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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/62

3:00 p.m., April 30, 1982

FILE

J. de Larosière, Chairman  
W. B. Dale, Deputy Managing Director

Executive Directors

Alternate Executive Directors

B. Kharmawan

G. Laske

J. J. Polak  
A. R. G. Prowse  
J. Sigurdsson  
Zhang Z.

H. Alaoui-Abdallaoui, Temporary  
C. Taylor  
J. L. Feito, Temporary  
O. Üçer, Temporary  
P. D. Peroz, Temporary  
T. A. Connors, Temporary  
S. R. Abiad, Temporary  
T. Yamashita  
R. T. Salazar  
M. Casey  
J. R. Gabriel-Peña  
V. Supinit  
F. Sangare

C. P. Caranicas  
M. K. Diallo, Temporary  
A. S. Jayawardena  
S. El-Khoury  
T. de Vries  
B. Legarda

L. Van Houtven, Secretary  
R. S. Laurent, Assistant

Also Present

Asian Department: P. R. Narvekar, Deputy Director; H. Neiss, Deputy Director; A. Abadjis, K. A. Al-Eyd, J. P. Healy, G. R. Kincaid, M. R. P. Salgado, I. Zaidi. Exchange and Trade Relations Department: H. W. Gerhard, M. Guitian, J. P. Lipsky. Fiscal Affairs Department: O. Pettersen. IMF Institute: M. B. Suleik, Participant. Legal Department: Ph. Lachman, J. K. Oh. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: G. Jauregui, Wang E., F. Yeo T. Y. Assistants to Executive Directors: A. Halevi, P. Kohnert, M. Michelangeli, W. Moerke, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, J. G. Pedersen, C. N. Pinfield, J. Reddy, D. I. S. Shaw, J. C. Williams, J. F. Williams, A. Yasserli.

1. PHILIPPINES - 1982 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/82/61, 4/30/82) their consideration of the staff report for the 1982 Article IV consultation with the Philippines (SM/82/55, 3/24/82; and Sup. 1, 4/28/82). They also had before them a report on recent economic developments in the Philippines (SM/82/66, 4/9/82).

Mr. Kharmawan noted that it was the predominant task of governments in developing countries to help their economies to evolve to ever higher levels of development while, at the same time, trying to maintain internal and external equilibrium. As the Fund was a financial institution it tended, for understandable reasons, to look upon the situation in developing countries from a financial standpoint. The Fund dwelt on the price performance, the balance of payments performance, the instruments that were being used relating to the budget, credits, interest rates, and exchange rates; but it should not be forgotten that the foremost objective of every developing country was to achieve economic growth. In analyzing the situation in a developing country, the Fund should consider both the real side and the financial side. Mr. Legarda had correctly said that the Philippines had achieved uninterrupted positive growth rates in the years following World War II, an outstanding record compared with that of many other developing countries.

At independence, the structure of the Philippine economy had been predominantly agricultural, Mr. Kharmawan observed, and diversification had been essential if the country was to avoid becoming the victim of the fluctuations associated with the demand for, and prices of, agricultural products. The authorities had tackled the agricultural problem in an energetic and sometimes innovative manner. In 1970, the share of agriculture in GDP had been 28 per cent; it had declined to 23 per cent by 1982. At the same time, the Philippines had joined Thailand and Burma as one of the few rice exporters in Asia. Furthermore, the share of manufactures in GDP had grown from 22 per cent in 1970 to 26 per cent by 1980. In terms of GDP, the manufacturing sector in the Philippines had become larger than the agricultural sector, a development that provided still more proof that the diversification efforts of the authorities had yielded substantial results. Unfortunately, owing to the worldwide recession, exports of Philippine manufactures had been subjected to protectionism in a number of developed countries.

