

**The Country Study
for Japan's Official Development Assistance
to
The Republic of the Philippines**

March 1999

The Committee on the Country Study
for Japan's Official Development Assistance
to the Republic of the Philippines

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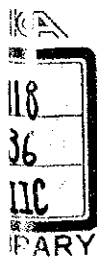


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This report is based on the discussions and findings of the Committee on the Third Country Study for Japan's Official Development Assistance to the Republic of the Philippines organized by the Japan International Cooperation Agency (JICA).

Opinions expressed in the report are those of the members of the Committee and do not necessarily reflect those of JICA and its affiliated organizations.

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Institute for International Cooperation (IFIC)

Japan International Cooperation Agency (JICA)

10-5 Ichigaya Honmura-cho, Shinjuku-ku, Tokyo 162-8433 JAPAN

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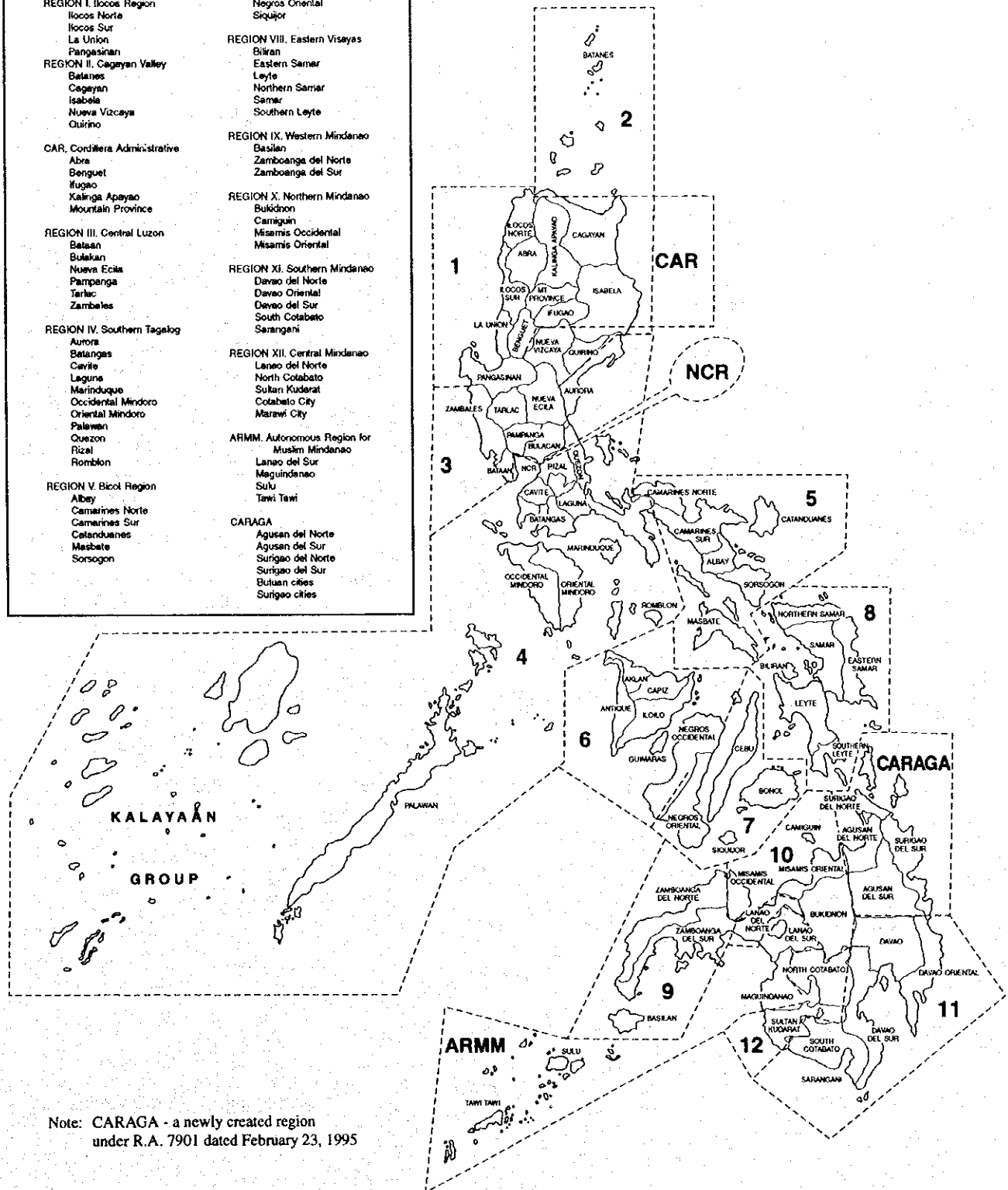


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REGIONAL DELINEATION

NCR - National Capital Region Manila M. Manila Municipalities Kalookan City Pasay City Quezon City Mandaluyong City Makati City Muntinlupa City Pasig City	REGION VI. Western Visayas Aklan Antique Capiz Guamoras Iloilo Negros Occidental
REGION I. Ilocos Region Ilocos Norte Ilocos Sur La Union Pangasinan	REGION VII. Central Visayas Bohol Cebu Negros Oriental Siquijor
REGION II. Cagayan Valley Batanes Cagayan Isabela Nueva Vizcaya Oquirino	REGION VIII. Eastern Visayas Biliran Eastern Samar Leyte Northern Samar Samar Southern Leyte
CAR. Cordillera Administrative Abra Benguet Ifugao Kalinga Apayao Mountain Province	REGION IX. Western Mindanao Basilan Zamboanga del Norte Zamboanga del Sur
REGION III. Central Luzon Bataan Bulacan Nueva Ecija Pampanga Tarlac Zambales	REGION X. Northern Mindanao Bukidnon Camariguin Misamis Occidental Misamis Oriental
REGION IV. Southern Tagalog Aurora Batangas Cavite Laguna Marinduque Occidental Mindoro Oriental Mindoro Palawan Quezon Rizal Romblon	REGION XI. Southern Mindanao Davao del Norte Davao Oriental Davao del Sur South Cotabato Sarangani
REGION V. Bicol Region Albay Camarines Norte Camarines Sur Catanaguanes Masbate Sorsogon	REGION XII. Central Mindanao Lanao del Norte North Cotabato Sultan Kudarat Cotabato City Marawi City
	ARMM. Autonomous Region for Muslim Mindanao Lanao del Sur Maguindanao Sulu Tawi Tawi
	CARAGA Agusan del Norte Agusan del Sur Surigao del Norte Surigao del Sur Butuan cities Surigao cities

Map of the Philippines



Preface

This report has been prepared by the Committee on the Third Country Study for Japan's Official Development Assistance to the Republic of the Philippines, which the Japan International Cooperation Agency (JICA) organized in April 1998. This is a compilation of study results in the form of proposals on future assistance for the Philippines.

The Committee began its study just before President Ramos finishing his term of office in June 1998. In highly appreciating the political stability, economic reforms and reconstruction, and further progress in decentralization that were achieved by the Ramos Administration, the Committee concluded that political and economic conditions had improved significantly in the Philippines, and it pointed out need for further reforms focused on the financial sector, addressing the economic crisis in Asian nations, although its impact was comparatively small in the Philippines because of its successful reform efforts thus far. The Committee reviewed regional disparity reduction and human resources development, which had been identified by the Committee on the Second Country Study for Japan's Official Development Assistance to the Republic of the Philippines, organized in 1992, as development challenges requiring long-term efforts. The present Committee also studied how assistance in economic infrastructure-building, which Japan has prioritized, should be implemented in the future.

Based on the study results, the Committee concluded that assistance was indispensable for the Philippines to reduce, notably, poverty and regional disparities, for its future development, while keeping good balance with economic growth. As part of efforts to address these challenges, the Committee came to recognize the importance of assistance in education, health care, decentralization, and the environment and disaster prevention in order to support sustainable development. Development by foreign assistance, producing changes such as in the environment and the structure of employment in a community, can place a heavy burden on specific people. The Committee therefore made proposals in this report while keeping in mind the need for more careful consideration in providing assistance.

The Philippines, as you know, has been a recipient country since the initial stages of Japan's official development assistance, which accounts for a high ratio of the total foreign assistance to the country. There are active contacts in the private sector as well, such as in business, notably with direct foreign investment, and through NGO activities. A good relationship has thus been established between the Philippines and Japan. I hope this report will contribute to discussions concerning the direction of

Japan's assistance to the Philippines, a significant partner of Japan, and to the Philippines' further development and the advancement of friendly relations between the two countries.

Last, but not least, I would like to express my gratitude to the Committee members, who gave of their precious time to actively participate in discussions related to compiling this report. I must acknowledge cooperation in field surveys and valuable advice provided by the Japanese Embassy in Manila, the Manila Representative Office of the Overseas Economic Cooperation Fund, and the JICA Philippine Office. I must also acknowledge views and information that can only be provided by persons who are active on-site, i.e., JICA experts and personnel of other aid agencies. In addition, I am deeply grateful for the cooperation and support provided by the Economic Cooperation Bureau of the Ministry of Foreign Affairs and the JICA Institute for International Cooperation and its Secretariat for this Committee.

