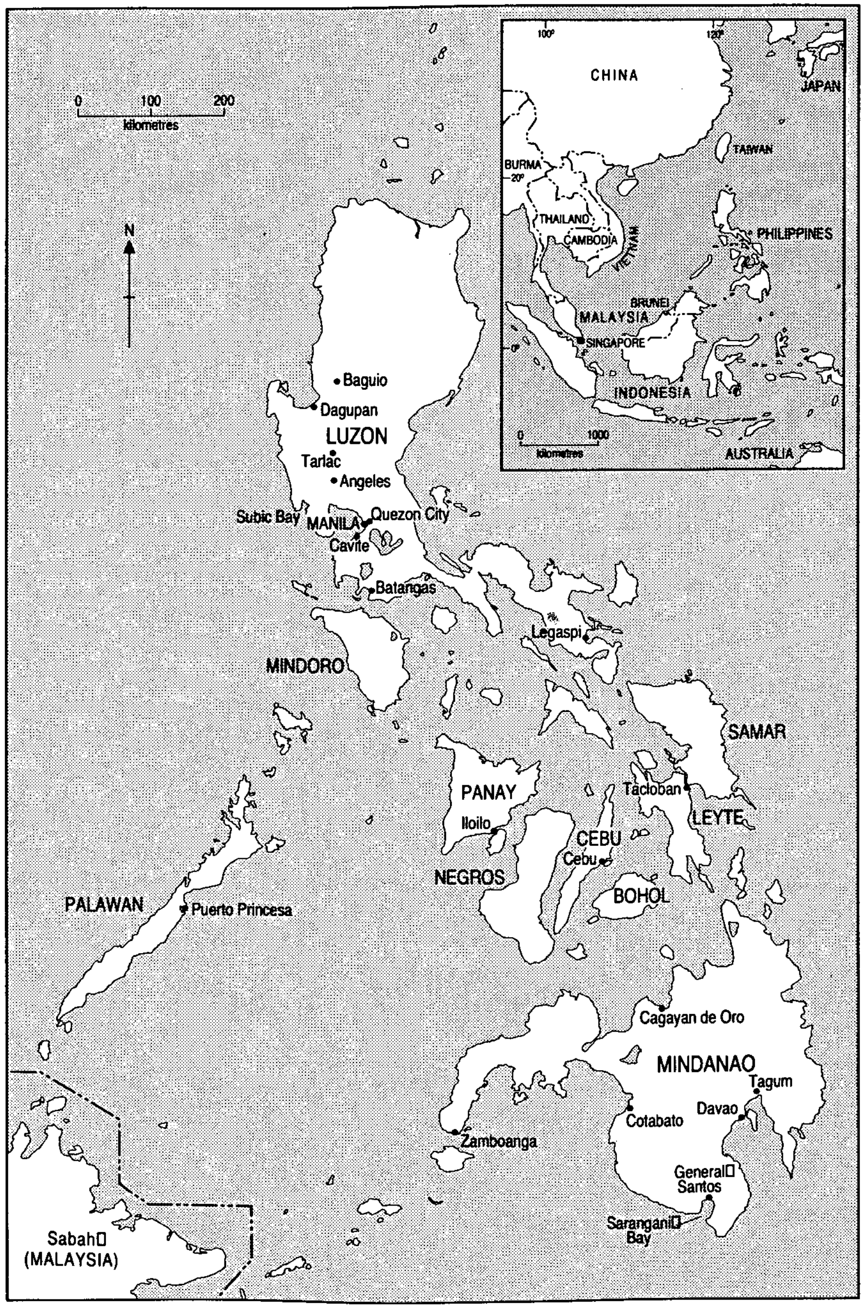

1

An Introduction to the Key Issues

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1.1 A PUZZLE TO EXPLAIN

The Philippines is one of the world's major development puzzles. In the immediate aftermath of the Pacific war, and despite extensive wartime destruction, it had one of the highest per capita incomes in East Asia: above South Korea and Taiwan, significantly higher than Thailand, Indonesia and China, and below only Japan, the then Malaya, and the city states of Hong Kong and Singapore.

Among newly independent countries, its initial conditions were favorable. American rule from 1898 had been comparatively benign by colonial standards. The transition to formal independence was relatively painless, certainly when compared with the experience of some neighboring countries. Again, unlike some of its neighbors, the Philippines had no really serious communal or ethnic divides. Its educational standards were among the highest in the developing world. By dint of its colonial experience, it had privileged access to the market of the world's largest economy, a facility which continued until the expiration of the Laurel–Langley Agreement in 1974. The country's civil institutions were comparatively well developed, too. It possessed a reasonably democratic political system, albeit of the "winner-takes-all" variety. Its judiciary and legal system were quite well developed and somewhat independent. Its press was open and vigorous. Finally, while not especially resource-rich, the Philippines possessed ample agricultural land to sustain several decades of rapid agricultural growth.

By the mid-1960s, there was still little evidence that things were to go seriously wrong. Indeed, the Philippines was largely free of the major problems then besetting Southeast Asia: the Vietnam War, amid fear of the "domino theory"; Indonesia's campaign of *konfrontasi* against newly formed Malaysia; and the Malaysia–

Singapore separation of 1965. As a vote of confidence in Philippine stability and the country's future, the headquarters of the region's major international development institution, the Asian Development Bank, were located in Manila. Even as late as 1980, the Philippines was still regarded by most analysts as belonging to the second generation of the Asian "tiger" economies.

Yet its development outcomes have been disappointing by any yardstick. In 2000, official statistics suggest that its real per capita GDP was about the same as in 1980. Its per capita income was overtaken by Korea and Taiwan in the 1950s, Thailand in the 1970s, Indonesia in the 1980s (though more recently it has fallen behind again), and China in the 1990s. It missed out almost completely on the Asian boom from the late 1970s until the mid-1990s. In particular, the restructuring from the mid-1980s, which witnessed the large-scale migration of labor-intensive industries to China and the lower-wage ASEAN economies, bypassed the Philippines. Especially in the 1980s and early 1990s, the country became an increasingly marginal player in the region's trade and investment flows. In consequence its social indicators stagnated, in marked contrast to the situation in its high-growth neighbors. The Philippines is obviously well endowed with human capital, but an uncomfortably high proportion of its best and brightest aspire to employ their talents abroad, often never to return.

The comparison with Thailand is particularly pertinent. The two countries have much in common apart from their location—a similar population size, land area, resource base, and economic structure, and similar movements in their terms of trade. Yet Thailand, which was significantly poorer in the 1950s, overtook the Philippines in the early 1970s; just before the recent Asian crisis, its per capita income was almost three times higher. If ever there were a case of non-identical twins, this would be it.

A number of caveats need to be attached to this gloomy assessment. First, it is important not to overstate the initial conditions. There was extensive wartime destruction. Many of the apparently well-developed political, legal, and bureaucratic institutions established in the wake of the American colonial era had shallow roots, and could easily be manipulated by powerful political–business oligarchs. This was particularly the case since the country's agrarian structures, which in turn established the parameters of political power, were highly unequal. Moreover, the relationship with the United States, while conferring significant potential commercial advantages, proved to be a troublesome one. It arguably distorted the elite's commercial calculus, and it complicated political and strategic considerations.

The second caveat is that the performance of the Philippines looks deficient partly because it is most often compared with its neighbors. The above comparisons are with economies which, until 1997, were the world's fastest growing. The Philippine record is in fact broadly similar to that of the developing world as a whole. If the comparison were with Latin America (with which the Philippines is sometimes grouped in view of its colonial history), or with South Asia or Africa, it would be about par for the course.

Third, it is important to emphasize that the really pronounced divergence in development performance occurred in the decade and a half from the late 1970s until the early 1990s. Philippine growth rates never matched those of the newly industrializing economies (NIEs), and especially from the late 1960s the country's economy grew more slowly than those of its major ASEAN neighbors. But decennial growth comparisons reveal only a gradual divergence in the 1950s, 1960s, and even the 1970s. The gap became sharply evident only in the 1980s; despite a modest recovery, it continued to widen in the first half of the 1990s. Thus, explanations for the weaker record of the Philippines need to focus on this period, while of course recognizing its historical roots.

The final caveat is that the Philippines weathered the recent economic crisis more successfully than most major Southeast Asian economies. For once, being the "East Asian exception" was good news.

The chapters in this book examine all major facets of the Philippine economy and development policy. The authors attempt to look both backward and forward. They examine and assess trends since the 1980s, in the process synthesizing the relevant specialist literature. They identify the major policy issues and provide a balance sheet of achievements and deficiencies over the past decade and beyond. Finally, they highlight future challenges which need to be addressed if the country is to embark on a sustainable, durable, and equitable growth trajectory.

Drawing on the contributions to this volume, the objective of this introductory chapter is three-fold. First, in section 1.2 we provide a broad overview of the development record since around 1980. Next, we look at the picture in more detail, examining international and macroeconomic dimensions, trends at the sectoral level, and various socioeconomic development indicators. On this basis, we offer an assessment of the achievements and failures of the post-Marcos period. Finally, in section 1.4 we return to the larger question of why the Philippines has often underperformed relative to its obvious potential. As a corollary to this larger question, it is also of interest to explore why the country has not received a larger "reform dividend" from the significant policy achievements of the first three-quarters of the 1990s, and why also it came through the recent Asian crisis relatively unscathed.

Our approaches are variously descriptive, analytical, interpretive, and comparative. The subject of the book is self-evidently important. The Philippines is a large country of more than 75 million people, and the world's second largest archipelagic state. It is often poorly understood abroad, a factor not helped by tired old cliches such as that it is a "Latin American country located in East Asia." It is the least integrated within Southeast Asia of the original ASEAN member countries. With the removal of U.S. bases in 1992, its geostrategic ties with its former colonial master have waned. The country has been off the radar screens of international investors recently, as it was for most of the 1980s. The world takes note of spectacular successes, such as the Asian tigers since the 1960s, and catastrophic failures, such as Indonesia in 1997–98. The Philippines has really been neither, and therefore for much of the past 20 years it has received surprisingly little international attention.

We are therefore approaching the subject as one worthy of study given its inherent importance. But there is clearly much more to the story than this. There are lessons from the Philippines' development experience that are of much general relevance and interest. In particular, there is the question of why it has been an East

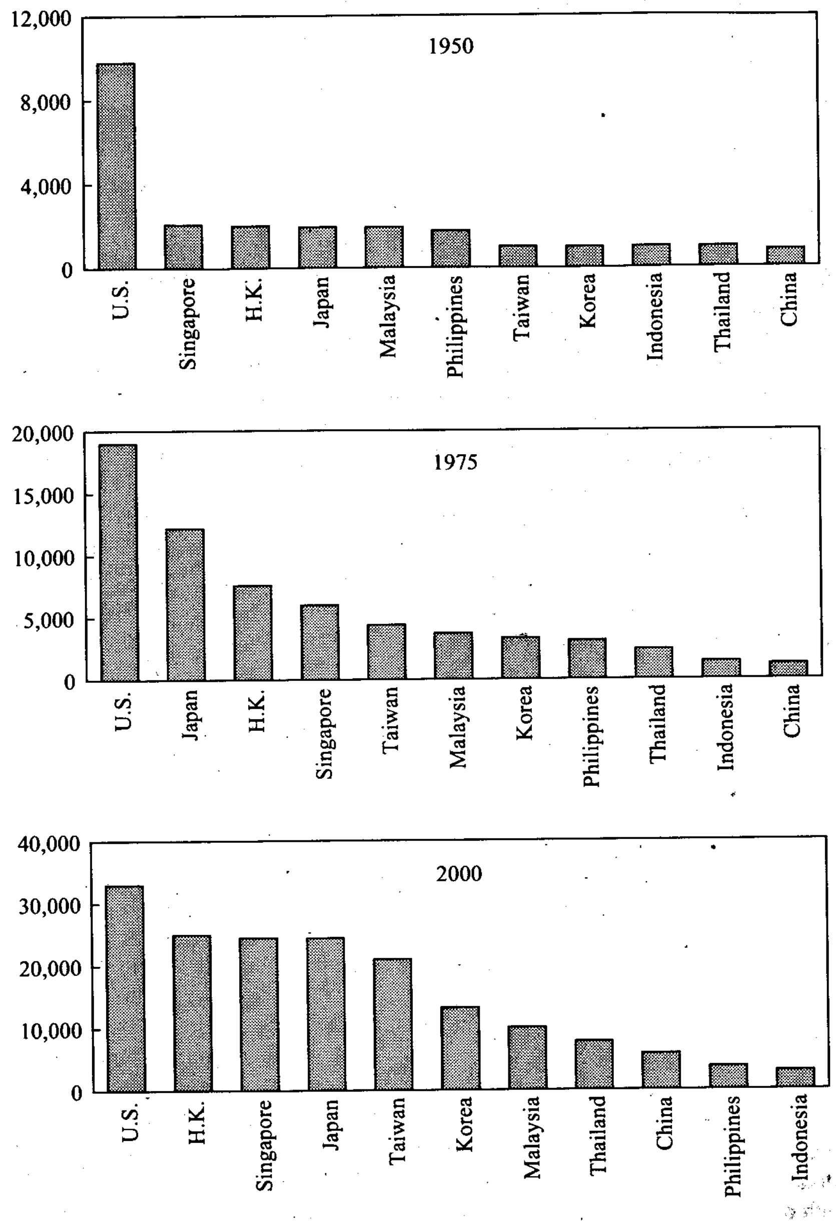

Figure 1.1 Real GDP per Capita in Selected Countries, 1950, 1975, and 2000 ($)

In constant prices based on 1999 purchasing power parity (PPP).
Sources: IMF, World Economic Outlook database.