As a net importer of petroleum, the Philippines had suffered from the increases in the price of oil during the 1970s, Mr. Kharmawan recalled. The authorities had tackled the problem in an energetic manner by seeking to increase conservation, by looking for new sources of energy, and by searching for petroleum deposits in their own territory. All in all, their continuing efforts to improve the structure of the economy had maintained the rate of real growth at about 5-6 per cent a year.

Ideally, any growth in production and supply in an economy in real terms should be accompanied by equilibrium in the financial sector and by internal and external stability, Mr. Kharmawan noted. The most recent stand-by arrangement concluded by the Philippines with the Fund had been for SDR 410 million. The drawing of the whole of that amount indicated that the country had fulfilled all the performance criteria agreed with the Fund. For quite understandable reasons, its economic performance in 1981 had been worse than that of 1980, a development attributable chiefly to the worsening of markets abroad. The appendix to Mr. Legarda's statement demonstrated a sharp drop in the prices of primary products during the previous year. The financial performance must also have been influenced by the less favorable environment for growth in the Philippines, together with high interest rates and high inflation abroad. Nevertheless, the authorities deserved credit for doing their best to meet the requirements of the stand-by arrangement on which they had agreed with the Fund.

The two areas of weakness in the economy were the balance of payments and the budget, Mr. Kharmawan stated. In 1981, the balance of payments had worsened in the light of the world recession and certain domestic events, such as the failure of one business enterprise. Moreover, the budget deficit had turned out to be larger than expected, perhaps because of the continuing concern of the authorities to ensure high rates of economic growth. When the external sector of the economy had shown signs of weakness, concern about economic growth had led the authorities to resort to countercyclical measures, which had naturally resulted in higher budget expenditures. The extent to which the authorities should attempt to remedy such a situation was of course open to question, but there was a logical and legitimate link between the external sector and the internal sector. Thus, the so-called budget deficit and the weakness of the balance of payments should be viewed against the background of the same events.

Obviously, there had to be limits on expenditure in order not to create too much disequilibrium between the performance of the real sector and the performance of the financial sector, Mr. Kharmawan remarked. The need for limits had been recognized by Mr. Legarda when he had said that "growth remains the main objective of the Philippines' economic policy," and had gone on to say that the expected recovery in the world economy should lessen the need for counterrecessionary measures by the Government; adjustments would take the form of a gradual cutback in the budget deficit, a reduction in the current account deficit, and a fall in the inflation rate. The authorities had succeeded in controlling inflation, even though the weakening of the economy could have been expected to heighten inflationary pressures. When would the adjustment take place? Mr. Legarda had said that it was regarded as a medium-term effort and would require a balancing of elements to make up a coherent and consistent program. It was encouraging that the authorities recognized the need for adjustment.

If an economy was growing, observers might tend to conclude that the country needed fewer resources for financing economic growth, Mr. Kharmawan said. However, the experience both of the World Bank and of developing countries indicated that the contrary was true. As an economy grew and as the momentum of growth took shape, a country's requirement for resources would also increase. The Government could attempt to increase the domestic resources available for development by increasing public and private savings; however, as long as the economy remained less developed, it needed resources from abroad. The steady modest economic growth that the Philippines had experienced over the years implied that the economy steadily required larger amounts of resources. Naturally, the authorities would not wish to allow a disequilibrium to arise between economic growth and financial development; and they should be allowed to choose the path of adjustment that they considered best. In SM/82/55, Supplement 1, he had noted a narrowing of the differences between the views of the staff and those of the authorities with regard to a number of variables. There was therefore no obstacle to the establishment of further sound policies which should restore the balance between steady economic growth and financial stability.

Loans from abroad were necessary in order to keep up the momentum of economic growth, Mr. Kharmawan considered. Although a debt service ratio of over 20 per cent might appear frightening, the authorities had never failed to meet their obligations. However, their definition of the debt ratio included both public and private debts; by the World Bank definition, the debt ratio was normally restricted to public debt. Thus, the burden of the Government was in fact far less than was indicated in the figures. The Philippine economy had some of the same problems as other developing countries. With the willingness of the authorities to adopt new policies relating to structural adjustment and the liberalization of imports, the exchange rate, and interest rates, he was confident that in due course they would take appropriate measures, with the assistance of the Fund.