March 1999

Akira Takahashi

Chairman

Committee on the Third Country Study
for Japan's Official Development Assistance
to the Republic of the Philippines

Members of the Study Committee

Akira TAHAKASHI (Chairman)	Professor, Faculty of Economics Kokushikan University
Hiromitsu UMEHARA	Professor, Department of Geography, Faculty of Arts, Rikkyo University
Takehiko OHTA	Professor, Department of Forest and Science, Graduate School of Agricultural and Life Science, The University of Tokyo
Yutaka KATAYAMA	Professor of Social and Political Development, Department of International Cooperation Studies, Graduate School of International Cooperation, Kobe University
Hideaki SHIBUYA	Associate Professor, Faculty of Education, Tokyo Gakugei University
Hiroshi SUZUKI	Director, 3rd Division, Operations Department I, Overseas Economic Cooperation Fund (Since October 1998)
Juro CHIKARAISHI	Director, Planning Division, Grant Aid Project Management Department, Japan International Cooperation Agency
Kazuto TSUJI	Director, 3rd Division, Operations Department I, Overseas Economic Cooperation Fund (Until October 1998)
Toshitaka NAKAHARA	Professor, Department of Public Health, Graduate School of Medicine, Kyoto University
Katsumi NOZAWA	Professor, Faculty of International Relations, Asia University
Mitsuo FUKUSHIMA	Director, Area Studies Department 1 ID-JETRO

(As of March, 1999)

Members of the Task Force

Hideaki HOSHINA (Chief)	JICA Development Specialist
Toshiyuki HAYASHI(sub-Chief)	JICA Development Specialist
Nozomi IWAMA	Research and Development Division, Institute for International Cooperation, JICA
Yukihiko EJIRI	Deputy Director Disaster Assistance Division, Secretariat of Japan Disaster Relief Team, JICA
Takuya OTSUKA	First Medical Cooperation Division, Medical Cooperation Department, JICA
Toshio OGAWA	Deputy Director Agricultural Development Study Division, Agriculture, Forestry and Fisheries Development Study Department, JICA
Naoyuki OCHIAI	Planning Division, Planning Department, JICA Philippine Office
Susumu KATSUMATA	First Technical Cooperation Division, Mining and Industrial Development Cooperation Department, JICA
Kai KIKUIRI	First Training Division, Training Affairs Department, JICA
Kazue KOBAYASHI	Researcher, Japan International Cooperation Center
Akira NAKAYAMA	First Regional Division, Planning Department, JICA
Kenji MATSUMOTO	Deputy Director Coordination and Appraisal Division, Grant Aid Project Study Department, JICA

(As of March, 1999)

Abbreviations

AFTA	ASEAN Free Trade Area
ARMM	Autonomous Region of Muslim Mindanao
ASEAN	Association of Southeast Asian Nations
BHN	Basic Human Needs
BIMP-EAGA	Brunei-Indonesia-Malaysia-Philippines-East ASEAN Growth Area
BIR	Bureau of Internal Revenue
BOC	Bureau of Customs
BOT	Build, Operate and Transfer
CAR	Cordillera Administrative Region
CARP	Comprehensive Agrarian Reform Program
CBCRM	Community-Based Coastal Resource Management
CBFM	Community-Based Forest Management
CHED	Commission on Higher Education
CIS	Communal Irrigation System
GOCC	Government Owned or Controlled Corporations
DA	Department of Agriculture
DAR	Department of Agrarian Reform
DECS	Department of Education, Culture, and Sports
DENR	Department of Environment and Natural Resources
DILG	Department of Interior and Local Government
DOST	Department of Science and Technology
DOTC	Department of Transportation and Communication
DPWH	Department of Public Works and Highways
DSWD	Department of Social Welfare and Development
ECC	Environmental Compliance Certificate
EIA	Environmental Impact Assessment
GAD	Gender and Development
GDI	Gender Development Indicator
GEM	Gender Empowerment Measure
HDI	Human Development Indicator
HUDCC	Housing and Urban Development Coordinating Council
IA	Irrigators' Association
IRA	Internal Revenue Allotment
JOCV	Japan Overseas Cooperation Volunteers
LGU	Local Governments Units
LRT	Light Railway Transit
MDF	Municipal Development Fund
MAI	Multilateral Assistance Initiative
MILF	Moro Islam Liberation Front
MNLF	Moro National Liberation Front
MWSS	Metropolitan Waterworks & Sewerage System
NASPCP	National AID/STD Prevention and Control Program
NCR	National Capital Region
NCRFW	National Commission for Role of Filipino Women
NEDA	National Economic Development Authority
NGO	Non Governmental Organization
NHA	National Housing Authority
NIA	National Irrigation Administration
NIES	Newly Industrialized Economies
NIS	National Irrigation System
NPC	National Power Corporation
NSCB	National Statistical Coordination Board
NSO	National Statistics Office
PDPW	Philippine Development Plan for Women 1989-1992
PLDT	Philippine Long Distance Telephone Company
PPGD	Philippine Plan for Gender Responsive Development 1995-2025
RAM	Reform the Armed Forces Movement
SPCPD	Southern Philippine Council for Peace and Development
SRA	Social Reform Agenda
STD	Sexually Transmitted Disease
SZOPAD	Special Zone of Peace and Development
TESDA	Technical Education and Skills Development Authority
WHO	World Health Organization

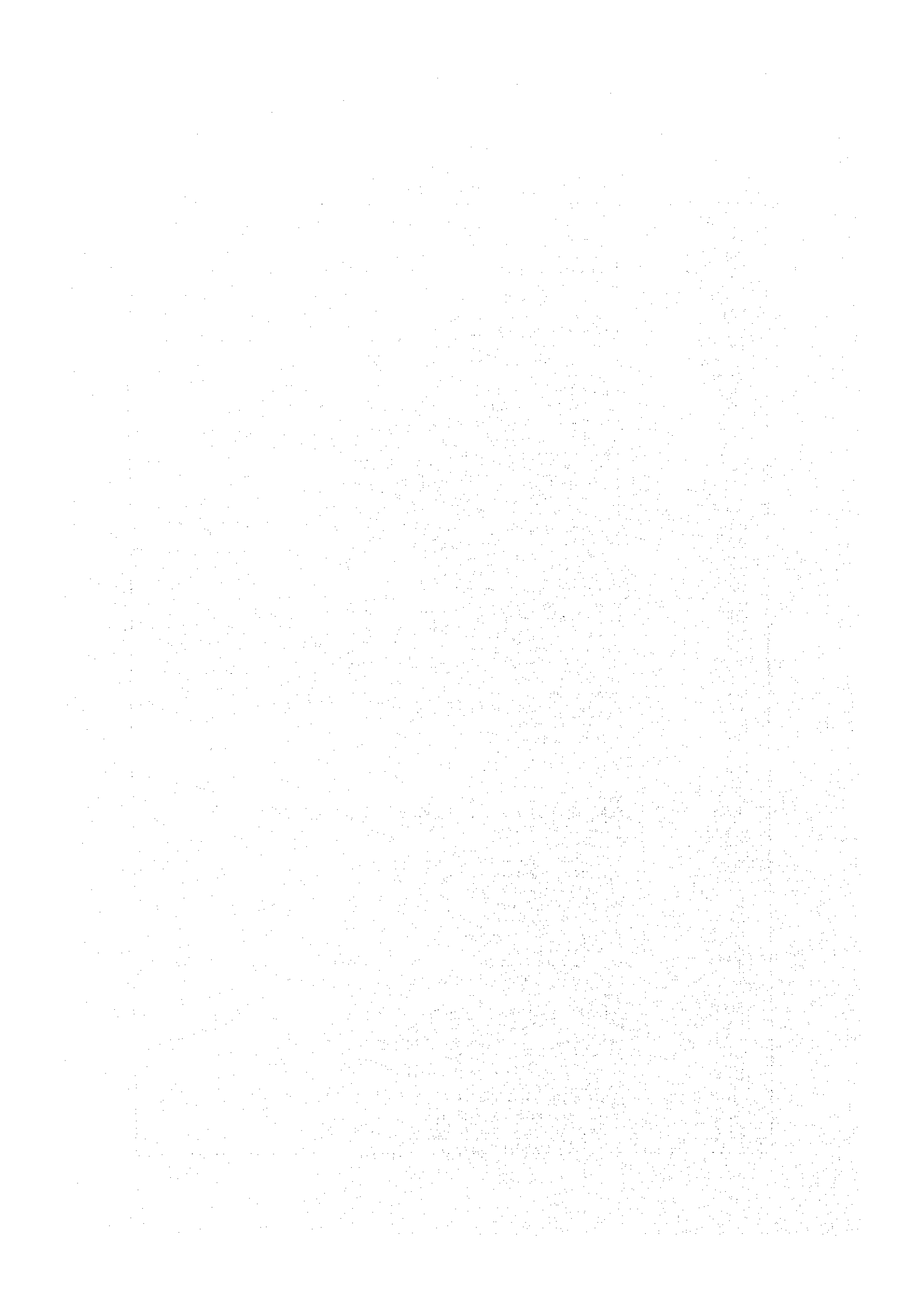


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Summary

1. Prospect of Issues in Development of the Philippines

1.1 Overview of political and economic conditions

The Ramos Administration positively tackled economic restoration; it improved the bottleneck due to a quantitative shortage of infrastructure, and it implemented various economic reforms toward liberalization and deregulation, based on the IMF's Structural Adjustment Lending. As a result, investments from overseas and exports grew smoothly, in part supported by favorable economies in Asia and America, and a GNP growth rate of between 5% and 6% was achieved in the four years between 1994 and 1998. During this period the per capita GNP reached \$1,000, and in the financial aspect, breaking away from a structure of deficit finance was attempted, and a budget surplus was temporarily achieved, though the main reason was growth of non-tax income, such as profit from sales generated by privatization. As to the economic crisis since 1997, though such influences as a decrease of revenue and decreased investments due to the sluggish economy over several years cannot be avoided, the influences are considered to be smaller than in neighboring countries. As such, the Philippine economy can be said to have gotten back on a track of stable growth.

On the other hand, due to enforcement of the Local Government Code in 1991, administrative functions, work, staff, budgeting, etc., were transferred from the central Government to local government units, and local initiative in developmental administration was institutionally secured. Actually, however, the bestowed functions are not working sufficiently, due to fund shortages, the limited experience of staff who handle the transferred work, and local government units' poor development-planning capacity. As such, further improvements are needed.