Asian outlier—first in the negative and then in the positive sense—for much of the past 30 years. As noted, the comparison with Thailand is especially apposite here. The Philippine record post-Marcos may also, unfortunately, be indicative of what is in store for post-Soeharto Indonesia as it grapples with a difficult mix of abrupt political transition and deep economic crisis, much as Filipinos had to in the second half of the 1980s.

1.2 AN OVERVIEW OF THE RECORD

Figure 1.1 and Table 1.1 locate the Philippine record in comparative East Asian context. In 1950, when most developing countries' national accounts were admittedly rudimentary, per capita GDP in the Philippines, in purchasing power parity (PPP) terms, was midway between that of the richer city states and that of the poorest country in the sample, China. By this measure, some 25 years later it had slipped behind Taiwan and Korea and was similar to Thailand. By 2000 China and for a period Indonesia had overtaken it. As Table 1.1 makes clear, the growth record of the Philippines was comparable to that of its neighbors in the 1960s and 1970s, albeit a percentage point or more lower. The really pronounced divergence occurred in the "lost decade" of the 1980s, when its neighbors averaged about 6% annual growth, in contrast to its 1%. (In per capita terms the differences were larger still, since by the 1980s Philippine population growth rates were significantly higher.) The differences in growth rates narrowed in the 1990s, but for most of the decade the Philippines continued to fall further behind.

Economic Growth

Figures 1.2 and 1.3 document the story on an annual basis from 1970 to 2000. The 1970s were a decade of continuous expansion, with GDP growth averaging 5.8% annually.[1] In every year during that decade, growth in both GDP and per capita GDP

Table 1.1 Average Growth of GDP in Southeast Asia, 1950–2000 (% p.a.)

Country	1950–60	1960–70	1970–80	1980–90	1990–2000
Indonesia	4.0	3.9	7.6	6.1	4.2
Malaysia	3.6	6.5	7.8	5.3	7.0
Philippines	6.5	5.1	6.3	1.0	3.2
Singapore	n.a.	8.8	8.5	6.6	7.8
Thailand	5.7	8.4	7.2	7.6	4.2

Sources: Lim (2001: 38); World Bank (2002), *World Development Report 2002*.

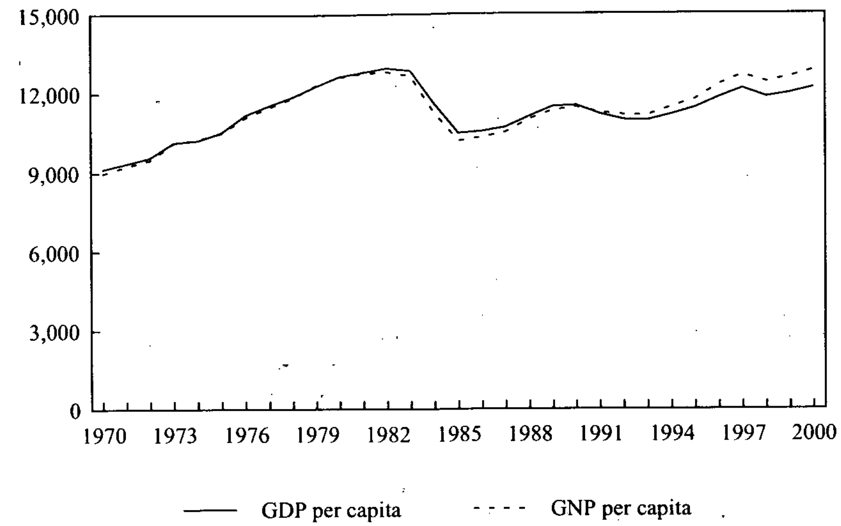

Figure 1.2 Real GDP and GNP per Capita, 1970–2000 (pesos, in 1985 prices)

Source: National Statistical Coordination Board.

was positive, with peaks in excess of 8% GDP growth twice, in 1974 and 1977. However, by the late 1970s growth was more subdued, at less than 6%. It then collapsed in 1984, as a political and an economic crisis set in. The former was triggered by the assassination of former opposition leader Benigno Aquino at Manila International Airport in August 1983. The economic crisis was partly a response to this incident, but its roots lay deeper, in the economic policy settings of the previous decade in particular. Negative external shocks further complicated the situation. These events culminated in a deep economic contraction in 1985–86, in the midst of which Ferdinand Marcos was deposed after 20 years of rule. Per capita GDP plunged by almost 20% over these two years.

Thereafter, a patchy economic recovery got under way, but this proved to be short-lived. By the early 1990s growth had again stalled, and there were two years of contraction. This was a much milder recession than in the mid-1980s, and by 1994 the growth momentum had resumed. In 1998 there was further dislocation, this time caused by the Asian economic crisis in combination with a severe El Niño-induced drought. On this occasion the downturn was very brief. Growth—albeit subdued—was restored the following year.

Figure 1.2 plots the picture in terms of real per capita GDP and GNP in 1985 prices. There is a growing divergence between the two series in the 1990s, reflecting the increasing impact of (probably more accurately measured) overseas remittances. The data suggest that, by 2000, per capita GNP had recovered to the peak

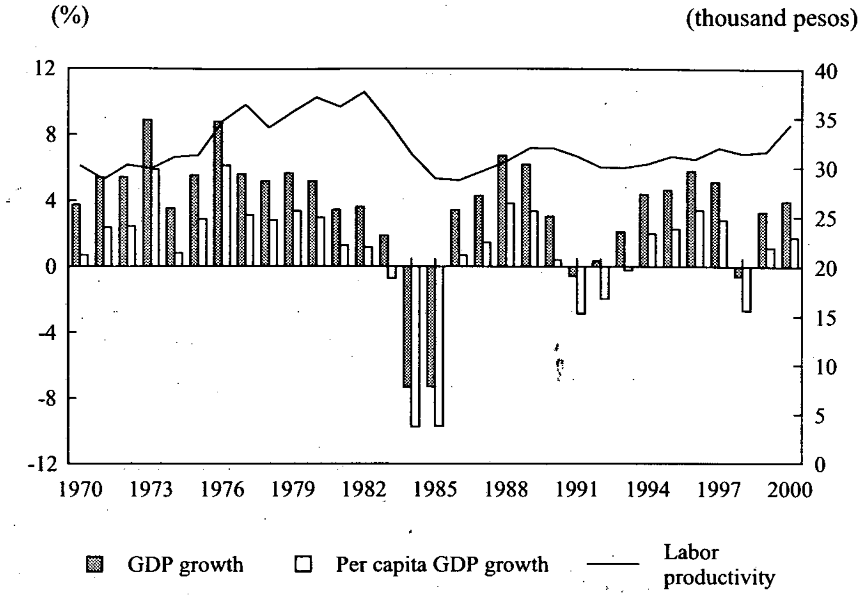

Figure 1.3 GDP Growth (%), per Capita GDP Growth (%), and Labor Productivity (in thousand pesos at 1985 prices), 1970–2000

Source: National Statistical Coordination Board.

year of 1983, but that per capita GDP remained almost 10% below this high point, at about the level achieved in 1980.[2]

The main point to emphasize is that, unlike many of its neighbors, the Philippines has not experienced a sustained period of rapid growth since the 1970s. The 1970s were its best decade, but even then very high rates were a rarity. Moreover, since 1980 the Philippines has not had more than four consecutive years of positive growth in per capita GDP. Finally, what growth there has been has been rather anemic, rarely above 3% (in per capita terms). With so many years of decline, it is easy to understand why progress has been minimal.

Labor productivity broadly followed the trend in real per capita GDP, except that its decline in the mid-1980s was sharper and its recovery thereafter slower. As Herrin and Pernia (Chapter 9) point out, several factors are at work here. Labor productivity typically falls faster than per capita GDP during a recession. In the formal wage sector, both employers and employees adopt various survival strategies, imperfectly recorded since hours worked are not measured accurately. Non-wage employment is elastic, especially in agriculture and the informal sector. Within sectors, too, there have been adjustments. In some cases the decline may have been no bad thing, most notably the shift in manufacturing from protected, capital-intensive activities toward export-oriented, labor-intensive industries.[3]

How might the years since 1970 be classified episodically? Inevitably the divisions are somewhat arbitrary, with different criteria (growth rates, policy emphases, external conditions, administrations) yielding different results.[4] One classification might be as follows.

- *Debt-driven growth, 1970–83.* Growth was quite respectable over this period, but was declining steadily following the 1977 peak. Moreover, it was driven by large overseas borrowings. This strategy was unsustainable since the funds were generally not invested productively, and by the early 1980s the country had essentially hit its borrowing limits.
- *Stagnation, then deep crisis, 1984–86.* Political and economic events together resulted in a very large economic contraction, the largest in the country's post-independence history. President Marcos was finally removed from office in February 1986, through a combination of disputed electoral returns and massive demonstrations along Manila's main arterial route, EDSA.
- *Erratic recovery, 1987–91.* Economic recovery ensued as the political situation stabilized, facilitated also by some return of capital, a competitive peso, mostly positive movements in the terms of trade, and strong regional growth. Toward the end of this period, a serious reform agenda began to be implemented.
- *Mild crisis, 1992–93.* Notwithstanding a pick-up in the momentum for reform, both in the late Aquino period and more decisively under the Ramos administration, the economy slowed. This mild downturn was the result of the conjunction of several negative factors—a succession of coup attempts in the early 1990s, very serious power shortages, some particularly destructive natural disasters (especially the eruption of Mt Pinatubo in 1991), and the removal of U.S. military bases in 1992. (The latter alone were estimated to contribute, directly and indirectly, as much as 5% of GDP.)
- *Recovery and growth, 1994–97.* This was an important period in Philippine economic history. It was an era of decisive reform in which there was a return to moderately good growth rates, peaking at almost 6% in the middle of the decade. There was a clear, if modest, reform dividend. Unfortunately, however, just as the country appeared set to rejoin the East Asian growth club, external factors intervened.
- *Weathering crises, 1998–2001.* The Asian economic crisis affected the Philippines only mildly and briefly (certainly when compared with its neighbors). The period was notable for at least two reasons. First, it was the country's first significant crisis that was clearly not of the government's making, but rather precipitated mainly by external factors—namely the regional economic crisis of 1997–98 and, not much less importantly, a very serious drought. Second, it was the first occasion on which a sharp devaluation of the peso did not trigger either a financial crisis or a generalized economic contraction. Both were significant achievements in the long sweep of post-independence Philippine economic history. From mid-2000 a general political malaise began to set in, owing to widespread disenchantment with the administration of President Estrada. This eventually resulted in his removal from office in January 2001.

Sectoral Expansion and Structural Change

Growth in the principal sectors of the economy has generally followed the aggregate picture, once sector-specific factors are taken into account (Figure 1.4 and Table 1.2). All major sectors grew quite strongly in the 1970s. The momentum of growth fell sharply in the 1980s, and the pick-up in the 1990s was mixed. As would be expected, the sharpest fluctuations have occurred in industry. High levels of protection in manufacturing, the major sector, left it exposed to the contraction of the 1980s (Hill, Chapter 7). Firms were simply unable to switch quickly to exports, notwithstanding the sharp peso depreciation and buoyant international markets. After double-digit growth rates in the 1970s—much of it public sector-dependent—construction activity shrank during the 1980s before it too returned to modest growth in the 1990s.

Agriculture grew strongly in the 1970s, driven in particular by a creditable performance in food crops (David, Chapter 6). For a number of reasons growth petered out in the following decades, and per capita agricultural output actually fell marginally. In contrast to several of its neighbors, the Philippines has not developed a viable export-oriented cash crop sector. Its historically important cash crops, sugar and coconuts, are both in the doldrums. Forestry output has declined continuously, a trend that accelerated in the 1990s, by which time virtually all primary forests had disappeared.

If there has been a sectoral success story, it would be services. It is the only sector to have recorded positive per capita growth in all three decades, as shown in

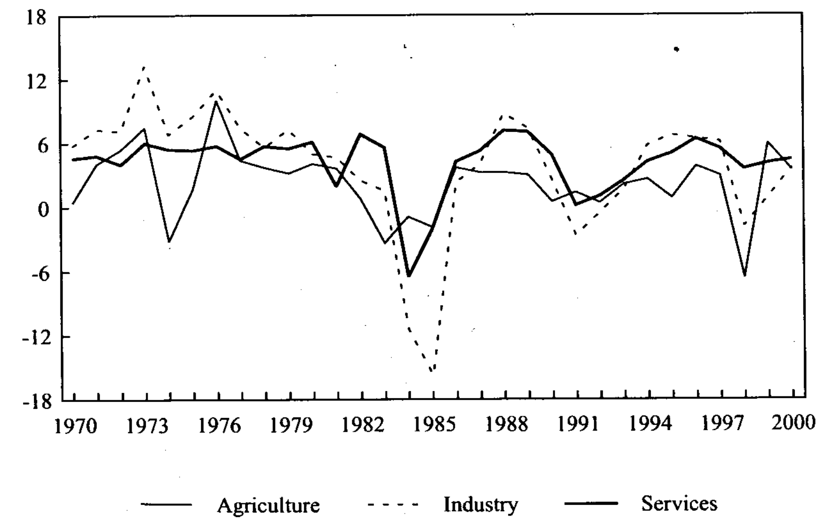

Figure 1.4 Growth by Sector, 1970–2000 (%)

Source: National Statistical Coordination Board.

