle of a structural adjustment program to correct this problem, but results are not expected for several years</p>
<p>Accumulation of payments arrears. Countries which rescheduled had payment arrears approaching 40 percent of merchandise export earnings</p>	<p>Private-sector arrears are growing rapidly, particularly among firms which depend on government business. Payments by the public sector are on schedule, however, and total arrears are a small fraction of export earnings.</p>
<p>Erosion of international financial community's confidence in borrowing country's economic management. Reflected in slowdown of loan growth and hardening of terms</p>	<p>International financial community downgrades Philippine creditworthiness in 1981. Loan terms deteriorating in 1982. Doubts surfacing about Manila's economic management.</p>
<p>Recourse to renegotiation and rescheduling</p>	<p>Several large private corporations are currently rescheduling their loans. Government finances are on a firm footing, however.</p>

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Appendix C
The Philippines:
Selected Private
Commercial Borrowers, 1977-81

Borrower	Amount (million US \$)	Spread (percentage points)	Maturity (years)	Remarks
1977				
Construction and Development Corporation of the Philippines	14.0	NA	5.0	Manager: Republic National Bank of Dallas
Philippine Long Distance Telephone Company	63.0	NA	NA	Manager: European Asian Bank
1978				
Elizalde Consolidated Steel, Inc.	20.0	NA	1.0	Guaranteed: The Development Bank of the Philippines
San Miguel Corporation	130.0	1.250 1.375 1.500	5.0 3.0 2.5	Manager: Citicorp International Group; Bank America International Group; BT Asia, Ltd.; Chase Manhattan Asia, Ltd.
Construction and Development Corporation of the Philippines	17.0	1.250	10.0	Grace period 4.0 years Guaranteed: Philippine National Bank
Atlas Consolidated Mining and Development Corporation	80.0	1.250	8.0	Grace period 3.0 years
Consolidated Mines, Inc.	49.1	1.000- 1.125	8.0	Over six months SIBOR rate varies between 1.0 and 1.125
1979				
Construction and Development Corporation of the Philippines	25.0	0.625	4.0	Standby guarantee facility Guaranteed: Philippine National Bank
Construction and Development Corporation of the Philippines	31.9	1.000	10.0	Grace period 3.0 years Guaranteed: Philippine National Bank
Construction and Development Corporation of the Philippines	13.0	1.625	3.0	Manager: Citicorp International Group; Amex Bancom, Ltd.
San Miguel Corporation	100.0	1.000	10.0	Grace period 2.0 years Signed in Hong Kong
1980				
San Miguel Corporation	300.0	0.750- 0.850	6.0-6.0	
Republic Telephone Company	10.2	NA	10.0	Manager: Private Investment Company for Asia, Philippine Investments Systems Organization
Manila Electric Company	47.0	0.875-1.00	4.0-6.0	
Philippine Associated Smelter and Refining	85.0	0.750- 0.875	6.0-9.5	Manager: Fuji Bank
Landoil Resources Corporation	50.0	NA	NA	Standby guarantee facility for borrower's activities in Saudi Arabia
Various Philippine contractors	20.0	0.875	8.0	Manager: Arab banks
Dupax Rubber Corporation	18.5	1.00	8.0	Margin above SIBOR Guaranteed: Development Bank of the Philippines
Landoil Resources Corporation	26.0	1.00	1.0	Manager: Credit Suisse First Boston
Marinduque Mining and Manufacturing	83.0	0.875- 1.00	4.0-4.0	Guaranteed: Development Bank of the Philippines

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Borrower	Amount million US \$	Spread (percentage points)	Maturity (years)	Remarks
1981				
Asia Breweries	60.0	1.00	8.0	Manager: Marine Midland
Construction and Development Corporation of the Philippines	46.5	1.00	7.0	Guaranteed: Philippine Export and Foreign Loan Guarantee Corpora- tion; US EXIM Bank
Philippine Long Distance Telephone Company	76.8	1.125	8.0	Manager: European Asian Bank
Asia Reliability Company	17.0	1-1.125	5.0-3.0	Manager: Credit Suisse First Boston Guaranteed: Philippine Export and Foreign Loan Guarantee Corporation
Landoil Resources Corporation	20.0	1.00	4	Manager: Al Bahrain Arab African Bank
Atlas Consolidated Mines	155	0.750-1.00	5-5	Manager: Chase Manhattan

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