1.2 Present state of sectors and issues

1.2.1 Poverty

In terms of poverty indices, the share of poor households in the total number of households has decreased, but in terms of absolute number there was no improvement. Income distribution has not either necessarily ameliorated. In addition, improvement

of the poor household share in rural areas is behind compared with that in urban areas. The Philippine Government adopted the Social Reform Agenda (SRA) in 1994, and it has been promoting poverty alleviation projects in the selected 21 provinces and six urban areas, such as Metro Manila, Baguio city, and Cebu city. Poverty can be explained by the factors, such as the slower expansion of employment in the manufacturing sector, compared with this sector's growth accompanying industrialization. In rural villages, the increase of harvest realized through the introduction of high-yielding varieties has not necessarily led to increasing farmer's incomes due to the oligopolistically controlled markets for agricultural inputs and rice products. Also, the spread of commercialized agriculture has escalated the farmers' need for cash income.

Furthermore, poverty is related to soil erosion in the uplands and flood in the lowlands, as a result of cultivation in the uplands by poor farmers. Rural poverty also leads to urban poverty exemplified by slums, which are formed by the small peasants migrating into urban areas in pursuit of employment opportunities.

1.2.2 Health

The Philippines has various issues to tackle, such as the population increase, the deterioration of public health, including the nutrition problem, spreading of infectious diseases, and drug abuse. The population increase rate has been decreasing, though only slightly, as family planning was promoted from the perspective of improving health and welfare. As to infectious diseases, in the 1990s, the disease rates of malaria and measles have been decreasing, but new problems, such as increases of skin disease and AIDS, are being faced. Also, the regional disparity in the state of public health is a serious problem.

The situation of health-care supply was worsened by the system transition accompanying decentralization, in many cases.

1.2.3 Education

In the 1990s, universal basic education was positioned as an important issue in educational policy, and programs aimed at qualitative and quantitative improvement, and at promoting decentralization of educational administration, as well as strengthening its function for that purpose, have been promoted. As to basic education, the following problems are pointed out: a high dropout rate and poor study achievement levels;

regional unevenness in spreading of basic education; and not enough specialized subjects related to teaching methods, content of education, and curriculum, in teacher training courses. Problems regarding higher education are shortages of study facilities and teachers who hold degrees. As to vocational training, education that connects training schools and on-the-job training was systematized, but participation of the private sector in the program is insufficient. Also, personnel-training in accordance with regional industrial demand is inadequately conducted, and training instructors are in short supply.

1.2.4 Agriculture

The issue in the agricultural sector is how improvement of productivity, which is the major issue in any industry, should be promoted, in good balance with rural development for the alleviation of regional disparity and poverty.

As to the former, amid further increasing international competition, such as lowering of tariffs and trade liberalization within the area of AFTA, Philippine agricultural products for exportation are required to improve competitiveness in both price and quality. It is also necessary for non-export agricultural products to increase competitiveness in price, such as by lowering the production unit cost, in order to avoid devastating effects from the inflow of imported agricultural products. Judging from the Philippines' natural conditions, it is considered possible to improve the food self-sufficiency, and the opportunity cost of using valuable foreign currency to import foods is too large. Therefore, it is necessary to make further efforts to improve productivity, such as by agricultural research and spreading of its results, and by efficient usage of irrigation facilities.

On the other hand, improving the income of the poor, most of which lives in agricultural villages, contributes not only to the purpose of development itself, which is correction of poverty and regional disparity, but also to expanding the domestic market, resulting in the development of other industries. In order to support independence of the poor, production means should be distributed through such as agrarian reform, and in addition, the Government should provide continuous support, regarding agriculture and the living environment, to farmers who conduct agriculture in areas of low fertility, such as upland.

1.2.5 Infrastructure

At present, the supply of energy just manages to keep up with the rapid increase

of demand in the process of economic growth, such as by the increased number of vehicles and improved living conditions.

Roads play the most important role in the Philippine traffic system, and it has been increasingly expanded, centered on the Metropolitan area. Future issues included establishing a nationwide road network and strengthening of management and maintenance systems. For that purpose, it is necessary to establish a nationwide road network, improve the quality of existing roads, and strengthen the maintenance and management system. In addition, in order to solve traffic congestion in the Metropolitan area, construction and operation of railways and LRT lines, as a means of mass transport, are needed.

The usage frequency of marine transportation is also extremely high, due to the geographical features, and, it is necessary to improve such problems as insufficient navigation safety facilities, obsolescent ships, poor harbor facilities, etc. As to air traffic, it is necessary to improve airports, deregulate the domestic airline industry, and improve facilities and strengthen their management for air traffic safety, in order to respond to the rapid increase of air travel accompanying economic growth.

Regarding telecommunications, domestic telephones have spread rapidly in the past several years, but about 60% of them are located in the Metropolitan area.

As to the spread of water supply also, there is a considerable disparity between the Metropolitan area and rural areas. In the Metropolitan area, deterioration of the housing situation is a large problem, and construction of medium-rise apartment houses and arrangement of the environment in the illegal residence district are being tackled.

1.2.6 Mining and manufacturing

The ratio of the mining and manufacturing industries, including electric power, gas, and water supply, to the GDP declined from 40% in 1983 to 36% in 1997. The share of manufacturing declined from 26% to 25%. The ratio of persons employed in manufacturing declined from 12.1% in 1960 to 9.9% in 1997, while that in the entire secondary industry remained almost unchanged: it was 15.3% in 1960, and 16.3% in 1997.

Very limited employment created by industrialization, and a rate of population increase that is higher than in Southeast Asian neighboring countries, brought high rates of unemployment and underemployment, contributing partially to chronic poverty.

The ratio of mining to total exports was declining, with 21.33% in 1980 as a peak, and it was as low as 3.03% in 1997. This was caused by worsened metal

market conditions, lower-grade mineral deposits, and so on.

1.2.7 Private sector participation and privatization

In recent years, private sector participation and capital is actively employed in public works, such as the construction and operation of power stations and roads, which the public sector has handled.

Recent worsened economic conditions in the Philippines and its neighbors, however, have discouraged investors, and a consequent decrease in fund seems to hinder private projects.

1.2.8 The environment and disaster prevention

The Philippines' environmental problems concern national land conservation, mainly caused by destruction and deterioration of forests in agricultural, mountainous, and fishery regions, and destruction of the coastal ecosystem. They are connected closely with the economy in agricultural and fishing villages, and further to poverty problems of farmers and fishermen. Also, various environmental pollution problems accompanying urbanization and industrial development are becoming obvious, especially in the National Capital Region (NCR).

The Philippines has active volcanoes, frequent earthquakes, and rivers running rapidly. Situated in the Southeast Asian tropical monsoon zone, the country has much precipitation, and typhoons strike every year. Under such conditions, disasters from such as earthquakes, volcanic activities, landslides, and flooding occur frequently, and which are accelerated by the destruction and deterioration of forests due to social factors, such as the population increase and the inadequate management of slope farmlands.

The Philippine Government is urged to build a country resistant to natural disasters, against natural conditions and social conditions that are vulnerable to them.

1.2.9 Gender

In the Philippines, women's participation in the economy, politics, and professions is relatively active, but in terms of gender-related development index, there are large disparities among regions, between urban and rural areas, and among classes. Amid noticeable job specialization by sex, about half of women are as active as men in the

labor market. Many women in the poor brackets and in squatter quarters in cities, however, work in the informal sector. More than half of people working abroad are women, engaging in service labor, such as housekeeping.

2. Perspective of assistance toward the Philippines

2.1 Perspective of assistance toward the Philippines

The Philippines, during the Ramos Administration, was able to achieve a prerequisite condition for full-scale development, which is national reconciliation. Based on this foundation, the Ramos Administration actively tackled economic restoration; it improved the bottleneck due to a quantitative shortage of infrastructure, and it implemented various economic reforms toward liberalization and deregulation, based on the IMF's Structural Adjustment Lending. As a result, a relatively high GNP growth rate, supported by investments and exports, was achieved, and a budget surplus was temporarily achieved. The influences of the economic crisis in Asia are considered to be less than in neighboring countries, and the Philippine economy can be said to have gotten back on a track of stable growth.

On the other hand, there are still wide-ranging poverty problems that are slow in improving. Though the share of households below the poverty line is decreasing, it was still high, at 32.1%, in 1997, and no improvement can be seen in the real number. Further, the income share of the upper income class is expanding, and regional disparity has not been solved either.

Poverty alleviation and correction of regional disparity are purposes of development, and they are also essential to achieving political stability and sustainable economic growth in future development of the Philippines. Therefore, in future assistance, direct work on these issues is important. Another concern is the expansion of disparity that may accompany future economic development. From this viewpoint, support for poverty alleviation and correction of regional disparity is important.

In efforts toward such issues as poverty alleviation and regional disparity, support for basic health service and education, which are directly related to these issues, in addition to support for direct improvement of livelihood, is necessary.

As to health, there is great disparity between the National Capital Region (NCR) and other regions, in terms of indices and personnel who work in health care. As healthy living is the base of every social and economic activity, it is important to

support improvement of accessibility and quality of public health and basic health service.

Education is a basic human need, and it is also closely related to improving poverty problems, environmental problems, and public health. It is pointed out that, in the Philippines, in relation to empowering citizens to participate in nation-building, priority should be placed on improving access to and quality of basic education. There are actually many problems related to basic education, and supply of educational opportunities to regions that are far behind, as well as improvement of quality, is needed. From the perspective of realizing social justice, the significance of Japan's cooperation is great.

Promotion of decentralization is also important as part of efforts to reduce poverty and regional disparity. It is highly significant that decentralization since 1991 has institutionally given LGUs functions to initiate development plans, including distribution of budgets and staff. Actually, however, things are not proceeding smoothly, due to LGUs' lack of administration experience and abilities. As the distribution of funds and staff has become left to the discretion of local government units, which have little know-how and experience, stagnation in supplying of basic social services, and lowering of their standards, are seen, also depending on the priorities of such local government units.

Support for these issues will contribute to improving LGUs' initiatives in their development and to correcting regional disparity, which are the expected purposes of the decentralization policy, resulting in greatly helping development in the Philippines. Support for decentralization is necessary also in that the role of local government units is significant in expanding efforts in each sector of poverty measures, basic health service, and education, on a level close to residents, and in enhancing their effectiveness and sustainability.