Table 1.2 Annual Growth by Sector, 1970s, 1980s, and 1990s (%)

Sector	1970s	1980s	1990s
Agriculture, fisheries & forestry	3.7	1.5	1.5
Agriculture	5.8	2.4	2.0
Crops	6.3	1.3	1.3
Livestock & poultry	3.1	5.7	4.7
Fisheries	4.1	4.1	1.7
Forestry	–2.7	–6.0	–13.5
Industry	8.0	0.9	2.5
Mining & quarrying	6.8	3.8	–1.5
Manufacturing	6.6	1.2	2.3
Construction	14.2	–0.7	2.9
Electricity, gas, & water	13.7	5.7	5.3
Services	5.2	3.5	3.7
Transport, communication, storage	7.6	3.7	4.4
Trade	5.9	3.3	3.6
Finance	8.4	3.3	5.6
Occupied dwellings and real estate	1.2	2.7	2.2
Private services	5.0	5.5	3.6
Government services	4.6	3.4	3.6
GDP	5.8	2.0	2.8
GNP	5.9	1.8	3.6

Source: National Statistical Coordination Board.

Table 1.2. Growth has been positive in every year except the two severe recession years of the mid-1980s. The same relatively even pattern has been evident in most of its subsectors; all recorded positive growth during each decade. Whether this resilience can be interpreted positively is a moot point. Clearly, as Abrenica and Llanto (Chapter 8) emphasize, the 1990s reforms propelled growth in several subsectors. But growth in the 1980s was very similar to that in the 1990s, suggesting the possibility that, with its highly elastic employment coefficients, services may also have acted as a sector of "last resort" employment.

Trends in real sectoral labor productivity shed a little light on this issue (Table 1.3). In agriculture, productivity bottomed in 1985 and has increased erratically since then. In services, productivity also reached a low point in 1985, and since then has been virtually constant. In industry it peaked in 1980, declined by 30% during the 1980s, and then remained fairly flat in the 1990s. Increases in the 1970s and declines in the first half of the 1980s are easy enough to explain, since they predominantly reflect the effects of the economic cycle. But since 1985 industry has become more labor-intensive, and agriculture less so. In other words, sectoral differences in factor proportions have narrowed. Labor productivity in industry was 5.9 and 2.5 times that of agriculture and services respectively in 1980. By 2000, the ratios had declined to 4.2 and 2.2. This narrowing may be interpreted positively, as presumptive evidence of a more integrated, and less distorted, "dualistic" economy.

Table 1.3 Real Value Added per Worker, 1970–2000 (pesos)[a]

Year	Agriculture	Industry	Services
1970	15,884	62,364	36,666
1975	14,961	84,227	38,578
1980	16,791	99,162	39,048
1985	14,472	77,396	32,551
1990	16,046	69,976	33,279
1995	15,391	67,985	32,897
2000	17,151	72,000	32,436

a Each entry is a three-year average of the year indicated, the previous year, and the succeeding year, using 1985 prices.

Source: National Statistical Coordination Board.

Diverging sectoral growth rates of output and employment have resulted in some structural change, though not in the manner customarily expected (Tables 1.4 and 1.5). Because economic growth has generally been slow, the really sharp and rapid structural transformation commonly seen in East Asia is not evident. The share of agriculture in GDP has declined steadily. But whereas the more general pattern is for the share of industry to expand, in the Philippine case it too has shrunk, albeit marginally. The consistent gainer, as implied by the growth rates, has been services. Its share of GDP has risen by an extraordinary 50% since 1980, and during both good times and bad. The employment story has been broadly similar, with the declining agricultural share more or less mirroring the increase in services. In the early 1980s agriculture's share of total employment dipped below 50% for the first time. In the late 1990s services overtook agriculture as the single largest employer of labor, and on present trends is likely to account for half of the total quite soon. Of course, agriculture remains a major employer of labor (39% in 2000). And, especially for rural employment, one should be careful about drawing too sharp a distinction between the sectors.

These trends throw up several pertinent questions. Why is agriculture's share of GDP declining even with slow growth? Why has the industry share—and in particular that of manufacturing—actually declined marginally? And why is the share of services increasing inexorably? Several factors would appear to be relevant.

Table 1.4 Share of Sectors in Current Price GDP, 1970–2000 (%)[a]

Sector	1970	1975	1980	1985	1990	1995	2000
Agriculture, fisheries and forestry	29.9	30.2	25.8	24.4	21.9	21.4	16.5
Agricultural industry	25.7	27.5	23.2	22.6	21.0	21.2	16.4
Crops	16.2	18.5	14.9	13.5	12.0	12.5	10.1
Livestock & poultry	4.9	3.9	3.2	3.3	4.2	4.2	3.4
Fisheries	4.9	5.2	4.7	4.8	3.8	3.5	2.5
Forestry	4.2	2.7	2.6	1.9	0.9	0.2	0.1
Industry	31.5	35.2	38.5	35.9	34.5	32.2	30.9
Mining & quarrying	1.8	1.6	2.1	2.0	1.5	0.9	0.6
Manufacturing	24.5	25.6	25.5	24.8	25.0	23.0	22.1
Construction	4.3	6.7	9.4	6.4	5.7	5.7	5.2
Electricity, gas, & water	0.8	1.4	1.6	2.6	2.2	2.6	2.9
Services	38.6	34.6	35.7	39.7	43.7	46.4	52.6
Transport, communication, storage	3.4	3.8	4.5	5.5	5.2	4.7	5.7
Trade	9.5	10.4	11.9	14.1	14.4	13.7	14.2
Finance	3.0	3.2	3.6	3.1	3.9	4.2	4.6
Occupied dwellings & real estate	8.3	6.3	5.2	5.5	5.8	6.8	6.9
Private services	7.5	5.5	5.5	6.7	7.6	8.9	11.4
Government services	6.8	5.4	5.1	4.9	7.0	8.1	9.8

a Each entry is a three-year average of the year indicated, the previous year, and the succeeding year.

Source: National Statistical Coordination Board.

Table 1.5 Share of Major Sectors in Employment, 1970–2000 (%)[a]

Year	Agriculture	Industry	Services
1970	52.1	16.1	30.9
1975	54.3	14.7	30.7
1980	51.3	15.1	33.5
1985	49.7	13.9	36.4
1990	44.8	15.6	39.2
1995	43.5	16.0	40.5
2000	38.6	15.8	46.3

a Each entry is a three-year average of the year indicated, the previous year, and the succeeding year.

Source: National Statistical Coordination Board.

First, agriculture has encountered resource constraints. These are most obvious in forestry and fishing, but more generally the country hit the land frontiers—and hence the limits of extensive agricultural growth—around the 1970s, especially against a backdrop of continuing rapid population growth and slow non-agricultural employment absorption. For the reasons discussed by David (Chapter 6), agricultural yields have increased only slowly since 1980.

The case of industry is particularly interesting and unusual. The share of manufacturing output is now lower than it was in 1970. Is this cause for concern? As Bautista and Tecson (Chapter 5) and Hill (Chapter 7) point out, several factors have been at work. Output growth has been sluggish in some years. It may be that some of the new, export-oriented electronics output is not being counted properly. Protection has fallen steadily, and thus the reported decline is overstated if measured in international prices. (By contrast, the opposite phenomenon has occurred in agriculture, since protection has risen over this period.) An appreciating currency in the mid-1990s, combined with an urban minimum wage appreciably higher than that in competitor countries, may also have impeded growth in what is overwhelmingly a tradable activity. Thus there is no clear answer to the question. The evident decline in labor productivity may be no bad thing, since the sector is now embarked on a more labor-intensive and efficient trajectory. And the overcounting implicit in past protection has been removed. But the fact remains that growth has still been anemic.

There is no clear and obvious explanation for the continuing rise in services. The trend has occurred across virtually all subsectors, public and private, quasi-tradable and non-tradable, substantially and minimally deregulated alike. The increase has occurred both when the real exchange rate has been appreciating and when it has been depreciating, so the relative price of tradables to non-tradables does not seem to have been a decisive factor. The increase has also occurred during periods of high and low growth, so it is difficult to find support for either an "employment of last resort" or "agent of growth" hypothesis. Perhaps the inflow of remittances has in various ways been particularly pro-services, as some have conjectured. It may also simply be that services are what the Philippines is best at, another school of thought which has its adherents. Clearly more research is needed on this subject.

Expenditure and Savings

The slow growth has also been reflected in the expenditure accounts (Table 1.6). The share of personal consumption is high in the Philippines by East Asian standards. It rose sharply in the first half of the 1980s, predictably, as a protective strategy during the economic downturn. However, once ratcheted up to over 70%, it has failed to decline in response to positive growth. The share of government consumption has also picked up appreciably since the mid-1980s recession, rising by about 70% over the period 1985–2000, and now well above the level prevailing during the 1970s. An increase would be expected as the economy recovered; democratic expenditure pressures have no doubt also played a role.

While the rising consumption shares have cushioned living standards during hard times, this has been achieved partly at the cost of falling investment. Since

Table 1.6 Expenditure Shares in Current Price GDP, 1970–2000 (%)[a]

Type of Expenditure	1970	1975	1980	1985	1990	1995	2000
Personal consumption	67.2	62.3	64.2	71.9	71.6	74.0	71.7
Government consumption	9.5	10.5	9.1	7.5	9.9	11.4	13.0
Capital formation	21.6	30.2	29.1	16.6	22.0	23.5	18.3
Fixed capital	18.7	23.6	26.7	18.5	21.3	23.1	18.6
Construction	7.8	11.9	15.2	10.5	10.8	10.0	8.9
Durable equipment	8.8	10.1	9.8	6.5	8.9	11.5	8.3
Breeding stock & orchard development	2.1	1.7	1.8	1.6	1.6	1.6	1.4
Changes in stocks	2.9	6.6	2.4	–1.9	0.7	0.4	–0.3
Net exports	–0.8	–4.8	–4.4	1.7	–3.6	–7.7	3.2
Statistical discrepancy	2.5	1.8	2.1	2.3	0.2	–1.21	–6.0

a Each entry is a three-year average of the year indicated, the previous year, and the succeeding year.

Source: National Statistical Coordination Board.

1990, the share of investment has been around 10 percentage points below that prevailing for much of the 1970s. Both net exports and a puzzlingly large statistical discrepancy have fluctuated considerably. The movement in net exports correlates closely with the overall level of economic activity. Years of high growth (1975, 1980, 1995) result in a negative figure (that is, a current account deficit), while periods of recession or slower growth (1985, 2000) have the opposite effect. There is no obvious explanation for the statistical discrepancy.

The data in Figure 1.5 highlight the proximate cause of slow Philippine growth. The country had something approaching "East Asian" savings and investment rates during much of the 1970s. Both, but particularly investment, declined sharply during the 1980s recession. Investment then recovered somewhat, albeit to levels much below those in other countries in the region, whereas savings remained anemic, at essentially "OECD" levels. With such a low savings rate, and an inability to run much more than a 3–5% current account deficit (anything higher would in any case have been dangerous), Philippine growth has struggled to get above 6%. That the country was able to grow quite vigorously in the mid-1990s—at something approaching the 1970s rate, but with an appreciably lower savings and investment rate—is a creditable achievement, and indicative of the higher post-reform efficiency levels. But a savings rate of 15–18% remains too low for high growth.

Why did savings remain so low, even when growth resumed and financial liberalization ushered in positive real interest rates for savers? One explanation lies in the

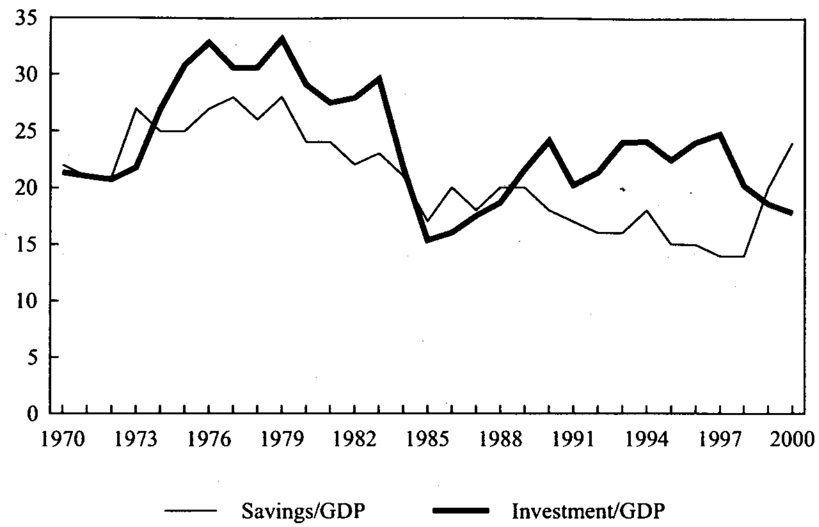

Figure 1.5 Ratio of Savings to GDP and Investment to GDP, 1970–2000 (%)

Savings, investment, and GDP are in current prices. *Source*: World Bank, *World Development Indicators*.

country's chronic fiscal deficits. Unlike the governments of its high-growth neighbors (Malaysia partially excepted), successive Philippine governments have almost always been net dissavers. Partly, of course, this reflects low economic growth. As the East Asian experience illustrates, there is a "virtuous circle" in the sense that it is easier for governments to achieve fiscal balance during periods of high growth, which in turn facilitates good macroeconomic outcomes. (Hence, it is no coincidence that a (small) fiscal surplus was achieved in the years of growth, 1994–96.) Another element of the East Asian growth story is that higher rates of savings invariably follow a period of sustained growth (see, among others, Harrigan 1998). Indonesia and Thailand, for example, both had savings rates closer to the current Philippine levels in the early stages of their long economic booms. So the real problem may simply have been that the country never achieved a long enough period of growth to induce higher rates of savings. Political instability and lack of security (among the Philippine Chinese community, for instance) have no doubt contributed at the margin.