Mr. Polak remarked that the Philippines was maintaining a reasonable measure of success in an extremely difficult economic environment. Real growth was not as high as it had been previously, but even in 1981 it had attained 3.8 per cent, close to the Government's revised estimate and not nearly as low as the unduly gloomy staff estimate of 2.5 per cent. Inflation rates had come down from about 18 per cent in 1979 and 1980 to 12 per cent in 1981 and a forecast 11 per cent in 1982. The monetary targets were being observed, and the authorities were in the midst of a liberalization process with respect to both imports and interest rates.

Against those favorable features, budget performance had been disappointing: the shortfalls in revenue had been primarily due to cyclical factors, but the main cause of the increased deficits had been government investment expenditure undertaken to offset the decline in private investment, Mr. Polak went on. As Mr. Legarda had clearly pointed out, the purpose of that expenditure was to maintain demand. There was little ground for the fear expressed by the staff that the

expenditure would crowd out private investment expenditure, because the conditions for private investment were poor. Mr. Legarda had noted that the thousand largest corporations in the Philippines had had a joint loss in 1981 of P 700 million; the loss raised the question whether greater resources should not be provided to rekindle demand and stimulate recovery. In addition, the staff had pointed out that the Philippines had had a high investment ratio without a high growth rate to show for it; in other words, the capital/output ratio had been unduly high. The conclusion drawn in other countries with low capital/output ratios had been that the authorities should cut down on unproductive or marginally productive investment. In the Philippines, he wondered whether the investment had all been made in sectors with high productivity. Perhaps the aim at present should be to put less emphasis on new investment and more on the most productive uses for the investments already in place.

A number of Executive Directors had already referred to the long history of collaboration between the Fund and the Philippines under successive stand-by arrangements, including a three-year extended arrangement, Mr. Polak recalled. Mr. Laske had made the point that those arrangements had not yet produced a sustainable balance of payments position for the Philippines, which still had to cover an overall deficit by a reserve loss. External factors had obviously been important, and the decline in prices for the country's principal primary product exports--copra, sugar, copper, and abaca--was particularly worrisome. Mr. Legarda had referred to "the widely anticipated recovery in the world economy" which would help to correct the situation. When would the recovery come, and how strong would it be? How would it affect the prices of primary products?

The authorities should ask themselves how far the country, through an internal compensatory policy, could continue to stay out of step with developments in the world economy, Mr. Polak recommended. He understood their reasons for trying to ride out the current recession. Nevertheless, in any policy that relied heavily on trying to maintain internal demand, the exchange rate and the maintenance of exports were extremely important; in trying to promote nontraditional exports in a basically unsatisfactory world situation, the Philippine authorities had to rely heavily on a competitive exchange rate. Mr. Legarda had indicated that they were flexibly managing the rate with a view to maintaining competitiveness, forestalling speculation, and avoiding undue inflationary pressures. He had great sympathy for all three of those objectives. He also agreed to some extent that the measure provided by the staff for gauging competitiveness in terms of the real effective exchange rate with the Philippines' most important trading partners might not be the most relevant statistic. With respect to nontraditional exports, competitiveness with other suppliers--mostly other countries in Asia--was the most important factor. In one of the papers for the recent consultation with Thailand, the staff had provided a comparison of exchange rates among exporting countries of that type, and he would appreciate learning how competitive the Philippines would be by that comparison.

On exchange rate tactics and strategy, the Philippines found itself in a difficult twilight zone in which domestic inflation did not exceed inflation abroad by an amount sufficient to justify adopting a crawling peg policy, Mr. Polak said. Moreover, the link between the peso and the dollar was strongly maintained in the Philippines, although not at a fixed level, and was an important element in keeping up confidence. He agreed with Mr. Legarda that the authorities had to decide carefully how to go about becoming and remaining more competitive. He did not believe that the Philippines could succeed in trading off the inflation impact against the competitiveness impact, nor that confidence could be long maintained if competitiveness declined.