In addition, support for environmental and disaster-prevention issues is also important.

In agricultural and mountainous regions in the Philippines, the destruction of forests and devastation of slope farmland are becoming a problem in aspects of both resources management and farmers' living environment. In urban areas, such problems as the deterioration of air and water, and waste disposal, are becoming apparent. Because they constitute a factor inhibiting sustainable development, and they can greatly affect the low-income class in particular, cooperation in this field is significant.

There is large-scale damage from natural disasters in terms of human suffering, economic activities, and the basic economic foundation. In addition to conventional

cooperation in restoration from disasters and in establishing the disaster-prevention infrastructure, it is essential, for long-term development, to support improvement of the existing disaster-prevention system from a long-term perspective.

On the other hand, in order to realize progress of social development and poverty alleviation, efforts for economic development are continually important. Improvement of productivity in the agricultural sector, which has traditionally provided important employment opportunities, and strengthening of interrelations within the manufacturing sector, are necessary to create employment and to strengthen international competitiveness. For that purpose, issues that need continued support are industrial development, centered on agriculture and manufacturing, and the establishment of an economic infrastructure that is prerequisite to industrial development.

2.2 Priority issues in assistance

Based on the above-mentioned perspective, the priority issues in assistance toward the Philippines are itemized as follows.

2.2.1 Assistance in poverty alleviation

- (1) Promotion of rural development
- (2) Assistance for the urban poor

2.2.2 Assistance in health care

- (1) Strengthening of health administration and staff
- (2) Expansion of access to health service in poor regions
- (3) Nationwide expansion of family planning and maternal and child health
- (4) Assistance in AIDS and tuberculosis measures

2.2.3 Assistance in education

- (1) Assistance that contributes to improving the quality and spreading of elementary and secondary education
- (2) Assistance in non-formal education
- (3) Assistance from the planning stage and grasping of issues in local-level educational development

2.2.4 Assistance for decentralization and capacity-building of local government units

- (1) Assistance for capacity-building of local government units
- (2) Addressing problems emerging with the development of local autonomy
- (3) Adequate financing and budget-sharing with the national Government

2.2.5 Assistance in environmental conservation and disaster prevention

- (1) Assistance in resources management by CBFM and CBCRM focusing on environmental conservation
- (2) Assistance in industrial pollution control
- (3) Assistance in capacity-building in environment-related administration
- (4) Assistance in domestic waste treatment in urban cities
- (5) Assistance in disaster prevention in areas frequently struck by disasters
- (6) Assistance in water resources management
- (7) Assistance in earthquake disaster prevention in Metro Manila

2.3 Issues needing continued support

The issues that need support to continue efforts for economic development are itemized as follows.

2.3.1 Assistance in industrial development

- (1) Agricultural development
- (2) Industry development

2.3.2 Assistance in the development of economic infrastructure

- (1) Assistance in transportation sector
- (2) Assistance in the capacity-building of LGUs in planning and implementing water supply projects
- (3) Assistance in energy and power development
- (4) Assistance in enhancing the Government's monitoring capacity for development of telecommunications network

1. Evolution of the Philippines' Development Policy

This chapter summarizes political and economic changes in the Philippines before the Ramos Administration, focusing on development challenges confronting the country.

1.1 Until the Marcos Administration

Economic development in the Philippines, which became independent after World War II, was affected greatly by the U.S.-Philippine Trade Agreement^{NOTE 1} (later replaced by the Laurel-Langley Trade Agreement), which gave 28-year preferential tariff treatment to the country and national treatment to U.S. citizens. It was also affected by a fixed exchange rate system, which was maintained well into the postwar period. This increased the Philippines' dependence on the U.S. market for its traditional agricultural exports, such as sugar and coconut, and led to specialization in certain crops.

In the 1950s, a favorable environment was provided for early-stage import substitution industrialization by over-valuation of the fixed peso, the foreign exchange allocation system stipulated in the New Necessary Industries Act in 1946, selective low-interest credit, and exchange and import control triggered by the balance-of-payments crisis in 1949, despite that domestic markets were open to U.S. products in accordance with the above-mentioned agreement^{NOTE 2}. In this situation, the industry sector attained average annual growth of more than 8% in the 1950s, with manufacturing production accounting for as much as 20% of the GDP.

Export competitiveness of Philippine manufacturing, however, was reduced to a large extent due to peso overvaluation and a protectionist tariff structure, which favored imports over exports. As a result, Philippine trade deficit and external deficit increased greatly from 1957 and thereafter. The Government took measures, such as restricting imports of non-essential consumer goods and trying further import substitution, but they turned out not as effective as was expected. It finally took action and liberated

NOTE 1 Came into effect in 1946. Major contents were as follows: 1) after a duty-free period of eight years, tariff rates shall be raised by 5% every year, up to normal tariff rates in 20 years, 2) national treatment shall be given to U.S. citizens and capital, 3) the sovereignty of the Philippines shall be restricted by not being empowered to impose export taxes, or change the par value or stop convertibility of the peso, and 4) restriction of the absolute volume of traditional exports to the United States, such as sugar and coconut, under the quota system shall be continued.

NOTE 2 Mitsuo Fukushima (1989), "Chapter I History and Results of Industrialization" in *Philippines' Industrialization, Groping for Reconstruction* edited by Mitsuo Fukushima, pp. 5-10, Institute of Developing Economies.

imports. In 1962, it removed import and exchange controls and devalued the peso^{NOTE 3}. The continued exchange overvaluation in the 1950s made prices of capital goods, most of which were imports, relatively lower than labor costs. This resulted in low growth in employment in the manufacturing sector, despite higher growth in production, while producing an unfavorable economic environment for agricultural exports. This economic environment continued to the 1960s^{NOTE 4} as the protectionist tariff structure remained almost unchanged even after the removal of exchange controls in 1962.

Eventually, the import substitution policy produced economic stagnation, resulting from a worsened foreign currency position, in the latter half of the 1960s, because of limited expansion in domestic demand, in the face of internal restrictions, such as increasing urban-rural gaps due to urban-centered industrialization. This situation paved the way for the Marcos Administration to come into power, advocating a policy of socioeconomic reforms and the promotion of national interests^{NOTE 5}.

The Marcos Administration, implementing economic expansion policies utilizing easy money and external borrowing, to cope with economic stagnation, successfully raised the rate of growth. These policies, however, brought a balance-of-payments crisis and inflation. These, combined with import substitution strategy having reached its limits, and the approaching 1974 expiration of the Laurel-Langley Trade Agreement^{NOTE 6}, which stipulated preferential relations with the United States, aroused a sense of crisis among Philippine people. And it predisposed them to accepting the Marcos Administration, which advocated national interests and social reforms.

The martial law of 1972, proclaimed as a just cause of socioeconomic reforms, aimed at economic reform for the second import substitution and export expansion by utilizing foreign currency and social reforms, focusing on agrarian reform. The establishment of the Export Promotion Act and the Investment Promotion Act, as means of economic reform, provided an opportunity for export-oriented industrialization. In addition, regulations were tightened in order to concentrate power in the central government, and selective preferential treatment was expanded. The first half of the 1970s marked steady advances in reforms in various areas, producing certain results.

NOTE 3 *Ibid.*, p.p. 11.

NOTE 4 *Ibid.*, p.p. 18.

NOTE 5 Yukiho Asano (1991), *The Philippines-From Marcos to Aquino*, Institute of Developing Economies, p.p. 56.

NOTE 6 In 1955 the agreement, revising the U.S.-Philippine Trade Agreement based on the Bell Trade Act, changed the rate of tariff reduction for the remaining period in favor of the Philippines, instead of extending the duty-free period. Terms favorable to the Philippines included the recovery of currency autonomy, the removal of the absolute volume quotas, and the introduction of bilateralism of national treatment.

Throughout the 1970s, however, reforms that were disadvantageous for import substitution industries were apt to be evaded, and protectionist measures were not removed completely^{NOTE 7}. Government interventions, such as through regulations allowed rent seeking and the growth of new entrepreneurs benefited by it^{NOTE 8}.

Government-owned and/or controlled corporations (GOCCs), established one after another, deepened government involvement in the national economy, though they were launched, in part, with the aim of establishing national self-possession of energy industry and key industry. The strengthened state monopoly of sugar and coconut became a burden to the agriculture sector, because agribusiness was made to bear part of the huge sum of capital needed for the first and the second import substitution industrialization, and to bear external debt service.

GOCCs and undertakings caused borrowing and deficits to increase, because of poor domestic managerial and operational capability, and under such external conditions as the second oil crisis and worldwide high interest rates. Thereby the Government's fiscal deficit was expanded, and external debts became evident.

In the global economic depression beginning in 1979, the Marcos Administration had no choice other than accepting the structural adjustment program formulated by the World Bank and the IMF in 1980, and it started export-oriented industrialization, which had made little progress thus far. Accepting the IMF recommendations, it adopted an open trade policy, but continued its expansionary fiscal policy depending on short-term foreign borrowing, instead of taking tightening measures^{NOTE 9}. For example, it continued public works and decided to implement 11 large industrial projects. Their execution consequently increased the fiscal deficit. Apprehension arose about economic management by the Marcos Administration, with overvalued peso and its failure to implement a structural adjustment program. In 1981, capital flight occurred, time and again, triggered by a Chinese business tycoon who fled abroad while owing a huge debt. This produced a credit crunch, and many enterprises were plunged into financial difficulties. As the Government tried to cope with the situation with emergency financing or through nationalization, a great burden was left to public finance reconstruction in later years. In addition, increased distrust of the Philippines in the international financial market made medium-and long-term external borrowing difficult for the Government, which became more dependent on short-term borrowing.

NOTE 7 Mitsuo Fukushima (1989), *op.cit.*, p.p. 20.

NOTE 8 Seiichi Fukui (1999), "Chapter 10 The Philippines" in *Asian Economics* edited by Yonosuke Hara, p.p. 357.