1.3 THE RECORD IN DETAIL

We turn now to a more detailed look at the development record, drawing primarily on the contributions to this volume, and following its general structure. We focus particularly on the post-Marcos period, and therefore do not look in detail at the events leading up to the economic crisis of 1984–86.[5]

The Political Economy Setting

Is the Philippine system of democracy and government conducive to rapid economic development? Democracy is of course an end in itself, but here we are particularly interested in the economic and political interactions.

As de Dios and Hutchcroft emphasize in Chapter 2, this is a complex issue, and the system has notable strengths and weaknesses. The authors survey the post-Marcos period, starting with Aquino's "modest revolution" (1986–92). Forced to grapple with a severe economic crisis, a major political transition, attempted coups, and serious natural disasters, President Aquino was at least able to institute a more open and accountable system of government and, later in her term, initiate some policy reforms. But much of the period was characterized by "stop–go" economic policies, continuing fiscal crises, largely futile attempts to regain the Marcos wealth and manage sequestered corporations, and a cautious and limited social agenda. In the end, de Dios and Hutchcroft conclude that the "Aquino government came to rationalize its role as being limited to that of undoing the Marcos legacy."

The Ramos administration (1992–98) is characterized as one of "building reform momentum." It continued and deepened the macroeconomic and trade reforms of the late Aquino era, began to dismantle cartels in telecommunications, shipping, and civil aviation, achieved a measure of peace in Mindanao, and took steps to overcome the then very serious power shortages. Several factors were significant in this process: the beginnings of reform in the late Aquino period; the global and regional trend toward liberalization; a distrust of elements of the traditional Philippine elite; and a sense of vulnerability in the wake of the removal of the U.S. bases in 1992. The reforms were decisive enough that they delivered a prompt though modest dividend, which saw rising growth by 1995. De Dios and Hutchcroft conclude that the Ramos administration was good at liberalization; made less progress with institutional reform (of the bureaucracy, the tax system, and the judiciary); focused only to a limited extent on redistribution objectives; and had a very limited capacity to deliver on political reforms.[6] But there was an orderly succession of power in 1998, even in the midst of the Asian economic crisis.

Finally, there was the "flawed experiment" of the Estrada administration (1998–2001). This attracted a highly diverse group of supporters, was avowedly pro-poor in its rhetoric (though much less so in practice), and broadly maintained Ramos's macro and trade policy framework. But "palace connections" and cronyism quickly and blatantly became important again, and by the second half of 2000 the whiff of scandal began to engulf the administration. Ultimately, Estrada was tipped out in quasi-constitutional circumstances in January 2001.

In sum, what can be said? The Philippines is now a more democratic society, nationally and (since 1992) locally. Its civil society is undoubtedly stronger. Its economy is more open and diversified. There are considerable checks and balances on government, both from inside and outside. Once a reform has passed into law, there is a reasonable prospect that it will be durable. The country's post-independence economic history has been one of recurring economic crises—in 1949, the early 1960s, 1969, the mid-1980s, and the early 1990s. Policy reforms have been partial at best, and sometimes quickly overturned by powerful vested interests. Perhaps now there is a chance that the boom–bust economic and policy cycle can be more or less permanently overcome, at least in some measure. But there remain notable weak points, putting aside the immediate challenge of bedding down the legitimacy of the young Macapagal-Arroyo administration. Three in particular stand out.

First, the political system is highly personalistic. It can produce competent or inept presidents (such as Ramos and Estrada respectively). This can happen in any country, of course. The particular problem in the Philippines is that regime changes have major consequences since, with its U.S. style of government, they percolate right through the system. In contrast to the situation in most of its neighbors, where the civil service remains largely intact when the regime changes, in the Philippines regime changes affect the top layer of the civil service (at the level of secretary), the next layer (under-secretary), quite often the third tier (assistant secretary), and sometimes even the fourth (at the director level).

This has two immediate implications. One is that it reduces the likelihood of policy consistency. If much of the top leadership of a department turns over every six years, there is a distinct possibility of change of direction. Secretaries want to leave their mark through pet projects. More importantly, investors will calculate that they have policy certainty for no more than six years, and in practice much less, owing to settling-in and "lame duck" periods and to turnover within administrations. Another implication is that, below these senior echelons, there simply is not the pool of high-level talent to anchor policy consistency, since poor salaries and a lack of career structure constitute major deterrents to entry into the civil service.

A more general consequence is that the Philippine system—unlike a system of career public service—makes it more difficult to deeply entrench pro-reform lobbies within the bureaucracy. Within the Philippine setting, the National Economic and Development Authority (NEDA) is perhaps the most reform-oriented—though not the most financially powerful—department. The other major proponent of reform, the Department of Finance, is generally preoccupied with the immediate struggles of fiscal policy, while the central bank has a limited remit in the field of monetary policy and banking. Similar comments apply at the level of agency head, accounting for their variable quality.[7]

A second challenge is that it is often difficult to get reforms through the system, because there are so many points at which progress can be stymied.[8] The bureaucracy, the legislature (both national and regional), the palace itself, and the judiciary can all be employed by lobbyists determined to resist reform. Moreover, different pressure points may be important in different administrations. Under Estrada, it was widely perceived to be the president himself whose so-called "midnight cabinet" of "drinking buddies" could overturn decisions taken by the "daytime cabinet." Ramos had problems with the legislature, while Aquino's cabinets became well known for their policy rifts, particularly in the early years.

A third challenge, systemic in nature, concerns the extent to which deeply entrenched and high levels of inequality impede reform. De Dios and Hutchcroft highlight this factor and implicitly suggest an "Olsonian" explanation for the slow post-Marcos policy reform processes. The Philippines has never experienced a Taiwan-style land reform, nor has there been an administration determined to cater to a poor rural constituency as there was in Malaysia and Indonesia. Thus, powerful land-owning groups and business conglomerates have been a constant feature of the country's history. This does not of course preclude the possibility of effective reformist administrations—as evidenced by Ramos—that can certainly help the poor by accelerating economic growth. But, it is contended, the political system is such that distributionalist objectives will always be difficult to achieve, and reforms may subsequently be overturned.

Macro and International Dimensions

If post-independence Philippine history has been characterized by stop-go economic policy, then macroeconomic and trade policy must surely have been at the heart of the problem. It is therefore not surprising to find that they have been central to reform efforts since the late 1980s. This is one area where the achievements have been significant, arguably constituting the key contributors to improved development outcomes. We consider each topic in turn.

Macroeconomic Policy

Philippine macroeconomic outcomes have traditionally lagged behind those of the high-growth East Asian countries, though by general developing-country standards they have not been disastrous. Inflation has been higher than in Singapore, Malaysia, and Thailand, but these have been the exemplars of the developing world. The Philippine record has not been significantly worse than that of Indonesia and Korea, and it has of course been superior to that of Latin America.

The bases of the country's macroeconomic problems are well known: chronic budget deficits, which were in turn monetized by a politicized central bank that was also attempting to run a quasi-fixed exchange rate regime. The results were moderately high inflation, a black market foreign exchange rate, and periodic balance of payments crises. The reform process that got under way in the late 1980s, and which delivered lower inflation in the 1990s, was therefore a milestone in the country's history.

Exchange Rate and Monetary Policy. Here the main story, as told by Gochoco-Bautista and Canlas (Chapter 3), is a major shift in the policy regime. Until the late 1980s the central bank was grappling with the funding of a chronic fiscal deficit, which was often monetized. The authorities attempted to control too many variables—money supply, interest rates, the exchange rate—with too few instruments. The central bank periodically incurred large losses, operating as it did as a de facto arm of government in a highly politicized atmosphere.

The reform momentum started in the late 1980s. The international capital account was progressively opened, culminating in full peso convertibility in 1992. This was one of the first major economic policy initiatives of the incoming Ramos administration. As part of the reform, a new institution was created in 1993, Bangko Sentral ng Pilipinas (BSP), and the debts of the old central bank were taken off its books. The new regime emphasized inflation targeting and instituted a floating exchange rate within a managed band. The results were immediately obvious: inflation stayed under control throughout the 1990s, remaining in the range of 6–9%. Perhaps more importantly, the peso convertibility removed an endemic source of corruption, both petty and grand, and was fundamental in instigating a more outward-looking mentality among investors.

As Gochoco-Bautista and Canlas stress (see also Rodlauer et al. 2000), the 1990s were a period of learning for the new monetary authorities. They had to manage a new and very different policy regime in the context of a rapidly changing international environment. The latter was an important consideration. The low global inflation of the 1990s facilitated their policy objectives. But opening up to international financial markets was a major challenge, because the country had effectively been closed to private capital until 1992 (owing to its protracted debt crisis), and because short-term capital flows to "emerging markets" were increasing dramatically throughout the decade. There was also some ambivalence about objectives, with a mixture of inflation and exchange rate targets being formally or informally pursued. Finally, banking supervision remained within the BSP's jurisdiction, an issue to which we return below.

Initially the authorities attempted to emulate neighboring countries, running monetary policy with a quasi-fixed exchange rate in the context of an open capital account. Here the familiar Mundell–Flemming problem began to surface, albeit in milder form than in neighboring countries owing to the much smaller volume of capital flows in the Philippines (Rodlauer et al. 2000). For a (fortunately) short period, in fact, Philippine conditions and policy settings were quite similar to those of the soon-to-be crisis economies. The real exchange rate began to appreciate mildly, threatening export competitiveness and also complicating the trade liberalization process then under way. Capital flows were increasingly directed toward non-tradable activities. Local banks became significant international borrowers, a trend hastened by the gap between domestic and international interest rates and by the perception that the authorities would hold the nominal rate more or less constant.

This period was short-lived, as the crisis began to impact by August 1997. The BSP's initial reaction, like that of its counterparts elsewhere, was to defend the peso through higher interest rates. This quickly proved futile. Allowed to float, the peso then fell sharply, approximately halving in value against the U.S. dollar in the next six months. But this was a most unusual balance of payments crisis by Philippine standards. First, the trigger (namely the contagion from Thailand) was mainly external. Second, it did not lead to a general financial crisis, as occurred in Thailand, Malaysia, and Indonesia. Finally, growth was interrupted only mildly.

We return to these issues shortly. The main point to stress here is that the BSP survived its first major challenge quite creditably. In the process, it further refined its monetary policy settings in 2000. It progressively de-emphasized a nominal exchange rate objective and asserted that its primary objective was to achieve inflation outcomes within a targeted band. The political crisis involving the transition from Estrada to Macapagal-Arroyo again tested this framework, but, while obviously intervening in the market, the BSP did let the peso slide considerably.

Thus the new framework appears to have taken root in the system. It is true that this framework will only work if fiscal policy is also cautious—and here problems remain—so that monetary policy does not have to "carry" the major task of macroeconomic management. There also continues to be debate about the advisability of some sort of capital controls, *à la* Malaysia. The major worry would be the feasibility of reintroducing foreign exchange controls given their history of endemic abuse.

Fiscal Policy. There has been major progress in fiscal policy since the 1980s, as outlined by Sicat and Abdula (Chapter 4). Successive Philippine governments have almost always run fiscal deficits. Although there has rarely been a complete loss of fiscal discipline, these deficits have invariably peaked around election time—the years 1969 and 1985 stand out during the long Marcos period. These deficits have typically resulted in difficult fiscal adjustments, and often a sharp depreciation of the peso.

As Sicat and Abdula point out, fiscal policy settings and the role of the government have varied since 1970. The size of the public sector grew significantly in the 1970s. There was a perceived need to accelerate growth through an increase in the supply of public goods, especially infrastructure. It suited President Marcos, too, of course, since large projects constituted a major source of patronage and largesse. By the end of the decade this strategy was no longer sustainable, as many of the projects were unable to generate viable returns and debt service difficulties were exacerbated by several negative external shocks. A painful period of adjustment followed in the first half of the 1980s. Real per capita expenditure almost halved. There were very large cuts in infrastructure expenditure, which arguably laid the basis for later problems. And debt service rose sharply; at one stage interest and debt payments absorbed more than 40% of the budget.

From the late 1980s significant progress occurred. The ratio of government revenue to GDP almost doubled between the recession years of 1983–85 (9.6%) and 1997 (17%), by which time the country's tax effort had nearly caught up with that of Indonesia and Thailand. Faster growth, a simplification of tax scales, and more vigorous collection procedures all contributed to this result. The resumption of growth, combined with some debt workouts, also meant that the debt service burden was progressively lightened over this period.