With respect to foreign debt, many years previously the Philippines had adopted a sensible policy that should enable it to avoid most of the difficulties into which other countries had stumbled, Mr. Polak remarked. The authorities had a solid system of debt monitoring, public and private. They made sensible decisions about maturity arrangements, although maturity was not entirely in the hands of the borrowers, and recent developments in the markets had led some countries, including the Philippines, into accepting shorter maturities than they would otherwise have wished. Finally, the authorities had imposed a statutory limit on the debt service. He accepted Mr. Legarda's statement that servicing the Philippine debt had never been a problem. The authorities should nonetheless remember that the Philippines had been contracting debt to the point where obtaining further credit might become difficult in an international credit market that was less solid and less generous than even one year previously. In conclusion, all the developments that he had mentioned pointed to the desirability of sustained close cooperation between the Fund and the Philippines and the continued pursuit by the Philippines of highly cautious policies.

Mr. Gabriel-Peña said that he had found Mr. Legarda's statement to be comprehensive and authoritative, although he found it difficult to pass final judgment on some important aspects of the performance of the Philippine economy, perhaps because the papers reflected not only past economic performance but also a possible future arrangement with the Philippines. In any event, during the previous decade, the Philippine authorities, with the cooperation of the Fund, had pursued adjustment policies for achieving satisfactory output growth, domestic price changes, and a sustainable balance of payments position. The annual growth in real output had averaged 6 per cent from 1977 to 1979 and about 4 per cent during 1980 and 1981, in spite of the adverse external circumstances. Furthermore, the average rate of inflation had fallen from 18 per cent in 1980 to 12 per cent in 1981.

The economic base had been steadily transformed, judging by the sectoral performance and the competitiveness of exports, Mr. Gabriel-Peña went on. For example, while the share of the agricultural sector in the economy had declined from 28 per cent in 1970 to only 23 per cent by 1981, agricultural growth had averaged 5 per cent a year since 1977, and the authorities had been successful in providing for all the consumption

needs of the population as well as expanded industrial consumption of the agricultural raw materials. On the other hand, manufacturing had increased its share in GDP from 20 per cent in 1970 to 23 per cent in 1981; although manufactured output remained depressed, the industrial policy performance envisaged by the Government should strengthen the sector. In addition, the share of nontraditional exports had risen from 21 per cent of total exports in 1970 to a figure expected to be more than double that in 1982. That trend seemed about to reduce the vulnerability of the growth-oriented strategy, although protectionist tendencies abroad continued to pose serious difficulties.

The demand management policy had been carried out satisfactorily in view of the need for countercyclical policies to offset inflation and for additional expenditure of a nonrecurrent nature to help enterprises affected by the financial crisis, Mr. Gabriel-Peña noted. To maintain economic momentum in 1981, the authorities had increased capital expenditure from the 1977-80 average of 4.1 per cent of GNP to 6.9 per cent; the figure was projected to fall to 5.9 per cent in 1982.

That policy, together with a reduction in revenue growth, had resulted in a widening of the overall fiscal deficit from 1.3 per cent of GNP in 1980 to 4 per cent in 1981, Mr. Gabriel-Peña observed. The proposed 30 per cent reduction to 2.8 per cent of GNP in 1982 represented a sharp adjustment over one year, and implied a sharp reduction in prices since revenues were expected to increase by only 5.7 per cent compared with 40 per cent in 1981. The increase in the budget deficit was attributable to the counterrecessionary action taken by the authorities in response to the economic recession in the world and sluggish private demand at home. The Fund's concern should center on the impact that the deficit might have on the smooth functioning of the economic system. It seemed reasonable to hope for a reduction in the fiscal deficit in 1982 and perhaps some improvement in the income elasticity of the tax revenue system over the medium term. In judging the magnitude of the fiscal deficit, Directors should consider the interrelationships among various factors. For example, in 1981, when the deficit had been 4 per cent, the volume of imports had dropped by 5.5 per cent, while financing the deficit had not resulted in crowding out private sector investment; part of the deficit had reflected government lending to the private sector. He did not believe that the budget deficit posed any problem with respect to foreign debt management, since the authorities had established an adequate system to monitor foreign debt. Unless the Philippines had experienced debt management problems in the past, he found it difficult to credit the judgment that the projected foreign debt level was unsustainable.