NOTE 9 Yukiho Asano, Mitsuo Fukushima (1988), *Aquino's Philippines-From Chaos to Rebirth*, Institute of Developing Economies, p.p. 41.

These serious economic conditions were further deteriorated to the extent that the Philippines could no longer be financed from foreign private institutions, due to political instability triggered by the assassination of Benigno Aquino in 1983. A large amount of capital was taken out of the country, resulting in a sharp decline in foreign currency reserves, and the Government was driven to declare a moratorium in the same year. After repeated negotiations with the IMF and the foreign banks concerned, debt relief measures were agreed upon finally in 1984. But they called for total reformation of the system the Marcos Administration had established during the 1970s. After that, the president, declining in health, gradually lost leadership, while anti-Marcos movements, triggered by the assassination of Benigno Aquino, were united in support of one candidate for the presidential election to be conducted in February 1986, ahead of schedule. Amid confusion caused by the election results, a political change took place in February, and the Marcos Administration was subverted.

1.2 Aquino Administration

Challenges of the Aquino Administration included economic reconstruction and the realization of social equity, which were also faced by its predecessor, in addition to the attainment of political stability.

Regarding political stability, it successfully established an institutional base, by enacting a new constitution aimed at resuming the process of democratization, and a political base, by winning a majority in the congress. President Aquino, however, did not have specific political support, as her administration was a coalition of parties that came together only to oppose Marcos. These parties became united only through the people's support of the president herself and her popularity, when the administration began. It was in a situation that could collapse at any time if its policies produced little effect and the people's support was lost^{NOTE 10}.

But a more fundamental problem of the Aquino Administration was its failure in national reconciliation. It failed to win, to its side, either of the National Army Reformists or the communist force New People's Army^{NOTE 11}, which led to repeated coup attempts and a continuing armed struggle.

Political instability greatly affected economic reconstruction that was the top agenda of the Aquino Administration. It won the IMF's understanding on growth-promoting

NOTE 10 Yukiho Asano (1991), *op.cit.*, pp. 250-251.

NOTE 11 *Ibid.*, p.p. 251.

economic reconstruction programs that were different from conventional deflation policy. It also won international financial support for a huge sum of the foreign debt burden the Marcos Administration had left. Therefore, the administration, in its Medium-Term Economic Development Plan, was able to aim at economic growth in order to realize social equity, the creation of productive employment, and poverty alleviation. The path of the Philippine economy to its reconstruction, however, was often impeded by repeated coup attempts, which resulted in reduced confidence of foreign capital and greatly discouraged investors.

Structural adjustment programs in Aquino Administration, progressed gradually even during the period of economic hovering after 1990, produced certain results. Progress was made in privatizing state enterprises, financial sector reforms, tax reforms, and improving investment conditions. Trade liberalization, however, was delayed in the first half stage of the Aquino Administration, resisted by import substitution industries. Foreign debt service exceeded the amount borrowed, and in the circumstances public borrowing became dependent exclusively on internal debt. The implementation of measures for budget deficit reduction made little progress, confronted by congressional objection. The fiscal deficit expanded rapidly in 1989.

Furthermore, the balance of payments was worsened by foreign currency flowing out of the country due to political instability after 1989 and the Gulf War. In 1990, financial and monetary tightening measures were taken, in accordance with IMF recommendations. A series of austerity measures worsened economic fundamentals, and, partially affected by the natural disaster of a Mt. Pinatubo eruption, economic growth slowed down considerably after 1990. Economic infrastructure, including electric power, fell into even worse condition, as shown by the power crisis, under restrained government investment.

To realize social equity, the administration decided to implement its Comprehensive Agrarian Reform Program (CARP), which was an expanded version of the Marcos Administration's agrarian reform. The program produced certain results in implementing the remaining part of the previous government's tenant land reforms for rice and corn and the distribution of state-owned lands. In other areas, however, little progress was made, due to budgetary constraints and resistance from landowners. From 1991 on, the administration transferred authority, facilities, and budgets to local governments, in accordance with the Local Government Code of 1991, as part of its democratization measures. This opened paths for the local government units to issue bonds and borrow from private banks and foreign donors, greatly affecting national development thereafter.

Another noticeable change under the Aquino Administration was an upsurge of

national spirit immediately before and after the President's inauguration. This gave the Philippine people great incentive to unite their efforts and address development issues, an example of which is that NGOs were encouraged to cooperate with the Government or donor nations. With the Cold War coming to an end and the position of U.S. forces bases in the Philippines changing in terms of security, NGOs and the private sector became more active for development during the Ramos Administration, playing an important role of supplementing development administration.

Meanwhile, the Philippines came to recognize the necessity of opening up new markets, in the changed U.S.-Philippine relations and movements for forming economic blocs in the Americas. In the 1990s, the country strengthened its relationships with Asian neighbors, regarding them as potential markets, and adopted an open policy.

2. The Philippines' Development Issues

2.1 Overview of political and economic conditions

2.1.1 Economic trends during the Ramos Administration

The greatest achievement of the Ramos Administration as the successor of the Aquino Administration was its efforts to produce a national consensus for realizing political stability and economic development. It attained political stability by forming the majority in the congress and concluding peace agreements through national reconciliation policy with the Moro National Liberation Front (MNLF) and the Reboluntaryong Alyansang Makabana (RAM, formerly known as Reform the Armed Forces Movement), except for the leftist group, namely, the Communist Party of the Philippines and its New People's Army (CPP-NPA). This success had a significant meaning for development initiatives taken by the administration. Regarding economic development, it focused on economic liberalization and democratization, following the policy of its predecessor, and succeeded in establishing laws to implement structural adjustment program. Its approach to address economic development based on political stability thus gained were reflected in its vision "the Philippines 2000," aiming to join NIES by the year 2000, and in its attempt to form a national consensus by formulating its Medium-term Philippine development plan 1993-1998 and holding an economic summit^{NOTE 12}.

The international financial institutions, such as World Bank and IMF continued their support for the six years of the Ramos administration. The administration carried forward various reforms^{NOTE 13} which constituted conditionality tied to their support; for example, a raise in public utility charges, tax reforms, internal debt reduction, and financial sector reforms. The administration took measures to remove bottlenecks in economic infrastructure, such as the power crisis caused by insufficient investment, due to fiscal tightening during the Aquino Administration. It actively utilized participation of the private sector in the management of the BOT scheme, and privatization, under the favorable Asian economy and firm business confidence, and amid the international trend of reconsidering the role of the public and private sectors.

As a consequence, the Philippine economy grew at more than 5% between 1994

NOTE 12 *Asian Trends Yearbook* (1993), pp. 298-299.

NOTE 13 For reforms under the Ramos Administration, refer to Seiichi Fukui (1999), pp. 364-366.

and 1996, and consumer prices were stabilized, at 8% to 9%, though exceeding target rates in the medium-term plan. In addition, the goal of per capita GNP of \$1,000 was attained. This growth was led by investment and exports. Foreign direct investment began growing steadily from 1994, as infrastructure and law systems for the favorable business environment were improved. Regarding portfolio investment, capital inflow and outflow in 1993 increased four times that in the preceding year, and the volume of transactions marked a sharp increase every year until 1996^{NOTE 14}. The money of the higher-income bracket, which had been saved overseas, began returning to the country by the mid-1990s and flowing into the stock market and real estate sectors, thus producing a miniature boom.

(1) Public finances, money, and banking

In the Philippines the ratio of revenue to GNP shows an increasing tendency. Fiscal reconstruction efforts, such as tax reforms, abolishment of the Oil Stabilization Fund, and the privatization of Government Owned or Controlled Corporations (GOCCs), have greatly improved the fiscal balance of the national Government.

NOTE 14 Bangko Sentral ng Pilipinas, *Selected Economic Indicators*, various issues.

Table 2-1 Basic Economic Indicators

	1993	1994	1995	1996	1997	1998
Real GNP growth rate	2.1	5.3	5	7.2	5.3	0.1
Real GDP growth rate	2.1	4.4	4.8	5.8	5.2	▲ 0.5
<By expense>						
(Growth rate)						
Private consumption	3	3.7	3.8	4.6	5	3.5
Government consumption	6.2	6.1	5.5	4.1	1.6	0.8
Gross domestic capital formation	7.9	8.7	3.5	12.5	11.7	▲ 17.1
Export	6.2	19.8	12	15.4	17.5	▲ 10.4
Import	11.5	14.5	16	16.7	14.4	▲ 11.4
<By industry>						
(Growth rate)						
Agriculture	2.1	2.6	0.8	3.8	2.9	▲ 6.6
industries	1.6	5.8	6.7	6.4	6.1	▲ 1.7
Manufacturing as part of above	0.7	5	6.8	5.6	4.2	▲ 1.1
Service	2.5	4.2	5	6.4	5.5	3.5
(Percent distribution)						
Agriculture	22.37	21.80	20.95	20.19	19.84	18.51
industries	33.67	33.83	34.48	34.28	34.44	33.87
Manufacturing as part of above	24.27	24.22	24.63	24.32	24.02	23.75
Service	42.26	41.85	41.87	41.68	41.63	43.06
Inflation rate	7	8.3	8	9.1	6	9.7
Ratio of the current account balance to GNP	▲ 5.5	▲ 4.5	▲ 4.3	▲ 4.6	▲ 5.1	na
Ratio of the central government balance to GNP	▲ 2.5	0.9	0.7	0.3	0.06	▲ 1.8 (p1)
Ratio of the total official sector balance to GNP	▲ 1.7	▲ 0.5	▲ 0.2	0.3	▲ 1.0	▲ 2.9 (p1)
Unemployment rate	9.3	9.5	9.5	8.6	8.7	10.5
Debt service ratio	17.11	17.43	15.81	12.71	11.65	11.99 (p2)
per capita GNP (current US\$)	825.9	957.9	1,083.9	1,199.7	1,166.1	907.5
Investment/GNP	23.6	23.5	21.8	23.1	23.8	19.3
Domestic savings/GNP	18.1	19	19.3	15.1	22.1	na

Source: Bangko Sentral ng Pilipinas, *Selected Philippine Economic Indicators, various issues*
 National Statistical Coordination Board, *National Statistical Yearbook 1997,1998*,
National Accounts of the Philippines 1996-1998
 Department of Budget and Management, *Fiscal Statistics Handbook 1980-1994*,

(p1) From January to September

(p1) From January to November

The revenue increase, however, has resulted mostly from non-tax receipts from privatization. As there are limitations in assets to be sold, it would be difficult to maintain revenues of the same level as during the Ramos Administration. Tax revenue have been increasing since the latter half of the 1980s, as effects of a series of tax reforms initiated by the Aquino Administration have become evident. These reforms, however, have been less effective in individual income tax than in sales tax. In the 1990s, tax collection efforts have reached a deadlock, and growth of the tax burden ratio (the ratio of tax receipts to GNP) has slackened, producing issues that must be addressed in the future.