As Sicat and Abdula show, the fiscal policy stance improved immeasurably from the mid-1980s. The deficit, narrowly defined, peaked at 8.5% of GDP in 1986. The position then improved steadily and for three years (1994–96) a slim surplus was recorded. With the onset of the crisis, however, there was a quick return to deficits.

The authors highlight a key issue in fiscal policy, namely that any assessment of the official budget position is highly sensitive to definitions. The deficits have been either quite modest or veering toward unsustainability depending on whether central government or consolidated government figures are used (Figure 4.11). The latter are of course the relevant indicator. As Sicat and Abdula show, deficits in excess of 5% of GDP were the norm in the 1980s and resurfaced in the late 1990s. The budget was in surplus in 1994–96, however, even according to this broader definition.

The principal difference between the two measures is that the state-owned enterprise (SOE) sector is included in the consolidated measure. In the worst years of the 1980s the losses of this sector were equivalent to over 5% of GDP; during the 1990s they were much smaller, although in 1999 and 2000 they again became large. Financial institutions (the old central bank, the Philippine National Bank, and the Development Bank of the Philippines) accounted for much of the sector's losses, but there were problems also in utilities and trade.

The SOE sector, though small, will pose a continuing challenge to policymakers. State enterprises are sometimes able to operate outside the normal checks and balances of the government's financial framework. Their financial operations lack transparency and are ostensibly justified by alleged (but often spurious) "social missions." Some cases of asset sales and privatization have been questionable.

To sum up, post-Marcos administrations have inherited a very complex fiscal situation. There has been major progress since the 1980s, especially in the tax effort, the restoration of essential public goods, and the control of the deficit. Against this:

- there was disappointingly little progress in recouping the "crony assets" of the 1980s (although in fairness the international experience anywhere else has not been much better);
- there is still chronic underprovision of key public goods (in infrastructure, education, and health);
- SOE reform and privatization continue to constitute major challenges;
- there is the ever-present danger of crony-related contingent liability, which surfaced again under the Estrada administration in particular; and
- decentralization has been managed quite effectively, though it has not been entirely revenue-neutral.

As Sicat and Abdula point out, the Philippines now has a president who, in her earlier academic writings, had stressed the importance of sound fiscal management. One has to hope that President Macapagal-Arroyo and Professor Macapagal-Arroyo are one and the same person.

International Dimensions

The Philippines has a history of perverse trade policy interventions, which have been extensively documented in earlier studies.[9] Significant progress has been made since the late 1980s, to the point where openness appears to be quite deeply rooted in the polity and in the community at large, and the country now has a reasonably open trade policy regime. Average rates of protection have fallen, the dispersion in these rates is lower, and there is less reliance on non-tariff barriers. Nevertheless, the Philippines is a much less significant international commercial player than most of its neighbors, as a result of past barriers to trade and investment, and an unwelcoming business environment.

Bautista and Tecson (Chapter 5) chart these changes, characterizing the 1970s as a decade of export promotion and flexible exchange rates, the 1980s as a decade of trade liberalization under a foreign exchange rate constraint (with most progress made in 1981–85), and the 1990s as a decade of reform, with an unstable and appreciating exchange rate. The progress made in the early 1980s was interrupted by the economic crisis of 1984–86. The momentum resumed in the late Aquino period and was carried forward under Ramos. During the period of the Estrada administration there was no significant regress, although several highly politicized cases of cronyism attracted attention.

There were two unusual features of the reforms in the 1990s: trade barriers came down notwithstanding an appreciating currency (typically reforms occur after crises, accompanied by a depreciation); and agricultural protection rose, to the point where it now exceeds that for manufacturing. Both require some political economy explanation. Bautista and Tecson attribute the decline in overall protection to decades of intellectual effort, gradually percolating through the bureaucracy and the political process.[10] Much of that work was located at the University of the Philippines and the Philippine Institute of Development Studies. Foreign inputs helped, but the domestic impetus was the critical factor.

The rising level of agricultural protection may be explained by several factors. One is the voice of the rural constituency with the return of democracy. Powerful landlords have played on this factor, together with sentimental notions of food self-sufficiency, to engage in pork barrel politics with Congress. Another explanation is rural–urban income distribution concerns (even if protection is a relatively blunt instrument to achieve this goal). Third, there has been a less intensive intellectual effort on the costs of protection in this sector. Finally, the availability of loopholes in regulating international trade in agricultural products may have meant that the international costs (of scrutiny and, possibly, reciprocity) are lower.

This more open trade regime has been accompanied by other reforms, most notably in opening up more sectors to foreign investment. Consequently, foreign investment flows rose during the 1990s. For a period the services sector became the largest recipient, while in manufacturing there was an impressive shift out of the former concentration in protected activities and into new export-oriented sectors.

Looking at the balance of payments as a whole, a striking feature is the dominance of remittances. They now total about $6 billion, equivalent to 20% of exports (to comprise by far the largest "export" item) and 70% of total service income. Both push and pull factors have been relevant here, including sluggish domestic growth, high levels of human capital across most skill groups, an increasingly open international labor market, and well-established information flows and recruitment channels. We return shortly to some of the pros and cons of these large labor flows.

Notwithstanding the significant achievements made, Bautista and Tecson are careful to highlight the outstanding policy agenda. First, protected sectors remain, particularly in agriculture, but also still in manufacturing. As and when protection is wound back, there will probably need to be some compensating support measures, particularly for poor rural dwellers. Second, the macroeconomic policy environment needs to be supportive of the reform agenda. The large effective depreciation of the peso since 1997 has facilitated trade liberalization, whereas if the appreciation in the mid-1990s had persisted, progress may have been jeopardized. Third, international competitiveness is still a concern, and obstacles ranging from poor infrastructure to a somewhat rigid formal urban labor market need to be addressed. Finally, there is the paradox that, in order to diversify exports, a strategy of industrial promotion was pursued, but—as in some neighboring countries as well—merchandise exports in the Philippines are now more narrowly concentrated (on electronics) than ever before.

The Sectors

As noted above, fortunes at the sectoral level have generally reflected economy-wide conditions. But there are exceptions to this generalization, and an examination of the major sectors provides additional insights into the Philippine development record.

Agriculture

Despite its shrinking share, agriculture remains a key sector, generating about 17% of GDP and employing a little under 40% of the workforce. If a broader definition that encompasses agricultural processing and related activities is adopted, the indirect shares rise to about 40% and 67% respectively. Moreover, some 70% of the poor depend on this sector, and thus its fluctuating fortunes have a direct impact on the nation's welfare.

As David documents in Chapter 6, agriculture's record has been mixed. The sector achieved respectable growth in the 1970s, much of it driven by yield increases in the wake of the Green Revolution of the1960s, and notwithstanding the high levels of manufacturing protection. But since then growth has been sluggish, and has failed to keep up with population growth.

There have been notable differences between subsectors and crops. The livestock and poultry industry has grown quite quickly and appears to be internationally competitive. The Philippines is an efficient producer of a variety of tropical fruits, including pineapples, bananas, and mangoes. But other sectors have lagged. It is striking, for example, that the country has not enjoyed any significant tropical cash-crop export boom over the past 20 years, analogous (for instance) to the boom in rubber in Thailand, palm oil in Indonesia and Malaysia, cocoa in Indonesia, and coffee in Vietnam.

Several factors appear to account for this outcome. The country's natural resource base is inferior to that of several of its ASEAN neighbors (though its population density is similar to that of Vietnam). An additional complication is that the natural area of expansion—the country's frontier zone, Mindanao—has been beset by constant unrest, deterring investors, who necessarily require a secure investment climate for longer-gestation cash crops. The agrarian reform program has introduced uncertainty with regard to property rights, again especially affecting cash crops.[11] The state of the country's rural infrastructure, particularly its roads, has also inhibited competitiveness.

Although rapid population growth is resulting in an inexorable decline in comparative advantage in agriculture, David stresses that government policies have accentuated the trend. Government expenditure on the sector declined sharply during the economic contraction of the 1980s. With growth and renewed emphasis on rural development, by the late 1990s expenditure had been restored to real 1970s levels (though not in per capita terms). However, budgets have continued to be misallocated. The authors argue that there has been too little productivity-enhancing investment, on rural roads (which are often intensely politicized), irrigation, and R&D, and further misallocations of priorities within each of these. By contrast, distributional goals (for example, price interventions and supports, and agrarian reform), often with perverse efficiency and equity outcomes, have been overemphasized.

Philippine agricultural interventions have traditionally favored the well-endowed regions close to the major centers of political power over upland and more remote regions. The case of perverse intervention in sugar—with powerful vested interests clinging to the quota rents implicit in favorable U.S. market access at the expense of the industry's general modernization—has been extensively documented. The once dominant sugar industry has shrunk dramatically, and is now smaller than both bananas (although here too there are restrictions on expansion) and pineapples.

David singles out the National Food Authority (NFA) as a particularly perverse case of costly intervention; its direct and indirect costs are as much as 50 billion pesos per year, most of which does not appear as a formal budget item. The official justification for its continued monopolization of international trade, namely to prevent "exploitation" by private traders, has little analytical basis. It has, rather, introduced major inefficiencies into the country's food-marketing system.

The authors highlight the need for a range of additional policy reforms. One example is the effects of the value added tax on the development of agro-processing industries. There is also a need for bureaucratic reform, including effective decentralization to regional offices of the Department of Agriculture, and removal of the overlap between this department and the Department of Environment and Natural Resources.

As noted above, the protection story has changed significantly. Agricultural protection has increased and now exceeds that for manufacturing. Moreover, although the dispersion in intersectoral rates has declined, that within agriculture has increased. The resultant increase in the (domestic) agricultural terms of trade has thus cushioned farmers from the declining international commodity prices of the 1990s. While desirable on income distribution grounds, protection is a blunt redistributive instrument, and there are more effective means of helping the rural poor. Perhaps there is a political economy dilemma here, in the sense that there are so few alternative instruments available in practice to assist this constituency of rural poor.

Industry

The industrialization record is also mixed. As noted above, the early push for industrialization through high protection resulted in a large but generally inefficient manufacturing sector. The sector has been unable to adjust to a less protected environment, resulting in the curious phenomenon of "deindustrialization" at a low level of economic development.

Nevertheless, there has been progress, as Hill documents in Chapter 7. The country has shifted to a more efficient, export-oriented trajectory. Fewer sectors are heavily protected, and a much higher proportion of output originates with internationally competitive industries. Thus, the observed decline in the share of manufacturing may not be such a cause for concern, since some inefficient activities have been shed, and value added at domestic prices is no longer inflated by high levels of protection.

Not only have effective protection levels declined, but the general liberalization has resulted in lower levels of industrial concentration. As a result of the reforms, there are relatively few industries with a serious competition problem. The past pattern of industries both heavily protected and subject to little domestic competition, in which the dominant players were the politically well connected or foreign owned (or often both), has been discarded.

Moreover, export growth since the early 1990s has been creditable. Electronics has been the major engine of growth, with its exports rising dramatically from about $1 billion in 1985 to $7 billion in 1995 and over $20 billion in 2000. This growth continued during the recent Asian crisis and was a factor in the country's resilience. Together with the smaller (and related) item of machine goods, electronics now constitutes almost 70% of Philippine merchandise exports. In addition, it accounted for the entire expansion of merchandise trade in the 1990s.

With this mixed picture as a background, Hill identifies a number of major challenges for development policy. One is the now very great reliance on electronics, and the puzzle as to why this industry has performed well while others with broadly similar characteristics (such as textiles and garments) have lagged. There is also impatience that backward linkages from electronics exporters have not developed more quickly. The industry's strong growth has been enclave and dualistic in nature, and located entirely in the zones of the Philippine Export Zone Authority (PEZA). Such a pattern has been observed in most early-stage East Asian exporters, and the weak linkages in part reflect industrial infancy. But to the extent that the barriers between these firms and those located outside the zones are regulatory in nature, the obvious solution is to adopt economy-wide reforms. There are also questions concerning the fiscal sustainability of PEZA incentives.

There are other industrial structural imbalances that need to be addressed. The Philippines has missed out on Taiwanese-style dynamism in the small and medium-sized enterprise (SME) sector. The reasons for this are complex, and no doubt reflect mainly economy-wide influences. Poor rural infrastructure, segmented factor markets, weak provision of industrial extension services, and unequal rural income distribution are all elements in this story. The spatial pattern of industrialization is also highly uneven. Almost 80% of value added comes from just the three central regions of Metro Manila, Central Luzon, and Southern Tagalog, which together virtually constitute the country's integrated industrial heartland. Elsewhere, only Cebu has a significant industrial base. Decentralization, better rural infrastructure (and international connections), a more scattered system of industrial zones, and congestion costs around the capital may in time produce a more even spatial distribution. But such a trend is not yet evident.

Services

As noted above, the services sector has shown consistent growth over the past three decades. It is now by far the largest sector and its share is likely to continue to rise. A number of decisive reforms during the 1990s opened up hitherto moribund industries to competition and innovation. It appears increasingly apparent, too, that the Philippines has a stronger comparative advantage in labor-intensive services than in much of the goods sector. The success of the country's labor exports is in effect an indication of this proposition.