Monetary aggregates had expanded in accordance with the liquidity needs of the economy and with output growth, Mr. Gabriel-Peña went on. He joined the staff in welcoming the measures recently taken by the authorities to improve the efficiency of financial intermediation. Interest rates had become positive in real terms. The increase in net credit to the public sector and to the National Government was expected



to slow considerably in 1982, and he welcomed the authorities' desire to balance financing at the budgeted level by issuing treasury notes at competitive interest rates. It was interesting that the rise in time and savings deposits that had begun in 1981 had continued into 1982, a communication of the positive response to the measures taken by the authorities during the financial crisis of 1981, when they had acted as a lender of last resort.

The balance of payments performance had been affected by unfavorable external developments, specifically the sharp deterioration in the terms of trade, high interest rates, low demand for Philippine exports, and protectionist tendencies in the major markets for those exports, Mr. Gabriel-Peña noted. Most of those factors were cyclical; strong adjustment measures could be expected to reduce the external pressures in the near future. The balance of payments projections for 1982 had been substantially modified: a current account deficit of only 5.2 per cent of GDP was expected. Naturally, the authorities should be ready to adjust monetary aggregates further if that projection should appear in danger. He would appreciate an explanation by the staff of the substantially higher outflow under "short-term capital and errors and omissions" that accounted for the revision in the current account mentioned on page 9 of SM/82/55, Supplement 1.

The authorities were to be commended for their continued efforts to liberalize the trade sector, Mr. Gabriel-Peña concluded. They had reduced tariffs and eliminated restrictions on exchange transactions. He also welcomed the more flexible exchange rate policy followed by the authorities.

Mr. Zhang considered that in the face of unfavorable circumstances the Philippine Government had been able in 1981 to implement policy measures along the lines envisaged in the Fund program. There had been a marked decline in the rate of inflation, but fiscal policy had been less successful, leading to a substantial increase in the ratio of budget deficits to GNP. The budgetary deterioration in 1981 had resulted mainly from the adoption of a countercyclical fiscal policy at a time of unfavorable external positions and revenue shortfalls. Such developments were similar to those that had occurred in many other developing countries under similar circumstances.

As to the prospects for 1982, it was encouraging to know that the Government was determined to undertake any further necessary structural adjustments, Mr. Zhang continued. The Government had recognized the importance of curtailing the budget deficit in the adjustment process. Consequently, according to the official projection, there was to be a large reduction in the budget deficit as a proportion of GNP, certainly an encouraging move. Structural adjustment would depend upon the implementation of various economic and social policies adopted by the Government. The Government would have to be flexible. He broadly supported the direction of policy; success would also depend upon a favorable change in the external economic environment.