In expenditure, government finances has apparently become rigid. The share

of current expenditures in national Government expenditures remains high, at 73.4% in 1998. Personnel services, Internal Revenue Allotment (IRA), and interest payment account for as much as 69.6%^{NOTE 15}. With the devolution of national government functions, IRA^{NOTE 16} has been increased, and this has expanded the Government's non-discretionary expenses. Although it is making efforts to mobilize private capital, such as the BOT scheme, such expenses restrict spending for production activities and also make it difficult to effectively meet changing conditions^{NOTE 17}.

The volume of budget local government units have to allocate at their discretion has been expanded. In response, many of them face the urgent challenge of improving their capacity of fiscal management. Regarding local public finances, problems awaiting solution include heavy dependence on IRA and inequitable budget allocation, insufficient tax collection capability, absence of supplementation measures for local government units that are suffering losses due to service transfer, and difficulties in local government units that have poor credit standing in both public and private financing.

Regarding external public debts, no serious problems seem to exist. On the other hand, there has been a tendency of dependence on domestic debts since external borrowing became difficult in 1986^{NOTE 18}. Interest payments for such debts, accounting for about 12.4% of the national Government expenditures in 1997^{NOTE 19}, still exceed those for external debts. It would be necessary to continue domestic debt management efforts started in the early 1990s, such as raising the ratio of medium-and long-term government bonds.

In money and banking, institutional reforms and policy operation have proved successful to a considerable extent. Progress has been made in deregulation of financial market since the end of the 1980s, with the relaxation of foreign exchange control and regulations on banking. With the reorganization of the central bank in 1993, as the Bangko Sentral ng Pilipinas (BSP), fiscal finance was transferred to the Department of Finance, enabling the BSP to devote itself to monetary management. In addition, regulations have been placed on DOSRI (Directors,

NOTE 15 Calculated from data of the Department of Budget and Management.

NOTE 16 Internal Revenue Allotment: an allotment to local government units.

NOTE 17 Moriyo Sonoda, Tomoyoshi Tominaga (1998), "The Philippines' Public Finance" in *The Course of Monetary and Fiscal Policy in ASEAN 4*, Institute of Fiscal and Monetary Policy, Ministry of Finance, p.p. 361.

NOTE 18 Seiichi Fukui (1999), *op.cit.*, p.p. 362.

NOTE 19 Borrowed from Bangko Sentral ng Pilipinas, *Selected Economic Indicators*, August 1998.

Officers, Stakeholders, Related Interests) Loans. Financial reforms have been advancing steadily, producing various effects, such as increased financing for small- and medium-scale businesses and foreign banks' entry to the Philippine market.

Meanwhile, the money supply has been regulated to meet IMF conditionality^{NOTE 20}. Consistent reduction of the reserve ratio from 1992 to 1996 lowered lending rates. The improved fiscal balance lowered the yield on 91-day treasury bills, the indicator interest rate. These rendered conditions favorable for economic growth^{NOTE 21}.

As such sound monetary and financial policy worked effectively, the Philippines was affected comparatively little by the Asian currency crisis, which will be mentioned later. However, the country must further promote foreign investment and effectively utilize domestic resources, by expanding the stock market through advancement and modernization of the long-term-capital market, excluding government bonds. Also, strengthening of the central bank's supervisory functions, including the monitoring of capital inflow and outflow, is indispensable for minimizing effects caused by speculation.

(2) Balance of payments

The austerity policy adopted by the Aquino Administration in its later stage reduced the current account deficit to as low as the 800 million dollar level. However, it rose again, up to around 3 billion dollars (ratio to GNP: 4% to 5%), the level of 1988 and 1989, as the Ramos Administration adopted a policy that prioritized economic reconstruction and increased imports to cope with the electric power crisis^{NOTE 22}. In trade balance, exports of electric and electronic products showed steady growth. As the manufacturing of these products needed importation of intermediate goods, imports grew at a rate exceeding that of exports, supported by consumer confidence. Regarding balance of capital and financial account, the flow increased considerably after 1993, reflecting active foreign investment and liberalization, as well as prosperous conditions in ASEAN nations, not to mention the increased net surplus.

As for external debts, the Aquino Administration made efforts to reduce public

NOTE 20 Kazuhisa Ito (1998), *The Philippines' Financial System and its Reform*, Institute of Fiscal and Monetary Policy, Ministry of Finance, *op.cit.*, p.p. 327.

NOTE 21 *Ibid.*

NOTE 22 Bangko Sentral ng Pilipinas, *Selected Economic Indicators*.

sector debts through negotiations with international financial institutions, creditor nations, and private banks, and through the introduction of a debt equity swap program. The Ramos Administration also succeeded in reducing short-term debts and the outstanding external debt to GNP ratio, with support of the international community.

The number of Philippine overseas contract workers (OCWs) is still large, and their traceable remittances alone account for 4% to 6%^{NOTE 23} of the GNP. This means the living and economics of Philippine people are easily affected by overseas economic conditions, but on the other hand it works as a buffer when internal economic conditions turn for the worse.

Table 2-2 Balance of Payments (million US\$)

	1993	1994	1995	1996	1997	1998 ^p
Balance of current account	-3,016	-2,950	-3,297	-3,953	-4,351	928
Balance of current account	-5.5	-4.5	-4.3	-4.5	-5.1	
Balance of trade	-6,222	-7,850	-8,944	-11,342	-11,127	-488
Exports (goods)	11,375	13,483	17,447	20,543	25,228	26,973
Growth rate %	15.8	18.5	20.4	17.7	22.8	na
Imports (goods)	17,597	21,333	26,391	31,885	36,355	27,461
Growth rate %	21.2	21.2	23.7	20.8	14	na
Balance of service account	2,507	3,964	4,765	6,800	5,496	1,015
Balance of transfer account	699	936	882	589	1,080	401
Balance of capital account	2,820	4,547	3,393	11,072	6,593	1,704
Net medium- and long-term	2,455	1,313	1,276	2,841	4,824	2,585
Net credit transactions	na	na	na	-37	-676	-1,080
Net investments	812	1,558	1,609	3,517	762	1,502
Net short-term capital	-148	1,002	-56	540	495	-1,201
Other items	544	254	81	-5	-360	133
Overall balance of payments	-166	1,802	631	4,107	-3,363	1,192

/p Tentative value up to November

Source: Bangko Sentral ng Pilipinas, *Selected Economic Indicators February 1999*

(3) Bottlenecks of the economic structure

As the economy improved under the Ramos Administration, the unemployment rate stayed around 8%, lower than during the previous administration. The structure of employment, however, still showed limited absorption of labor in secondary industry, with little movement from the agriculture sector to the service sector. Exports, which underpinned steady economic growth during the Ramos Administration, were accompanied by importation of intermediate goods and

NOTE 23 Calculated from Bangko Sentral ng Pilipinas, *Selected Economic Indicators*.

supported by increased demand in the U.S. market. Backward linkage effects were therefore small, leading to a situation in which a trade deficit was easily produced. Investments, reflecting leveling off of the domestic saving rate, depended heavily on foreign capital.

Further development of Philippine economy requires liberalization in response to the international liberalization of goods, services, and capital transactions. At the same time, more efforts are needed to resolve long-standing issues, such as an increased saving rate and financial deepening, sounder public finances, improved soundness of the financial system, the fostering of manufacturing industries for trade structure improvement, and productivity improvement in the stagnant agriculture sector.

(4) From the Currency crisis until the end of 1997

The currency crisis in Asia, triggered by a sharp decline of the Thai baht in July 1997, also involved the Philippines, and the peso depreciation continued until the end of January 1998, due to its speculative sales. The value of peso declined to around 61% of the rate in the end of June 1997, immediately before the eruption of the crisis^{NOTE 24}. Adverse effects of the depreciation, however, did not become apparent in the Philippine economy in that year, when the rate of GNP growth was 5.2%, and the inflation rate was on the 6% level, in the latter half of the year. This was attributable to the Philippines' good macroeconomic performance until 1996, its relatively sound financial system, and its shorter period of experience in credit expansion and capital inflow, compared with its Asian neighbors^{NOTE 25}. It can be pointed out, however, regarding its buoyant economy until 1996, that there was a tendency of concentration of investment in the most profitable real estate sector. In addition low-cost transactions in Foreign Currency Deposits Units (FCDUs) accounts, together with the stable exchange rate at that time, activated the intake of foreign currency funds and produced a situation in which one could enjoy the internal-external interest-rate differential without currency risk, which encouraged speculation^{NOTE 26}.