As services become increasingly tradable, numerous export opportunities are opening up for the country. It has already carved out a niche in certain areas. With a little over 1% of the world's population, for example, Filipinos constitute about 25% of the world's seafarers. They reportedly comprise as much as half of the non-managerial staff on international cruise lines. Filipinos also dominate Asia's live music and entertainment industry, as well as being the principal source of domestic employment in Hong Kong and Singapore. The country is emerging as a major information technology (IT) center in developing Asia and is competitive in health, education, and a range of other services, all increasingly traded. Business activities as diverse as international call centers and graphic cartoon design are being established. English-language competence, competitively priced labor for a range of middle-level technical skills, familiarity with American cultural norms, and widespread international employment experience all constitute a competitive advantage for the Philippines in these service exports. It is notoriously difficult to measure non-factor service exports such as these, but the available evidence suggests that they have been growing quickly since the late 1980s.

To exploit these advantages, the competitive provision of complementary inputs is also required. Where they are not available, growth has been disappointing. An obvious case in point is tourism, where, in spite of much natural potential, the record has been disappointing. Poor infrastructure and security concerns have held back growth in the tourism sector. Another example, now changing, is IT, where growth has been retarded by an inefficient telecommunications industry.

Abrenica and Llanto (Chapter 8) document the changing face of the services industry with special reference to two case studies, telecommunications and banking. Both are largely positive cases of reform leading to the more efficient provision of a range of services. The authors point out that there were other cases of successful reform in the 1990s, including domestic shipping and civil aviation. But the forward momentum seemed to slow under the Estrada administration, which was responsible for some damaging backtracking on international civil aviation.[12] Progress has also been slow in opening up the retail sector to competition, particularly from overseas, and in the employment of foreigners.[13]

In the first of Abrenica and Llanto's case studies, telecommunications, liberalization was initiated in 1993, while in the second, banking (and insurance), this happened in 1994. Civil aviation and domestic shipping followed a year later.

The reforms in telecommunications were bold, resulting in clear gains for consumers in terms of lower prices, improved services, and rising telephone density. However, the benefits of incumbency for the Philippine Long Distance Telephone Company (PLDT), the former near-monopolist, should not be underestimated. In 1999, for example, the authors estimate that PLDT still accounted for 61%, 55%, and 71% of local connections, cell phones, and international calls respectively. Moreover, there was such a large backlog in telecommunications infrastructure pre-reform that it will be some time before the country's services match those of its more advanced neighbors. Finally, the reforms have been incomplete. The various interconnection agreements between telecommunications carriers have thus far been left untouched. And foreign equity shares have been limited to 40%, which by current international standards is quite restrictive.

The record on financial services is also largely a positive one. Reform got under way gradually in the 1980s. The Philippines has had a history of tight central bank regulation of banks but weak (and sometimes corrupt) supervision of them. After the central bank itself had been cleaned up and reformed, the government rehabilitated the two large state-owned banks (the Philippine National Bank and the Development Bank of the Philippines), partially privatizing one of them. Some mergers and closures resulted, the regulatory framework was improved, and entry was eased. Several foreign banks entered the market as a result. Abrenica and Llanto show that the banking sector is in consequence more efficient. Bank profits have declined and spreads (between deposit and lending rates) are lower. There has also been an increase in national bank density ratios, although much of it has been concentrated in the three richest central regions of Metro Manila, Southern Tagalog, and Central Luzon. There has been some increase in seller concentration, but the rise has been modest and the ratios are not unduly high; they are well below those in Thailand, for example. Perhaps most important of all, the banks came through the Asian economic crisis intact—in part no doubt fortuitously, since they had not had the opportunity to indulge in the spending spree evident in several neighboring countries.

As with telecommunications, the reform process will have to be an ongoing one. Steps are in place to improve transparency and enforce stricter disclosure requirements. And while the banking sector is now a more efficient financial instrument than it was in the past, the same cannot be said of the Philippine stock exchange, which over the years has proven consistently resistant to attempts to clean it up.

Social and Distributional Issues

Most social indicators have reflected general economic conditions, with stagnation and decline in the 1980s and some hopeful signs in the 1990s. Overall the picture is mixed, with some very worrying problems alongside significant improvements. This is of course a case of complex, two-way causality, with social conditions being determined by, but also shaping, economic progress. We consider in turn each major area: demographics and human resources, poverty and inequality, regional development, and the environment.

Demography and Human Resources

Herrin and Pernia analyze this diverse set of topics in Chapter 9, highlighting the Philippines' daunting demographic challenges, its distinct (though arguably fading) educational advantage, and its labor market conditions.

Demographically, the Philippines is an East Asian outlier. Its population, of 75.3 million in 2000, has doubled since 1970, and most projections suggest that it will at least double again before stabilizing. The population is now growing more slowly: the growth rate fell from about 2.7% annually in the 1970s to 2.3% in the 1980s and 2.2% in the 1990s. The total fertility rate has also fallen, from about six births per woman in 1973 to 3.7 in 1998. These rates of decline are slow compared with those in high-growth neighbors (except Malaysia, owing to complex socioeconomic dynamics), and no doubt reflect both slow economic growth—a key factor in the process of demographic transition—and powerful church-based opposition to contraception. (As Herrin and Pernia point out, contraception options for most Filipinos are both limited and dangerous.) The authors allude to the "waxing and waning" of population policy and argue for an integrated approach to family planning, including measures to safely stem the high level of unwanted pregnancy.

Another factor is that infant mortality rates are still high, and declining only slowly. In 1990 the rate was about 60 deaths per 1,000 live births, and is now probably a little below 50. In addition there are marked regional differences, with poor regions recording rates some two-thirds higher than those in the national capital. Child malnutrition is high, again with substantial regional variation.

In education, the Philippines rates above most countries with similar per capita incomes, and has the additional advantage of widespread English-language fluency. It thus has an edge in activities requiring middle-level human capital inputs. Reflecting an early commitment to public education, about 95% of the population aged 10 years and over has "simple" literacy skills, while about 84% may be said to be functionally literate. Primary school participation is at least 95% of the relevant age group, falling to about 64% for secondary schools. There is no gender bias, and in fact female participation is slightly ahead of that of males. However, the country's lead is slipping as these rates stagnate and other countries catch up. Moreover, it rates poorly in international quality comparisons. For example, it ranked 39 out of 43 in a recent testing of math/science competence; Singapore and South Korea ranked first and second.[14]

Expenditure on both health and education is rising, and is broadly comparable to that in neighboring countries. But Herrin and Pernia worry about targeting and priorities in these sectors. Health expenditure is mostly in the private sector, and therefore highly inequitable. The Department of Health has a bias toward the urban, hospital-based system. Malnutrition also needs more attention. In education, there is a strong case for more funding at the primary school level and greater cost recovery at the tertiary level. The public school system needs more funds for non-salary items.

With rapid population growth and a large backlog of unemployed workers, employment provision is a chronic problem in the Philippines. The labor force is growing by about 2.8% each year, equivalent now to about 800,000 new job entrants.

Absorbing the rising numbers of female workers is another major challenge. Unemployment currently stands at about 10%, with underemployment variously estimated at around 20%. These levels fluctuate with the economic cycle and have predictably distinct age, skill, regional, and gender correlates. The problem of child labor also needs to be addressed.

The inevitable consequence is of course that many people are seeking employment abroad. The number of Overseas Filipino Workers (OFWs), as they are known in-country, has been growing at a phenomenal pace, almost quadrupling between 1980 (about 215,000 persons) and 1999 (around 837,000). The Middle East was a key destination during the 1970s oil boom. Its share has since declined, while that of East Asia has been rising quickly. Now the industry is global. While OFWs are predominantly unskilled and semi-skilled, they encompass all major occupational groups.

Analyses of this phenomenon display an understandable ambivalence. At the micro, household level, it is a sensible poverty alleviation strategy in the face of sluggish domestic employment growth. It accords with the country's comparative advantage across the spectrum of labor-intensive activities. In the neighboring countries that were able to achieve rapid export-oriented industrialization, the jobs migrated to the country concerned. In the Philippines to some extent the reverse has happened, with workers migrating across international boundaries.[15]

But what of the national cost–benefit ratio? Here the picture is more clouded. There is obviously a serious brain drain under way. Set against this, in some cases the migrants are among the less skilled, and thus the loss of human capital is not so significant. There is also a high return rate, often with augmented human capital. (This has been an important and beneficial factor in the case of Taiwan and Korea.) Remittances are a boost to national welfare (even if they may marginally worsen income distribution, to the extent that they are concentrated among better-off households and regions). But there are many workers who do not return, particularly among the more skilled, for whom permanent migration is possible. The option of exit appears to have become so prominent on the horizons of the country's "best and brightest" that one begins to wonder if it is affecting the national psyche, and perhaps in the process diminishing the urgency with which the political leadership tackles the country's pressing development challenges.

Poverty and Inequality

Balisacan's analysis of poverty and inequality (Chapter 10) is central to an understanding of the Philippine development record, both in the aggregate, and at the micro level in explaining variations among households and regions and over time.

The principal macro conclusion—obvious but often poorly understood—is that levels of poverty are highly growth-sensitive; that is, since distribution does not change significantly in the short to medium term, changes in the level of household income, which are affected by aggregate levels of economic activity, are the major proximate determinant of the incidence of poverty. Balisacan's analysis demonstrates this very clearly. The incidence of poverty fell sharply by about one-third (from 41% to 25%) from 1985 to 1997, that is, from the depth of the recession to the peak of the boom, although it rose perceptibly in 2000 due to the lingering effects of the Asian financial crisis and the drought-inducing El Niño phenomenon.[16] Moreover, Balisacan shows that poverty declined fastest during the subperiods of higher growth, 1985–88 and 1994–97. This conclusion requires some qualification, depending as it does on which poverty line is chosen and whether one focuses on the level of poverty or, in addition, on its depth and severity. But overall the principal conclusion is the primacy of growth as the key determinant of poverty reduction.

The poverty picture varies significantly among sectors, regions, and households. Poverty is higher in rural areas and among agricultural workers. About three-quarters of the poor are in agriculture (a similar ratio to that in the 1960s), and so agricultural growth is especially beneficial for the poor. Among regions, Luzon is generally better off, and Metro Manila always records the lowest poverty incidence. Consistently poor regions include Eastern Visayas (about 14 times the incidence of Manila) and Bicol. There has been a good deal of regional re-ranking since the mid-1980s, with some regions, such as Western and Central Mindanao, becoming relatively poorer, while others have progressed faster.

Balisacan then shifts attention to the key variables influencing provincial and household welfare. At the household level, he finds less poverty in male-headed households, with household size exerting a negative influence on welfare. Location is significant, but sector of employment is a minor factor. At the provincial level, he finds that changes in poverty over time depend not only on the rate but also on the type of local economic growth. Put differently, the poor will benefit even more from growth if institutions and policies are reformed to favor them, or are at least made more neutral. His model also shows that, apart from provincial economic growth, other factors exert a direct impact on the welfare of the poor: it highlights the importance of education, infrastructure, price policy regime, agrarian reform, governance, and certain geographic attributes. Schooling, if accompanied by complementary public investments, raises the welfare of the poor, apart from its indirect effect through economic growth. So do the implementation of agrarian reform, investment in land quality improvement, and the removal of price distortions that diminish the profitability of agriculture relative to non-agriculture. Political dynasties do not appear to benefit the poor, because they constrain local economic growth and because they restrict the access of the poor to basic services. High transport costs lead to geographic "poverty traps," as the poor are impeded from taking advantage of economic opportunities elsewhere.

Reverting to the national picture, the distribution of wealth is more unequal in the Philippines than in most of its neighbors. At the outset of independence, the distribution of land ownership from the Spanish colonial period was highly unequal. This inherited legacy seems to have been perpetuated in the modern commercial–industrial sector and, arguably, political structures. There have been no major ameliorating factors, in the form either of agrarian reform (as in Taiwan) or of a national leadership beholden to an initially poor and rural constituency (as in Malaysia). The question then becomes whether growth is a sufficient prerequisite for sustained poverty reduction. (It is clearly a necessary one.) And if distributional policies are pursued, which ones will also simultaneously achieve growth objectives? It is not obvious that agrarian reform has achieved much in aggregate, or that it ever will, although of course individual recipients have benefited. This analysis certainly points to the primacy of national governments focusing on the provision of good-quality, equity-oriented public goods such as primary and secondary education, basic health services, and rural infrastructure. It also highlights the importance of continued domestic and international liberalization, to ensure that the privileged commercial position of the highly concentrated family conglomerates (the so-called "oligarchs") is subjected to greater competitive pressure. As noted above, how and how much this concentrated agrarian and commercial power translates into political power is one of the most intriguing issues in Philippine political economy.

Regional Development

Regional development issues are important in the Philippines. It is the world's second largest archipelagic nation and thus features considerable spatial diversity. Beginning in 1991, a significant decentralization program was initiated to transfer administrative and fiscal functions to the regions. One decade on, an interim assessment of this reform is possible.

In Chapter 11, Manasan and Chatterjee start by tracing the history of regional development policies, taking as a point of departure an earlier major study (Pernia et al. 1983). They draw attention to the challenge of delineating "regions," pointing out that, inevitably, the official definition of regions (of which there were originally 12, now increased to 15) does not necessarily correspond to natural economic zones.

