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Central Intelligence Agency

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**DIRECTORATE OF INTELLIGENCE**

29 August 1986

# The Philippine Economy: Outlook and Key Issues [redacted] 25X1

## Summary

Having come to power in the wake of the worst peacetime recession in recent Philippine history, Aquino political success will in large part depend on improving living standards, which have sunk by 15 percent since 1981. Nonetheless, there are no easy methods for repairing the economy. Under these circumstances, we believe that Manila will continue to emphasize its need for more aid from the United States and other foreign donors and avoid politically unpalatable economic policies, such as devaluation. [redacted] 25X1

Investment is critical to the economic outlook. In our view, maintaining business confidence and encouraging foreign investment require keeping a lid on labor militancy, setting policies that provide even-handed treatment of the private sector and foreign investors, and demonstrating political stability. Our econometric analysis shows that, if Aquino can manage investment-related issues, the economy can grow by more than 2 percent this year and by as much as 7 percent next year. [redacted] 25X1
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This memorandum was prepared by [redacted] Office of East Asian Analysis. 25X1
Information available as of 29 August 1986 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Islands Branch, Southeast Asia Division, OEA [redacted] 25X1

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Sustaining a recovery beyond 1987, however, will require wide-ranging economic reforms that increase agricultural productivity, improve international competitiveness, narrow the budget deficit, and rescue the failing banking system. Achieving these objectives demands considerable political leadership, since each would adversely affect key interest groups in the short run. 25X1

**Economy Holds Promise in the Near Term**

President Aquino comes to power at an opportune time in the Philippine business cycle--the two-year recession bottomed out late last year. If investor confidence firms, the economy could grow by 2.6 percent this year, according to our econometric simulations; we estimate that GNP grew by 2 percent in the first guarter of this year. Moreover, with favorable external economic conditions, national output could bounce back by nearly 7 percent next year. 25X1

- Key economic indicators have been positive since the "February revolution". The small local stock market is up over 60 percent, foreign exchange reserves have grown by 80 percent to $1.6 billion, and inflation has been stopped--in June, consumer prices fell at a 10-percent annual rate. Moreover, our index of leading economic indicators suggests that an upturn in the economy is under way.

- Foreign exchange inflows will be sufficient to meet debt servicing and import requirements. Aid donors have pledged to deliver over $750 million in financial assistance this year, agreement is near on a new $500 million IMF program, and, in our judgment, negotiations with foreign commercial banks later this year will result in a rescheduling of debt payments due between 1987 and 1991.

According to US Embassy reporting, Aquino's economic advisers believe that an economic recovery can begin only with increased government spending and that it must subsequently be sustained by a reinvigorated private sector. A growth-oriented strategy for government spending means that Manila will run large budget deficits this year--equal to nearly 5 percent of national output--and increase the money supply by as much as 15 percent. Manila's foreign creditors, including the IMF and commercial banks, worry that such a policy course would reignite inflation and undermine the improved foreign payments position of the government. According to Budget Minister Romulo, however, the Philippines can no longer afford the social fallout of poor economic performance. 25X1

One bright spot is the performance of the agricultural economy. According to Philippine Government data, agricultural output in the first quarter of this year was 2.5 percent higher than in the same period in 1985, while the output of industry and services fell by 3 percent. Production of rice and corn--the two crops most commonly grown--increased by 8 and 13 percent, respectively, aided by good weather and government credit programs. The sector's only production decline was registered by sugar, where output dropped 10 percent in response to record low prices on the world market. Although agriculture's current gains are modest compared with the 5-percent



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annual growth rates achieved a decade ago, they have helped many Filipinos adjust to widespread unemployment in urban areas. [redacted] 25X1

**But Many Serious Problems Remain**

A long-term economic recovery is not ensured. Consumers, small businessmen, and organized labor are likely to resist tax reforms, trade and foreign investment liberalization, a floating exchange rate, and revamping government financial institutions. Furthermore, Manila's economic planners cannot count on sustaining growth with exports; commodity prices this year are at historically low levels, and most economists expect little improvement for at least the next few years. [redacted] 25X1