It would be reasonable to regard the Philippine economy as having been in

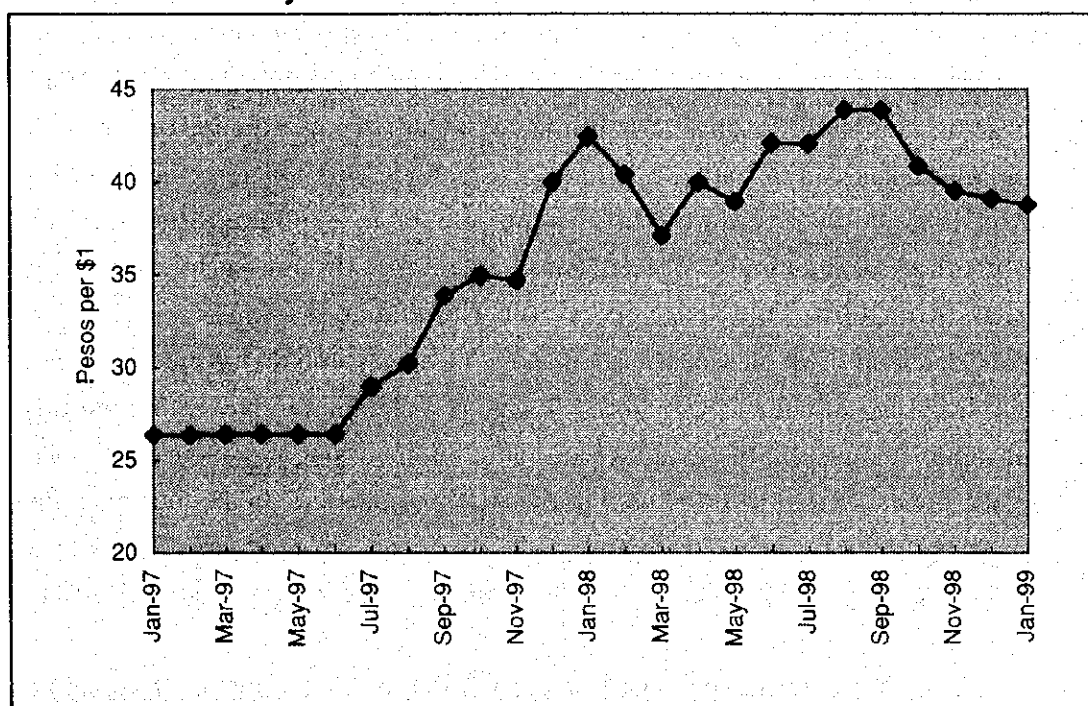
NOTE 24 Calculated from Bangko Sentral ng Pilipinas, *Selected Economic Indicators*.

NOTE 25 Kazuhisa Ito (1998), *op.cit.*, p.p. 323.

NOTE 26 *Ibid.*, pp. 336-337.

the adjustment stage from the beginning of 1997^{NOTE 27}. Stock prices began declining in January 1997, and the net outflow of portfolio investment was already apparent in June, before the eruption of the crisis. Furthermore, manufacturing production began slowing down during the first half of that year, and exports showed decrease in real terms.

Figure 2-1 Exchange Rate (month end) from January 1997 through January 1999



Source: Bangko Sentral ng Pilipinas, *Selected Economic Indicators*

(5) Movements in 1998

Since the beginning of 1998, effects of the weak peso on commodity prices have been observed. The inflation rate rose up to 9.7%, reaching double digits in June, after a lapse of two years. The GNP growth rate, at 0.1%, also showed a larger decline than in 1997^{NOTE 28}. Agricultural production reduced by 6.6%, reflecting poor harvests caused by the El Nino Current, etc., while manufacturing showed a growth of -1.7%. Production was lower than in 1997 in all sectors,

NOTE 27 Katsumi Nozawa (1998), "The Philippines: Slight Effects Without Resulting in Economic Overheating" in *The Asian Financial crisis*, edited by Mitsuo Takii and Mitsuo Fukushima, p.p. 121.

NOTE 28 *Manila Bulletin* dated January 31, 1999. GDP marked a growth of -0.5%, a reduction of 5.7 points from the preceding year.

except for the service sector, which marked growth of 3.5%. These declines were even greater than the 1998 macroeconomic targets, which had been revised downward in the negotiations with the IMF Mission in September^{NOTE 29} to study economic-policy implementation.

With the devaluation of the peso in 1997, the Central Bank of the Philippines raised interest rates. In 1998, however, it began restraining price and interest rises by controlling the money supply^{NOTE 30}, as precautions against credit shrinking. Since the eruption of the crisis, the BSP has taken these measures to restore investors' confidence in the Philippine financial system which have included imposing a cap on bank loans to the real estate sector, prescribing a 30% liquid cover on all foreign exchange liabilities of FCDUs, upward adjustment of the minimum bank capitalization requirements, requirements for minimum loan loss provisions, higher capitalization requirements to encourage mergers and acquisitions, tightening of the criteria for determining non-performing loans, issuance of policy guidelines for resolving problems the banks face, and the implementation of stricter qualification and competency criteria for processing new bank licenses. Simultaneously, the BSP has paid attention to preventing the fund position of the private sector from worsening by increasing the interest rate. The higher interest rates due to the peso devaluation put pressure on the manufacturing sector, but the rates began declining gradually in January 1998, and the yield on 91-day treasury bills, which is the Philippines' prime rate, was stabilized at a level exceeding that of July 1997, by more than 2%^{NOTE 31}.

Fixed capital formation sank to a growth rate of -17.1%^{NOTE 32}. It seemed to be affected mostly by reduced government investments under its austere fiscal policy. Investment expenditure in the consolidated public sector were reduced by 13.1%, and those of the national Government by as much as 21.9%, compared with the preceding year^{NOTE 33}. Foreign direct investment showed a growth of 28% in the first half of the year, compared with the previous year^{NOTE 34}. There was no considerable change in the volume of flow in 1998, either, because capital

NOTE 29 The target growth rates revised downward were 1.5% for GNP and 1% for GDP.

NOTE 30 Manipulated with increasing and decreasing in reserves and selling and buying of government bonds.

NOTE 31 Bangko Sentral ng Pilipinas, *Selected Economic Indicators*.

NOTE 32 Borrowed from the NEDA Homepage, 1998 Economic Performance.

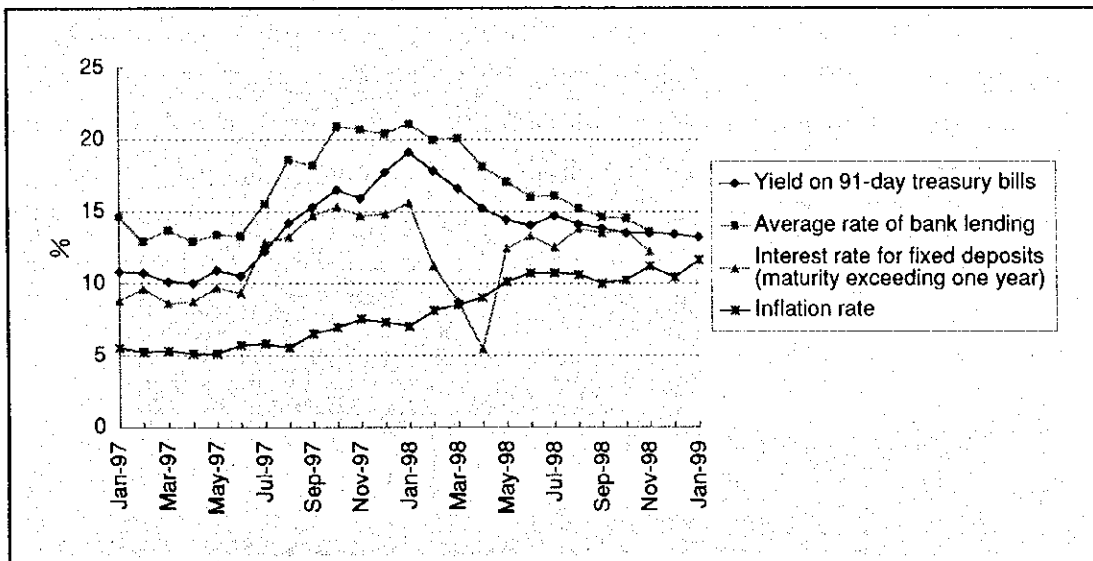
NOTE 33 Borrowed from the Department of Finance, *The Philippines Economic Update*, September 15, 1998, (projection).

NOTE 34 Borrowed from the Department of Finance, *The Philippines Economic Update*, September 15, 1998.

seemed to have flowed to projects that started before the financial crisis, with less of it directed to new ones.

In the external sector in 1998, imports marked a decrease of 17.5%, and exports an increase of 16.9%, compared with the preceding year, as a consequence of the peso depreciation. This resulted in the trade balance marking a deficit of 164 million dollars, the smallest in 26 years. The overall balance of payments marked a surplus of 1,330 million dollars, which resulted from an import slowdown due to hovering domestic demand and increased external borrowing. Foreign reserves, which had once fallen to a level of 8 billion dollars just after the currency crisis, recovered to a 10-billion-dollar level, reaching 10.8 billion dollars in the end of 1998^{NOTE 35}.

**Figure 2-2 Rate of Commodity Price Rise and Interest Rates
(January 1997-January 1999)**



Source: Bangko Sentral ng Pilipinas, *Selected Economic Indicators*

Regarding public finance, policy was focused on balanced budget in the beginning of 1998, because fiscal deficits could lead to higher internal interest rates or a decline of currency value. To achieve this, the Government took drastic measures to reduce its expenditures, to cope with the lower revenue than anticipated, such as by suspending 25% of non-personnel expenses.