There are significant variations across regions, and social and economic indicators are usually highly correlated. Manila in particular stands out, with a per capita income that is always about twice the national average, and superior social indicators (except for environmental amenities). There have been some re-rankings of regions, as Balisacan also pointed out. For example, relative to the national figure, Southern Tagalog has (surprisingly) been declining, while Central Visayas and West and North Mindanao have been gaining.

Employing convergence methodology, Manasan and Chatterjee find that there has been "alpha" convergence (that is, a decline in overall regional inequality) and also (most of the time) "beta" convergence (that is, the poorer regions catching up to the richer ones). Thus the record is moderately encouraging given past patterns of deeply entrenched inequality, and compares favorably in the East Asian context, where increasing spatial dispersion has been common (as, for example, in China or Thailand). The authors then decompose these economic outcomes into what they term "net differential shift" and "net proportional shift." They are able to show that, in the 1990s, the faster growth of industry and services tended to increase regional inequality because these sectors were unevenly spatially concentrated. (Something similar happened in China and Thailand, too.) By contrast, agricultural growth was faster before 1986, as David showed, and this tended to be spatially equalizing. There is a particularly strong correlation between beta convergence and agricultural growth.

The authors draw attention to the key role of physical infrastructure in shaping regional outcomes. There has been some reallocation of infrastructure expenditure away from the three central regions, though much of it has also been a reallocation from Southern Tagalog and Central Luzon to Manila. In addition, the Mindanao regions have received substantial additional funds.

Turning to the experience with decentralization, the authors observe a gradual freeing up of the system. Alternative growth centers have emerged, although Manila remains pre-eminent. As would be expected in a country with 79 provinces, 84 cities, and 42,000 *barangays* (barrios), the outcomes present a complex picture. In principle, since 1991 the division of funding and functions has been carefully defined, with special additional provisions covering the Autonomous Region of Muslim Mindanao (ARMM), set up in 1989. In practice, of course, the central government agencies remain very powerful. Moreover, local government units (LGUs) still account for only 3.4% of GDP (up from 1.7% in 1985–91). And much of this is concentrated in the major cities of the four largest regional economies (that is, the three central regions plus Central Visayas).

As in all spatially dispersed countries, there are vertical and horizontal fiscal imbalances. With regard to the former, the funding for LGUs is often not commensurate with their expenditure responsibilities. The pattern is uneven, with some LGUs receiving more than they can realistically absorb, and others less. Inevitably, too, there are disparities in revenue-raising capacities, with the "big four" collecting 72% of all local taxes in 1999. Horizontal imbalances also present a challenge. There is some, though rather limited, equalization across regions. In consequence, Manasan and Chatterjee show that total per capita LGU revenue (including both local and central sources) is positively correlated with the per capita income of LGUs.

In any discussion of regions, Mindanao and especially the ARMM must figure prominently. The central government continues to be fiscally generous to this region but, notwithstanding the best of intentions, a culture of dependency has emerged. The local tax effort is poor and the region has little incentive to develop its own revenue base.

Environment and Natural Resources

The state of the environment and natural resource management present serious challenges in the Philippines. This is a general East Asian problem. But at least in the high-growth economies there has been some material compensation for the environmental degradation, and some prospect of improvement through a "Kuznets environmental curve" at work as incomes exceed some threshold level.

Coxhead and Jayasuriya provide a comprehensive stocktake of the challenges and policy issues (Chapter 12). Beginning with forests and uplands, they point to rapid deforestation occurring at one of the fastest rates in East Asia, with the result that forest cover declined from about 70% to less than 20% during the 20th century. This has resulted from commercial exploitation and land clearing for cultivation, propelled in part by inexorable growth in the uplands population, which doubled to 18 million persons between 1960 and 1987. The familiar results have included loss of livelihoods and soil depletion.

In the agricultural croplands the quality of irrigation services has diminished, and around 74–81 million tons of soil is lost annually. There has been a rapid and dangerous increase in the (often uncontrolled) use of fertilizer and pesticides. Since the country has effectively hit the agricultural frontiers, and must therefore shift toward a strategy of agricultural intensification, the slow growth in agricultural productivity gives cause for concern.

With its 7,107 islands, very long coastline, and extensive coastal waters, the Philippines has much potential for environmentally sound marine activities. However, Coxhead and Jayasuriya show that these resources have been degraded and are subject to huge pressures. Fish stocks have been depleted, mangroves and coral destroyed, waterways polluted. Some 95% of reefs have suffered some destruction. Freshwater resources are even more heavily polluted, with the large Laguna Bay adjacent to Manila being among the worst cases.

Urban environmental systems are also under stress, owing to rapidly accumulating industrial and consumer effluents. Air pollution in Metro Manila is obviously very serious, at levels frequently above those recommended by the World Health Organization (WHO). The use of fuel oils is a major source of the problem, particularly given the shift from hydropower to oil as a source of electricity since the 1970s. There are also very serious waste disposal problems in urban areas.

There has as yet been little serious analytical work in the Philippines on the costs of this heavy environmental damage. Some countries have developed a system of "green accounting" that attempts to factor environmental degradation and depletion of non-renewable natural resources explicitly into the national accounts. For the Philippines, this has yet to be undertaken in a comprehensive manner. But these estimates, combined with loss of livelihood in rural and coastal regions and urban disamenity costs from high levels of pollution, would undoubtedly be very high.

There are many explanations for this state of affairs. Economic scale—principally high population growth—is arguably the major factor. Weak enforcement of property rights and corruption in the allocation and management of access to natural resources are additional factors. (The Department of Environment and Natural Resources is the subject of frequent public criticism.) There is no evidence that decentralization has made much difference, although in principle it might have been expected to help. Urbanization and the shift toward more pollution-intensive activities are additional factors.

Coxhead and Jayasuriya place particular emphasis on the interaction between the trade regime and the state of the environment. The past bias against agriculture and in favor of capital-intensive industrialization has resulted in limited employment generation, and pushed workers into environmentally destructive activities such as upland agriculture. (Increased protection for corn, grown mainly in upland areas, has had a similar effect.)

But the situation is not without hope. Manufacturing protection has fallen sharply, resulting in a more labor-intensive growth path and cleaner industry (particularly electronics). There is growing official and community awareness of the gravity of the problems. Several non-government organizations (NGOs) are active in identifying and combating environmental problems. There has been a shift away from the use of leaded petroleum, and some attempts to impose environmental use fees for heavily polluted waterways such as Laguna.

1.4 BACK TO THE PUZZLES

We now return to the puzzles, of which three in particular deserve attention. What explains the Philippines' indifferent long-term growth record? Why did it not receive a larger reform dividend from the significant policy initiatives that got under way in the late 1980s? And why was it able to come through the recent Asian economic crisis relatively unscathed? The answers to these questions are complex, interrelated, and not easily amenable to quantitative analysis. No simple or single theory suffices. We need to develop a coherent story relating outcomes to an array of external and internal factors—some narrowly economic, others broader and embedded in political, historical, and institutional factors.

Surviving the Crisis

Of the three questions, the second and third are arguably more straightforward. As is evident from the analysis above, the Philippines suffered only a mild recession in 1997–98, for two main reasons.[17] First, it did not receive the exceptionally large, private short-term capital flows that went into neighboring high-growth economies (see Gochoco-Bautista and Canlas, Chapter 3). The country was effectively excluded from international capital markets until 1992, except for inflows associated with the debt workouts. Even when the capital account was opened, foreign investors who had lost out in the 1980s approached the country with caution. By the mid-1990s these flows began to increase rapidly, and for a period portfolio investment exceeded foreign direct investment. Also beginning to emerge was the problem common to the crisis economies, of governments attempting to peg to the U.S. dollar, alongside which domestic currency interest rates exceeded those in international markets. With little perceived exchange rate risk, few foreign borrowers took out hedging. Had this continued for several more years, the Philippines may have encountered the same problems as other Asian countries. However, the boom was so short-lived—effectively three to four years—that the magnitudes were quite modest. Thus no (or limited) boom meant no bust.

Second, the Philippine financial sector was in better shape than was the case in neighboring countries. As Abrenica and Llanto show (Chapter 8), the banks were comparatively prudent and cautious, and the central bank's regulatory/supervisory framework had been strengthened since the early 1990s. The level of non-performing loans was modest, and there was not as sharp an appreciation in urban asset prices in the mid-1990s. Neither had there been such reckless banking expansion prior to the crisis. Most of the major banks were well established and had conservative portfolios. Several foreign banks had recently entered the country. The strength of banks is indicated by the fact that they were able to endure a sharp depreciation of the peso in the second half of 1997, a factor that was central to the financial crisis in neighboring countries. Here also, one would not want to overstate the case. If the boom had been of longer duration, the banks would no doubt have been tempted to borrow from abroad on a much larger scale.

There were other contributing factors. The Philippines recorded the strongest export growth of any crisis or near-crisis East Asian economy during 1998. Undoubtedly, the combination of a sharp peso depreciation and an intact banking system contributed to this result. The country was also riding the crest of a wave with its electronics exports, as investments from the mid-1990s onward came on stream. With the United States absorbing a higher percentage of exports from the Philippines than from any other East Asian economy, the connection to the then booming American economy provided a further fillip to export growth.

A Larger Reform Dividend?

It is sometimes argued that the Philippines should have received a larger growth dividend from the reforms that began in the late 1980s. After all, the argument goes, these reforms were significant. Moreover, the Philippines meets practically all the non-economic conditions set out in the so-called Washington consensus, with its very open press, vibrant "civil society," and democratic processes.

It is difficult to answer this question in a rigorous quantitative fashion, and so instead we adopt an inferential approach. It should be noted immediately that there was actually a sizable dividend. As noted, Balisacan (Chapter 10) found that the incidence of poverty declined from 41% in 1985 to 27% in 2000. But the economy struggled to grow faster than 6%, even at the peak of the 1990s boom.

Three factors ~~appear to be particularly~~ relevant. ~~First,~~ the reforms were inevitably partial. As we have seen, inflation was ~~still relatively high by~~ East Asian ~~standards.~~ Trade reform progressed, but there remained a large unfinished agenda. Government spending on infrastructure and social goods was politicized, and priorities suboptimal.

A second explanation is that there was not a prolonged boom. In the high-growth neighbors, growth typically accelerated as reforms attracted additional resources, thus contributing to the so-called "virtuous circle of growth." It takes time for investors, especially foreign firms (and the sometimes vulnerable local ethnic Chinese business community), to feel confident that the policy settings are durable. The Philippine boom was short-lived by these standards, essentially lasting just four years before the Asian crisis hit in mid-1997.

Finally, significant impediments to growth remained. As noted, savings never got much above 15% of GDP. Since the country could not safely run a current account deficit of more than 5% of GDP, investment could not exceed 20% of GDP for any sustained period, whereas in nearby countries it exceeded 30% for two decades or more. Unless the Philippine incremental capital–output ratio was exceptionally low—which historically it has not been—6% growth in GDP was about the upper limit. There were in addition serious supply-side constraints to growth as a result of the 1980s fiscal crisis. Notable among these were the rundown state of physical infrastructure and a public education system starved of resources.

Slower Long-term Growth

Perhaps the central question facing scholars of Philippine economic development is why long-term growth has lagged. Various schools of thought approach the question from different perspectives, and hence provide different answers. Economists focus on conventional policy weaknesses, for example in trade and macroeconomic policy. Political scientists highlight flaws in the structure of government, both during and after the Marcos period. Sociologists draw attention to the power of vested interests, rooted in the highly inequitable colonial past. Others simply point to extraordinary misfortune. These various hypotheses are not necessarily mutually exclusive, of course, and in this subsection we attempt to briefly integrate and assess the arguments.

"Conventional" Growth Explanations

There is a large literature that attempts to explain international variations in long-term rates of economic growth—or growth in total factor productivity (TFP)—with reference to a range of policy and country endowment factors (see, for example, ADB 1997: Ch. 2). A large set of variables is included, but the core typically consists of proxies that measure macroeconomic outcomes, trade policy, human capital, institutional quality, natural resource endowments, proximity to large economies, and initial levels of per capita income (to capture the "catch-up" phenomenon). Many other variables could be added to this list.

We are unaware of any systematic testing of such a relationship against Philippine data. A framework of this type might go some way toward explaining the country's inferior performance. For example, the Philippines has been somewhat more inward looking than most of the high-growth economies, and its macroeconomic outcomes have not been as good. But such a methodology is unlikely to explain all or even a major part of the divergence. The Philippine macroeconomic record (for example, its inflation rate) has not matched that of Singapore, Malaysia, and Thailand, but it has been broadly similar to that of Korea and Indonesia for much of the period since 1970. Similarly, its trade regime has not been as open as that of Singapore, Hong Kong, and Malaysia, but did not differ significantly from that of Indonesia and even Thailand over this period. Its stock of human capital has been better than in almost all of the lower-income East Asian economies, while institutional quality has not been markedly inferior. Other variables, such as proximity to major economies, length of coastline, the incidence of political disturbances, and ethno-linguistic fragmentation, are either irrelevant or would make little difference.

Moreover, the growth determinants framework is particularly useful in explaining long-term growth differentials, and is therefore less relevant in coming to grips with the episodic nature of Philippine growth—which until about 1980 was slower than, but not markedly inferior to, that of most of its neighbors. It was the "lost decade" of the 1980s which really separated the Philippines from East Asia.