Mr. Sangare noted that the Board discussion was being held after the expiration of a two-year stand-by arrangement that had followed two previous stand-by arrangements. During those arrangements, the authorities had cooperated with the Fund and implemented all the agreed measures under the stabilization program. Although a slowdown had occurred in 1981, the 3.8 per cent growth rate recorded was reasonable by current standards. Regrettably, the difficult international situation had caused the terms of trade to deteriorate by 9.4 per cent. He was encouraged by the fact that the growth rate for 1982 was expected to be higher and that the inflation rate appeared to be diminishing. As in most other developing countries, the balance of payments was expected to remain under pressure, reflecting mainly the continued deterioration in the terms of trade and increased debt service outlays resulting from high international interest rates. The 1981 program had emphasized the need to improve the supply position in the economy. The removal of quantitative import controls and the reduction in tariff rates should encourage competition while providing a basis for efficient production. The \$4 billion investment program covering 11 major industrial projects should strengthen the industrial structure and further expand the economic base. In financing those projects, the authorities had indicated their desire to encourage foreign capital inflows, particularly through equity participation and long-term suppliers' credits, while limiting government involvement in the investment program to an estimated \$3 billion. Moreover, by attracting capital from abroad, the Government would limit its recourse to domestic bank financing.

The fiscal expansion in 1981 had been designed to accommodate the liquidity problems of nonbank financial institutions and to provide equity contributions and lending to depressed enterprises, Mr. Sangare considered. Meanwhile, recurrent expenditure had been reduced to take account of the deceleration in government revenue. The authorities were to be commended for their flexible approach to overall fiscal management. Given the reduction in the capital budget, he had no problem accepting that the authorities' expectations would be realized. Fiscal adjustment, as shown by the size of the overall budget deficit compared with GNP, continued to reflect the authorities' desire to stimulate growth, an appropriate policy stance as Mr. Legarda had maintained.

Monetary policies in 1981 had been influenced by the need to restore confidence in nonbank financial institutions, Mr. Sangare remarked. The reform of the financial sector should be encouraged, and he welcomed the measures taken by the authorities to strengthen the government securities market and to remove interest rate ceilings on savings and time deposits.

He had noted the concern expressed by the staff about the increasing external debt service outlays arising mainly from the investment program, Mr. Sangare stated. The authorities expected that investment in the energy sector in particular would reduce reliance on imported energy and thus improve the country's balance of payments. Moreover, industrial projects, if properly appraised and implemented, should widen the basis

for value added and increase exports, thereby improving the balance of payments in the long term. In conclusion, he supported the proposed decision.

Mr. El-Khoury observed that during 1981 the Philippine economy had been adversely affected by a number of external factors and had had to cope with an internal crisis of confidence in the financial system. Given those constraints, the performance of the economy, although mixed, had been satisfactory on the whole: the growth rate had been close to 4 per cent, and the inflation rate had fallen to about 12 per cent. There had been increases in the ratios of the budget deficit to GNP and of the current account deficit to GNP, but they remained within manageable levels.

In the medium term, the authorities were aiming at reducing the size of the existing domestic and external financial imbalances, Mr. El-Khoury continued. As to the fiscal policy, the revised budgetary projections for 1982 showed a decline in the ratio of the budget deficit to GNP as well as a decline in the absolute size of the deficit. Revenue projections had been revised downward to a more realistic level. Although the staff appeared to be calling for a strengthening of tax efforts, he could not find in the staff papers any specific proposals either on tax administration or on discretionary tax measures. Perhaps the staff could shed some light on that issue. The staff also seemed to imply that, because the ratio of tax to GNP was relatively low in the Philippines compared with other developing countries at similar income levels, the authorities should increase taxation. He found that implication difficult to accept because the ratio of expenditure to GNP--about 14 per cent--was also relatively low in the Philippines compared with other developing countries. In speaking of international comparisons, the staff would do well to take both the tax side and the expenditure side into consideration.

The authorities had revised downward the projections for both current and capital expenditures, Mr. El-Khoury stated. The staff seemed to favor further reductions in capital expenditure, arguing that it would reduce imports and thus affect the balance of payments favorably. However, although capital expenditure in the budget had increased sharply in 1981, imports of capital goods had fallen. In the light of that fact, he had some questions to ask the staff. What was the propensity to import out of a given amount of capital expenditure in the budget? Could it have been that imports of capital goods by the Government had increased but that capital imports by the private sector had declined even more, so that total capital imports had declined? Finally, if there was a strong link between budgetary capital expenditure and imports, and if government imports had not increased in 1981, were they going to increase in 1982 and 1983?