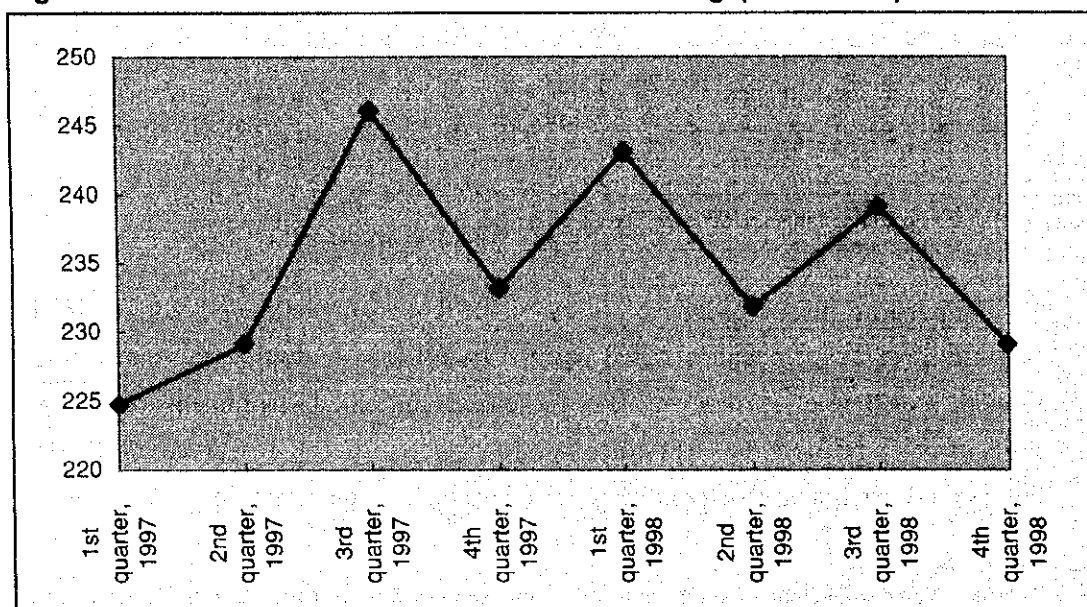
NOTE 35. Data selected from among figures published by the National Statistics Bureau in the News Net Asia Homepage (dated February 18 and 25, 1999).

As stagnancy of the Philippine economy became apparent in the latter half of 1998, the IMF and the Government decided in November to change the policy taken thus far. Instead they decided to stimulate the economy by expanding Government spending, thus producing a deficit of 50 billion pesos in 1998 (1.8% in ratio to GNP). For the 1999 budget bill (on a cash spending basis), expenditures were 568.4 billion pesos, and revenue was 550.5 billion pesos (a fiscal deficit of 17.9 billion pesos), when it was submitted to the congress in August 1998. The budget was revised following the above-mentioned agreement with the IMF in November that required a change for positive fiscal policy. Consequently expenditure was raised to 590.3 billion pesos and revenue reduced to 521.9 billion pesos (a fiscal deficit of 68.4 billion pesos), as of March 1999.

No progress has been made after the inauguration of President Estrada regarding non-tax revenue from privatization, because the Government is not very willing to sell stocks held by the state sector or the public sector at low prices.

Effects on the real economy have become visible, such as dismissals of company workers and shortened working hours (80,000 workers were affected in the first seven months of 1998), with the market shrinking, seemingly as a result of the crisis and reduced production in the manufacturing sector, due to increased production costs. Enterprises that are heavily affected include the automobile and electric appliance industries, and the production sector for the domestic market.

Figure 2-3 Production Indexes in Manufacturing (1997-1998)



Source: IMF, *International Financial Statistics*

2.1.2 Current conditions and issues in the decentralization of power

(1) Evolution of reforms

The Local Government Code was enforced in 1991 for the purpose of

- (i) promoting efficiency of local development, by controlling the concentration of power in the national Government,
- (ii) reducing regional gaps with appropriate distribution of resources from the national Government to local government units, and
- (iii) promoting development by local government units' initiative, through local citizens' participation.

With the inauguration of President Aquino, the people's desire to reduce urban-rural gaps created in the past development process intensified. The requirement of obtaining national Government approval to execute any administration regarding local development had constituted a great impediment to promoting efficient development. The Code served as a means to improve this situation.

Since the enforcement of the Code, decentralization of power has been promoted according to a plan comprising three stages: the turning stage (1992-1994), the transitional stage (1994-1996), and the stabilization stage (from 1997 on). Even today, which falls in the third stage, the strains resulting from the drastic reforms have not been removed completely.

With the Local Government Code, administrative functions, responsibilities, regulations, supervising power, etc., were transferred from the national Government to local government units. And personnel, assets, equipment, and facilities were transferred, too. The areas affected most included health care, economic infrastructure building, agricultural extension, social welfare, and tourist development. The decentralization involved more than 70,000 personnel nationwide and 250 million pesos in assets.

As financial sources for carrying out transferred undertakings, local government units were empowered to collect taxes within a certain range. This taxing power was supposed to ensure them their own financial resources. They were also authorized to bear debts, such as local bond issues and development loans from the Government and private financial institutions. Notably it became legitimate for local government units to have direct access to donors in obtaining

ODA grants. Internal Revenue Allotment (IRA) provided through the Department of Budget and Management, which came to be distributed at a uniform standard according to population and land area, ensured steadier revenue to local government units.

The present amount of revenue, however, is insufficient for many local government units to execute various public works. They have to raise funds independently, in some way or other. Private banks, however, are unwilling to lend money to local government units, regarding most of them as high risk. Government financial institutions and the Municipal Development Fund^{NOTE 36} cannot meet their demand either. To cope with this situation, the Philippine Government announced its scheme of sharing costs between the national Government and local government units, at a donor meeting in December 1996, defining six methods of fund-raising^{NOTE 37} according to credit standing of local government units, for undertakings whose cost recovery was deemed difficult^{NOTE 38}.

Regarding local development, it was decided that a Local Development Council, equipped with monitoring and evaluation functions, would be established in each province, city, and town. The code stipulated that local government units at each level would have their own development plans, and those of higher rank were empowered to examine plans of those of lower rank. Local development projects had been implemented as part of national development projects by the initiative of NEDA, the planning agency, or departments of the national Government. The larger local development projects were, the more extensive control those departments had over them. Local government units therefore had much less ownership over local development projects. Decentralization ensured their legal independence in development administration.

NOTE 36 Established in 1984, the Fund provides local governments with central government funds. With foreign aid as initial funds and repayments from local governments, it furnishes funds.

NOTE 37 1) Bond issues, 2) private bank loans, 3) BOT utilization, 4) government institution loans, 5) MDF (Municipal Development Fund) loans, and 6) MDF grants.

NOTE 38 Hiroshi Suzuki (1999), "Chapter 7 Local Government Finance and ODA" in *Report of the Philippines Financial Issues Study Group*, Institute for International Monetary Affairs, p.p. 55.

(2) Problems in the process of decentralization

(a) Problems regarding development planning^{NOTE 39}

Many local government units, have not been adequately carrying out the mandate of planning, coordinating, and implementing development projects transferred to them. This is partly attributable to insufficiency of accumulated know-how and experience regarding development planning, and to their lack of knowledge in specific fields and issues and administrative management capacity. Local Development Councils do not function or have not been established, due to insufficient budgets or inadequate implementation capacity; plus, there is no administrative coordination between national and local development, because there is no mechanism to achieve coordination between national and local development plan. As a result, local government units often make investments without coordination with LGUs of higher rank or the national Government, sometimes producing adverse effects, such as ineffective utilization of the limited funds they can use at their discretion.

(b) Problems in power transfer

Although part of the national Government's undertakings, as well as its personnel and assets, were transferred to local government units, it was a totally new experience for them to find, plan, implement and monitor projects. It cannot be said that LGUs have well-developed capability, even now^{NOTE 40} although capability of implementing projects is expected to be developed as projects are carried out. Even though there was no longer a system by which the national Government sent directions and orders directly to LGUs, but the Government should have given them relevant administrative know-how in some way or other, even after the transfer of power. The Department of Interior & Local Governments or the Department of Social Welfare & Development provided technical support^{NOTE 41} for local government units to some extent, yet it was limited to specific areas, which produced defects and delays in the implementation of projects. Accordingly, it would be necessary

NOTE 39 Japan International Cooperation Agency (1997), *Preliminary Survey Report on the Study on Davao Integrated Development Program Masterplanning: the Republic of the Philippines*, p.p. 25.

NOTE 40 *Ibid.*, pp. 24-25.

NOTE 41 For addressing by the Department of Social Welfare and Development, refer to Yasutoshi Yamada (1997), JICA project formulation specialist report *Project Formulation Report for Promotion of Regional Development in the Republic of the Philippines* p.p. 9.

to establish a transitional mechanism to extend national Government support for improving administrative capacity of local government units.

It is thought that power and undertakings transferred to local government units include projects pertaining to the basic living environment and services that should be implemented under the same national standards. Regarding these undertakings, which are apt to widen gaps both in financial and administrative capacity among local government units, measures are needed, such as strengthening LGUs' capacity and redefining responsibilities, as soon as possible. The national Government is now studying such measures.

(c) Fiscal problems

In many LGUs, the budget scale has been expanded with the transfer of a number of undertakings. Although financial resources have also been transferred through an increase in IRA (a grant from the national Government) and expansion of the LGUs' taxing power, the following problems await solution.

First, local finances still depend heavily on IRA^{NOTE 42}, even after taxing power has been transferred to the local government units, because of their lack of knowledge and experience in tax administration. Those LGUs suffering from insufficient finances have only limited means of revenue raising. There are no elaborate mechanisms of fund raising appropriate for the financial conditions and administrative capacity of individual local government units^{NOTE 43}.

IRA is allocated based on population and land area. Some people point out that this is unfavorable for provinces whose populations are small for their land areas, compared with highly urbanized cities^{NOTE 44}. The national Government is considering a revision of the standard (i.e. the calculation method).

NOTE 42 JICA (1997), *op.cit.*, pp. 25-26.

NOTE 43 Hiroshi Suzuki (1999), *op.cit.*, p.p. 57.

NOTE 44 The local government units of the Philippines are composed of four classes. According to the National Statistics Coordination Bureau (NSCB), 78 provinces, 83 cities, 1,525 municipalities, and 41,940 Barangays were divided into 14 wide-area blocks, namely 13 regions, including CARAGA, established in 1995, and the Manila Metropolitan Area, as of the end of 1998. The country is divided into 16 regions when Muslim Mindanao and self-governed areas in Cordillera are included. Highly urbanized cities among the cities resemble Japanese government-designated cities, not being under the control of provincial governments. As the regions are not legal persons, except for the Manila Metropolitan Area and some others, and they do not have legislative power, they are not regarded as "local governmental units."