Thus, we get some way in explaining the country's slower growth using this methodology. Just how much, precisely, is a separate study in itself, and beyond the scope of this book. But we can assert with confidence that a considerable part of the story remains unexplained.

Bad Luck

One might argue that, at critical junctures in Philippine history, there has been an awful lot of bad luck, or at least unfortunate timing. For example, from the mid-1970s the Marcos administration embarked on a strategy of aggressive overseas borrowing. This was partly to boost its own fortunes, but it needs to be remembered that the international financial institutions were concerned about the rapid build-up of petrodollars in the wake of successive oil shocks, and were concerned that they be recycled. Thus, for very different reasons, the objectives of the international financial institutions and President Marcos coincided. However, shortly after the borrowing commenced, the country experienced a large negative shock in the terms of trade. Sugar prices declined sharply in 1974–75 and coconut prices in 1979–80, while oil prices rose again in 1978–79. Then, in the early 1980s, with the country carrying a much increased external debt, world interest rates rose substantially.

A second instance is that, from 1984, the country experienced a prolonged political and financial crisis, and this occurred just as the massive East Asian restructuring got under way. The resultant regional boom in trade and investment almost completely bypassed the Philippines. Moreover, from the late 1980s the commercial environment was soured by a series of adverse events: several coup attempts, the terrible volcanic eruption of Mt Pinatubo in 1991, chronic and severe power shortages, and the removal of the U.S. bases. Each of these was large enough to trigger one-off decreases in GDP growth of several percentage points.

A third example occurred in the late 1990s when, just as the economy appeared set for a period of sustained progress, the Asian economic crisis and a severe El Niño-induced drought nipped growth in the bud.

Finally, owing to protracted instability, the Philippines has never been able to exploit the opportunities presented by its frontier region, Mindanao. This has not only resulted in reduced agricultural growth but also tarnished the international reputation of the country.

The question is how important these factors were, and how much of the misfortune was really endogenous? Other countries have survived sharp declines in their terms of trade, most notably Thailand in the 1970s and Indonesia in the mid-1980s. For well-managed, prudent economies, such shocks constitute a temporary setback, not a crisis. Much of the problem in the Philippines was not the borrowing strategy per se, but the uneconomic projects for which the funds were used. Similarly, natural disasters are quite common in the region. Taiwan, for example, has had many similar experiences. Finally, while recognizing the deep historical complexities, one could plausibly argue that Mindanao was essentially a home-grown problem. Other countries have been able to manage serious regional insurrections. Thailand and Malaysia immediately come to mind.

Thus, it is difficult to sustain the case that these instances of bad luck and misfortune are the key explanators. They have certainly been very costly, and have often occurred at inopportune moments. But by themselves they cannot explain chronic underperformance.

Institutional and Political Barriers to Good Policy

It is sometimes argued that good economic policy-making in the Philippines has been frustrated by particular social structures or political institutions. There are several strands to the argument, not all of them consistent. It might be tempting simply to assign the ills of the country to the 20-year Marcos rule. Obviously personalities do matter, but can one advance the argument in a somewhat more analytical manner?

One strand of the argument asserts that highly unequal social structures—the "oligarchs"—have infected the political process to the point where serious policy reform, especially if it challenges this group's vested interests, is impossible. While it is true that the distribution of wealth in the Philippines is more unequal than in its neighbors, it does not necessarily follow that growth has to be slower. The record of the Ramos administration in fact constitutes a partial counter to this hypothesis—there were quite significant reforms in trade policy, telecommunications, and inter-island shipping. One might quibble about the scope and pace of these reforms, but they do at least suggest that the sociopolitical system is not so ossified as to be incapable of reform.

As an aside, a popular view posits that the "Latin America" model can be employed to explain the poor Philippine record. There are some obvious similarities, especially in the colonial legacy of deep agrarian inequality. However, the parallels should not be overstated. The Philippines has never experienced Latin American-style hyperinflation (except very briefly in the mid-1980s). The plantation sector was never quite as dominant. The labor market has generally been more flexible. And, until very recently, there have been consistently positive "neighborhood effects" flowing from the proximity of the Philippines to high-growth economies. Thus the Latin America caricature, while helpful, is not a central element of the explanation.

In the post-Marcos period, it is argued that a different type of political obstacle has emerged. This is the assertion noted above that the political system is no longer able to provide longer-term economic policy predictability. Owing to the country's U.S.-style strong legislature and weak bureaucracy, and its highly personalistic politics, regime changes every six years introduce much commercial uncertainty. Each new administration results in significant turnover at the upper echelons of the bureaucracy, percolating down even to the middle levels. It therefore becomes very difficult to establish "insulated" technocratic policy-making capacities. In consequence, investors do not think much beyond a six-year time horizon, and few probably think even this far ahead.

Summing Up

As is usually the case in the search for explanations of complex phenomena, we are left with elements of a case but no grand and all-encompassing answer. All of the above factors are relevant and constitute part of the story. The Philippines failed to grow as quickly as several of its neighbors in the 1960s and 1970s for the reasons adumbrated above. In the second decade of the Marcos administration, the development strategy changed to one of adventurous overseas borrowing. This came unstuck owing to a combination of reckless investments, ever-increasing cronyism and corruption, rising community disaffection (especially in the wake of the 1983 Aquino assassination), and external misfortune. The culmination was a serious political impasse and a deep and prolonged economic crisis that set the country back more than a decade, and from which recovery has been slow and painful.

1.5 CONCLUSION

What would a balance sheet of achievements in the post-Marcos era look like? Recognizing that this is a complex and controversial issue, and at the risk of oversimplification, it might be useful to classify the record into three broad areas: significant accomplishments, a just-adequate record, and major remaining challenges.

The following areas would appear to belong to the first category, of significant accomplishments.

- *The monetary/exchange rate policy framework.* This has resulted in lower inflation, and clearer official objectives and assignment of instruments.
- *Trade reform.* Although areas of concern remain, the country now has much lower and "cleaner" levels of protection.
- *The financial sector.* Banks weathered the Asian crisis fairly successfully, and the supervisory framework is much improved.
- *Export-oriented manufacturing.* Reduced protection, liberalized foreign investment rules, and the system of export-processing zones resulted in strong export growth for most of the 1990s, albeit heavily centered around electronics.
- *Civil society.* The Philippines has one of the region's most active and open presses, together with some good quality thinktanks and NGOs. Whatever may be said of its democratic system, elections are generally orderly and open.

Among areas that are adequate, some only just, the following stand out.

- *The fiscal policy framework.* This is now better managed than in the 1980s, but except in very good years there are chronic though just managable deficits.
- *Decentralization.* This process has proceeded quite smoothly since its start in 1991, while not having a discernible impact on development outcomes at the national level.
- *Social progress.* This has been modest. Although the level of poverty has fallen, it is still high. Educational and health indicators continue to improve slowly.
- *Property rights and the investment climate.* Although there has been progress since the 1980s, the Philippines is still regarded as a relatively risky investment destination, in both a commercial and political sense.
- *Legal and judicial reform.* Elements of the legal system are sophisticated, but the courts cannot be relied upon to protect investors in an impartial manner.

Finally, among the major challenges remaining, the following would appear to be important.

- *Physical infrastructure.* Infrastructure such as roads (especially in rural areas), power, telecommunications, and ports has fallen behind that in neighboring countries. Major issues to do with supply, pricing, and regulation still need to be addressed.
- *Managing highly politicized regime changes.* The country has had four presidents since Marcos. All changeovers occurred without major violence, and two proceeded unambiguously according to the constitution. However, changes at the top lead to major turnover among the senior echelons of the bureaucracy and introduce the possibility of significant policy uncertainty.
- *Demographics.* Although falling slowly, both the population growth rate and the fertility rate are significantly higher in the Philippines than in most neighboring countries.
- *Corporate governance and the stock market.* The stock market is unable to play a role as an efficient instrument of financial intermediation owing to periodic scandals and the perception that the interests of minority shareholders are weakly protected.
- *Environment and the management of natural resources.* The Philippines continues to suffer major environmental degradation and loss of natural resources.
- *Mindanao.* Chronic problems of insecurity and disaffection create a serious problem both in the region itself and for the country's international reputation.

In the early 21st century, looking backward as well as forward, it would be tempting to conclude that the Philippines is at a crossroads, were it not for the fact that such a characterization has a sense of *déjà vu*. The past twenty years have seen very little achieved, but the past decade has demonstrated that the Philippines is not inherently a "non-developmental" state, as some have suggested. Extrapolating from the past to the future, it might be difficult to be optimistic about the country's development prospects. There have been episodes of growth, but they were short-lived and the growth has rarely matched the levels observed elsewhere in East Asia.

The key question is whether the political system can deliver the sort of substantial reforms achieved in the 1990s, in a durable and sustained fashion. The Aquino and Ramos administrations demonstrated that sound economic policy does deliver results, and seemed to suggest a decisive break with the past. But by 2000 it appeared again as though these achievements may have constituted a temporary aberration, as some of the reform progress was undone by a combination of external circumstances and domestic incompetence.

An optimistic scenario would envisage the Macapagal-Arroyo administration returning to something like the good economic management of the Ramos period, which featured sensible, pragmatic reform, and a reasonably secure and predictable policy and investment environment. With her academic and bureaucratic background, President Macapagal-Arroyo obviously understands the importance of sound economic management. She also has the prospect of a nine-year presidency

to pursue a coherent economic strategy. Whether this expertise translates into a decade of solid economic development remains to be seen. A decade of 5–6% economic growth would do much to overcome the country's deeply entrenched problems of poverty and social deprivation, and it would consolidate a pro-reform constituency. Conversely, a return to populist and corrupt politics *à la* Estrada would undo the gains of the 1990s and consign the Philippines to a dismal future.

NOTES

1. There is a considerable literature on Philippine economic development in the 1970s, with the most comprehensive being ILO (1974). This was the so-called Ranis Report, named after the report's mission chief, Professor Gustav Ranis of Yale University. (This was also the most acclaimed of the ILO's major country reports of the 1970s.) If the present study has a benchmark against which to look back over the past three decades, this report would be it.

2. This observation is not without controversy. Many seasoned observers believe that the national accounts figures are understated, mainly because new, faster-growing sectors (such as electronics and some services) are probably undercounted and underweighted. The fact that most social indicators are now better than they were in the 1980s lends support to this view. Conversely, it needs to be remembered that there is now probably slightly greater monetization of economic activities, and that allowance needs to be made for the upward bias caused by the consequent overstatement in measured growth rates.

3. Since there was very little growth in aggregate over this 20-year period, it follows that the usual growth-accounting techniques are not particularly relevant. The Philippines has thus been spared the East Asian "inspiration versus perspiration" debate. Not surprisingly, several studies have found TFP growth to be either negligible or negative (see, for example, Austria 1998 and Cororaton et al. 1995). In fact, even during the earlier period of modest growth, very little TFP growth was detected by Hooley (1985), at least for manufacturing.

4. The Philippines has had five presidents since 1970, and one cannot help but observe in passing that, perhaps understandably, members of each administration are inclined toward a somewhat partial assessment of the period in which they were in government. This is becoming a matter of no small consequence since, given the high turnover at senior echelons between (and sometimes within) administrations, practically all of the country's leading economists have served in government at some stage.

5. This episode is already well told by others. See, for example, Remolona, Mangahas and Pante (1986) and Dohner and Intal (1989).

6. The latter is illustrated by the fact that the administration suffered periodic scandals and, to get its reforms through, had to rely on extensive "pork barrel" discretionary funds to legislators totaling nearly $1 billion by 1996.

7. To give just one example from the Estrada administration, PEZA has generally been regarded as well managed, whereas the regulatory authorities have appeared unable to clean up the periodic crises on the Philippine stock exchange.

8. Perhaps this is what long-time Singapore leader Lee Kuan Yew had in mind with his controversial remarks in the early 1990s to the effect that the Philippines needed "discipline" more than it needed "democracy."

9. See, for example, Power and Sicat (1971), Bautista, Power, and Associates (1979), and Medalla et al. (1995/96).

10. In passing, it might be noted that modesty has evidently prevented the authors from mentioning their own significant contribution to this process.

11. More generally, agricultural growth appears to be more rapid, other things being equal, in countries with a "unimodal" structure of ownership than in those with "bimodal," dualistic land distribution structures. Here too the Philippines–Thailand comparison is relevant.

12. The issue was complicated by the close relationship between former President Estrada and the major owner of the national flag carrier, Philippine Airlines. Especially damaging was a protracted civil aviation dispute in 2000 with Taiwan, one of the country's major trading partners and sources of investment.

13. Controls on expatriate employment are puzzling, since the Philippines has depended on open markets abroad for its large-scale labor exports. Moreover, they are probably redundant. In the niches where Philippine workers would not be competitive with foreign labor, it would make sense to allow foreign workers in to facilitate emulation, and thus the rapid diffusion of new technologies.

14. In addition to the chapter by Herrin and Pernia, see ADB/WB (1999) and HDN/UNDP (2000) for recent detailed analyses of social policy issues in the Philippines.

15. For an analysis of these patterns in East Asia, see Athukorala and Manning (1999).

16. One frustration with Philippine household income and expenditure statistics, and hence poverty analysis, is that it is difficult to compare the data for the Marcos and post-Marcos (that is, post-1986) periods.

17. See in addition World Bank (1998a, 2000b), Sicat (1999), and Noland (2000).