Another aspect of capital expenditure was its effect on the debt service burden of the country, Mr. El-Khoury noted. Could the staff say what proportion of budgetary capital expenditure was really being

financed by concessional aid, since such financing was not expected to increase the debt service burden by a great amount? In general, with respect to the public sector, his chair was concerned neither about the share of government activity in the economy nor about the present size of the budget deficit. Therefore, his chair was sympathetic to the opinion expressed by Mr. Legarda and the Philippine authorities that an important objective of fiscal policy at the present time was to maintain the momentum of growth in the economy.

The authorities had been following flexible exchange rate policies and, by the admission of the staff, they had established prudent limits for external sector borrowing during 1982, Mr. El-Khoury went on. They had also been making great progress in reforming tariffs. They were continuing to liberalize import restrictions and to provide fiscal incentives to investors, while at the same time implementing various reforms in the financial system. In sum, the authorities were moving in the right direction, and he hoped that their negotiations with the Fund for a program would be successful.

Mr. Jayawardena noted that the Philippines had had a long history of cooperation with the Fund, so that the current discussion was of relevance to the future thrust of Fund policy. The Philippines had nearly 50 million people with a per capita income of nearly \$800 a year, a reasonably high figure for a developing country. Like other members of the Association of South East Asian Nations, the Philippines had consistently followed a strategy of high economic growth, which had been occasionally moderated by adverse external circumstances. On the whole, the country had been remarkably successful in mobilizing large volumes of external capital flows for its development effort, a policy with implications for the debt service and the long-term viability of the balance of payments. He welcomed the authorities' attempts to contain the debt service ratio to 20 per cent of current external earnings. Thus, the country's ability to raise foreign resources to supplement domestic resources for its development plans, subject to the debt service ratio and the long-term sustainability of the balance of payments, became the crucial factor in the management of the economy.

He would not be inclined to view with alarm the high emerging current account deficit in the Philippines, although as a percentage of GNP it appeared high relative to that of many other countries, Mr. Jayawardena commented. After all, a lower figure for the current account deficit would mean that the Philippines was not utilizing the external resources that it had mobilized. In other words, the higher the level of mobilization of external resources, the higher the current account deficit would be, to the extent that the external resources thus mobilized were reflected in import statistics. Hence, to understand the long-term underlying trend, observers should discount from the current account the import trade flows induced by external capital, if the ratio of current account to GDP was to be used for meaningful comparison with other countries, which tended to have mobilized lower

external capital flows. He was not suggesting that Directors ignore the debt service problem, but, given the Philippine track record, a 20 per cent debt service ratio did not appear alarming. He would be concerned if the ratio were to rise sharply in the future, and he therefore found Mr. Legarda's statement on that point reassuring.

He was glad to note that the effective tariff rates had been reduced and that steps had been taken to fully liberalize the exchange, trade, and payments systems, Mr. Jayawardena remarked. He welcomed the intention of the authorities to proceed expeditiously. The adoption of realistic energy prices in a country so heavily dependent on imported energy was a highly desirable step. The development of alternative energy resources was capital intensive, and although such investments would cause short-term payments problems, they would bring long-term beneficial effects to the balance of payments.

He was also encouraged by the success of the authorities in bringing down the rate of inflation despite sluggish economic growth in the recent past, Mr. Jayawardena continued. He welcomed the authorities' commitment not to relax their fiscal, monetary, or exchange rate policies. As for monetary policy, the authorities were to be complimented for the quick and effective action taken to resolve the financial crisis of 1981; without that action the entire economy might have gone off track. Recent developments in interest rates, whereby interest rate ceilings had mainly been eliminated and the remainder targeted for short-term removal, were also encouraging. The steps taken to improve financial intermediation would not only avert crises in the future, but would also help to increase the level of monetization and make monetary policy a more effective instrument. Similarly, he welcomed the adoption of market-oriented pricing in the public sector and the Government's commitment to persevere with such policies in the future. The authorities' economic policies were consistent with the policy aspirations of the Fund.