Another constraint to economic growth is that the Philippines is overborrowed--servicing its $27 billion foreign debt absorbs nearly 40 percent of export earnings. Moreover, despite a recent buildup of its foreign exchange reserves to levels equal to four months of import requirements, Manila's dependence on balance-of-payments loans from the IMF and a rescheduling its foreign exchange gap will continue. [redacted] 25X1

**Immediate Economic Issues**

In our judgment, the Philippines has three critical economic problems that must be addressed by government policymakers in the near term--stimulating investment, restraining labor militancy, and improving the economy's international competitiveness.

**Stimulating Investment.** In our judgment, the prospects for economic recovery depend crucially on increasing private-sector investments, especially by local businessmen. Manila will find it difficult to use more traditional methods of export growth or expansionary fiscal and monetary policy to prime the economy. The IMF, for example, has set budget and money ceilings for Manila. As long as businessmen believe that Aquino's government is biased against the private sector, encourages radical leftist unions, is ambivalent toward foreign investments, and lacks long-term direction, investment outlays are likely to remain low. [redacted] 25X1

Lessons from other Asian nations--including South Korea, Singapore, and Malaysia--suggest that taking advantage of global economic trends requires an economic and political environment that attracts the private sector--both domestic and foreign. [redacted] 25X1



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- Public-and private-sector investment--which totaled more than $5 billion last year--is essential to reviving the industrial sector, improving agricultural productivity, and generating new jobs. Gross investments have taken a nosedive in recent years, dropping from 29 percent of national output in 1980 to 14 percent last year, according to Philippine Government data. Aquino is increasingly impatient with the wait-and-see attitude of local investors and has said so publicly. Investments during the first five months of this year are little more than half the level achieved during the same period last year and, by all indications, have not picked up since the business-supported revolution that swept Aquino to power. Moreover, according to US Embassy reporting, the small but influential Chinese business community is postponing business spending until the country's political and economic prospects improve. [redacted] 25X1

- [redacted] overseas businessmen also are postponing 25X1 investment outlays, in part because of the low level of confidence in the government exhibited by the Philippine business community. Foreign corporate investments since January are running at half of last year's rate. The $125 million in foreign capital inflows last year--concentrated in export-oriented industries-- contributed only 2 percent to the investments made in the Philippines. [redacted] 25X1

- Aquino's government appears to be indifferent to foreign investment. For example, the government's draft five-year plan suggests that foreign investment will be channelled into sectors where domestic investment is inadequate and denied entry into other sectors. In addition, nationalists are pressuring the Aquino government to impose sweeping limitations on foreign investment. [redacted] 25X1

**Restraining Labor Militancy**. Philippine businessmen report that labor militancy is largely responsible for the poor investment outlook. In particular, businessmen are concerned with Labor Minister Sanchez's sympathy for leftist unions and his support of policies, such as radical profit-sharing plans, that they believe encourage labor-managment strife. More than 330 strikes during the first half of this year--60 percent higher than in the same period in 1985--involved over 90,000 workers. According to press reports, there is widespread criticism in the business community that the Ministry of Labor is helpless in preventing strikes. [redacted] 25X1

The leftist KMU (Kilusang Mayo Uno) labor alliance is widely held responsible for the increased labor militancy. Believed by many observers to receive policy guidance from Communist front groups, the KMU advocates a struggle against the Philippine military, elites, multinationals, and the US Government. [redacted] 25X1

**Improving International Competitiveness**. In our judgment, most Philippine manufacturing firms are uncompetitive in world markets because of tariff and nontariff





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barriers to both imports and exports. As a consequence, the growth of manufactured Philippine exports has been the lowest among developing countries in East Asia over the last several years. Moreover, the nature of world trade is changing because of weaker world demand for exports from developing countries, more emphasis on manufactured products, greater protectionism, and more trade competition among countries. Although Manila is taking steps to lift import restrictions and tariffs that have protected inefficient domestic manufacturers, local businessmen are likely to mount a stiff resistance to sweeping trade liberalization and, in our judgment, end up diluting the benefits of such policies. Agricultural products and raw materials account for about one-third of total exports. Because of our projected decline in US demand for such products, however, the Philippines cannot continue to rely on its traditional commodity exports to the United States, such as coconut oil, sugar, and forest products, as a major source of foreign exchange. [redacted] 25X1

The developing countries that have been successful in registering steady economic growth have all adopted an export-oriented development strategy. The typical package of outward looking growth policies includes an exchange-rate policy geared to making exports more competitive; a fairly tight monetary and fiscal policy to control inflation, favor production for exports, and strengthen export competitiveniness; and some measures to promote private and foreign investment. [redacted] 25X1

**Policy Options for a Rural-Based Economic Recovery**

Despite these gains in agricultural production, rural incomes have been depressed by rapid population growth and corrupt marketing monopolies. In our judgment, increasing the standard of living in the countryside--where 70 percent of the population resides and which contributes over a quarter of the national output-- and combating propaganda gains by the Communist insurgents require, among other things, agricultural growth rates in excess of four percent annually. [redacted] 25X1

Accordingly, President Aquino's economic advisers are weighing a commitment to rural development as the cornerstone of the government's program for economic recovery. They realize that declining support for the Marcos government and the rapid escalation of the Communist insurgency after 1981 coincided with the rural economy's sharp decline. [redacted] 25X1

One reason to adopt a rural strategy is that traditional development programs will not significantly improve the living standards of the average Filipino. Import-substitution policies of the Marcos government, for example, left large segments of the manufacturing economy plagued by high costs, discouraged agricultural export production, and created few industrial jobs. Moreover, Aquino's economic planners cannot count on sustaining growth by exporting unprocessed agricultural commodities or manufactured goods; commodity prices this year are at their lowest levels relative to those of manufactures since the 1930s, and most economists expect little improvement for at least the next few years. Furthermore, the low cost of Philippine labor is no longer sufficient to ensure the competitiveness of manufactured goods because, for over a decade, new production technologies have lowered labor's contribution to total manufacturing costs. [redacted] 25X1



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Alternatively, by boosting rural output and incomes through improved rural infrastructure, agricultural extension services, and appropriate pricing policies, we believe the Philippines could develop an internal market capable of sustaining economic growth. A necessary component of this strategy would be an exchange-rate depreciation that directly raises incomes for rural exporters and makes it profitable to invest in agribusiness enterprises. We believe the peso's nearly 50-percent devaluation since late 1983, for example, helped boost agricultural output by nearly 5 percent during 1984-85--despite a 10-percent decline in the economy's overall production. 25X1

Aquino's government faces numerous political hurdles in carrying out a rural development strategy. Urban interest groups--which were responsible for ousting Marcos--are likely to oppose exchange rate, tariff, pricing, and tax policies designed to encourage agricultural production and boost rural incomes if they believe those policies will hurt urban industries or raise consumer prices. Furthermore, Aquino's economic team--comprising businessmen, bankers, and academics with little experience in small-scale agriculture--may not be sufficiently committed to rural development to overcome lobbying by urban interest groups. Complicating the picture is the time it takes for rural development to succeed under even the best of circumstances, and Aquino has said publicly that she has to deliver tangible benefits quickly in the countryside. 25X1

Manila's projected large budget deficit this year--probably more than 4 percent of national output--will also restrict the scope of the government's rural development effort. A high-impact rural development program requires large outlays for roads, post-harvest food storage, irrigation, and a revitalized agricultural extension service. In addition, improving farmers' welfare will require a costly effort to coordinate disparate civilian and military counterinsurgency programs. 25X1

As a consequence of Manila's budget constraints, financial aid is likely to become a contentious and troublesome issue between Manila and its aid donors. We believe that Manila may come to the view the Military Bases Agreement as the key source for the funding it believes is needed to finance its rural development strategy. 25X1



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