Despite the depreciation of the peso in real effective terms during the second half of 1981, the real effective rate had appreciated slightly during the year, Mr. Jayawardena noted. Despite the appreciation, there had been remarkable growth in nontraditional exports, while there had been no evidence of a black market in foreign currency. The exports affected had been in the traditional sector, where the terms of trade had deteriorated sharply. Had exchange rate depreciation been an appropriate economic strategy, given the attendant effects on domestic inflation and on debt service? As demonstrated in the recent discussion on the exchange rate policy in developing countries, the answer to the question was not clear-cut. Faced with an unexpected and sudden deterioration in the terms of trade, the authorities of a highly import-dependent developing country might beneficially adopt a financing program coupled with an anti-inflationary domestic policy. However, the recent Board review of the World Economic Outlook had not augured well for the Philippines in the coming years.

The Philippine fiscal policy had been defined by Mr. Legarda as a countercyclical reaction to adverse external developments, Mr. Jayawardena went on. That approach probably stemmed from the genuine desire of the authorities to sustain the momentum of economic growth, but the effects of that approach on the balance of payments had already become evident. To the extent that the fiscal deterioration had been caused by the need to deal with the financial crisis, he would have no adverse comments to make: the financial crisis had threatened the very economic fabric of the country, and only the intervention of the Government had averted a catastrophe. The crisis had also worsened the investment climate, so that private sector investment demand had fallen substantially. Whether the rest of the public sector involvement in the countercyclical reaction was desirable would depend largely on the efficiency and productivity of public investment. Unless the public sector had relatively high productivity, some caution might have been preferable. There was scope for the Government to make a greater tax effort and to borrow from nonbank sources rather than resort to central bank finance.

Anyone looking at Chart 1 in SM/82/55 would be apt to conclude that the long-term association of the Philippines with the Fund had apparently not promoted an adequate process of adjustment, Mr. Jayawardena said. Such a conclusion would be unwarranted unless a one-to-one relationship could be proved between Fund assistance and current account balances in the country. The current account balance could be affected by many factors that might seriously undermine the adjustment measures taken. He was certain that the Executive Board in the past, in promoting adjustment in the Philippines, had adequately examined the country's adjustment needs when the programs had been agreed. It could be possible that unanticipated circumstances had defeated the objective of sustaining balance of payments on a viable basis over the medium term, but it would be wrong to conclude that continuing resort by a country to Fund support was unsatisfactory. Such a conclusion assumed that the world economic situation was static; on the contrary, it was highly dynamic, and the increasing number of countries compelled to come to the Fund for assistance was a criticism of the system rather than the countries. It might also mean that the extent of assistance had been inadequate and might inspire Executive Directors to consider longer-term perspectives than financing temporary shortfalls or to understand that the world system was in need of substantial reform. In any event, he welcomed the Philippine authorities' desire to continue relations with the Fund. Support by the Fund should be kept up because under extremely difficult circumstances the authorities had maintained the basic thrust of policy in the right direction.

Mr. Abiad stated that he found Appendix I in SM/82/55 helpful in understanding the medium-term perspective of the external sector of the economy. In recent years, except 1981, the Philippine economy had achieved an impressive growth rate. During 1980, the first year of the recent stand-by arrangement, the program had proceeded in the intended direction, except for minor deviations. In 1981, the performance of the economy had been less than satisfactory, although the original program

had been revised during the mid-term review to take into account the impact of the fiscal crisis and the deteriorating external environment. As for the growth rate in 1981, different estimates had been given by the authorities, the staff, and Mr. Legarda. The differences among those rates were significant enough to raise questions about the consistency of methods used in calculating GDP, the impact of a certain growth rate on other macrovariables, and the measurement and reliability of growth rates. He would appreciate staff comments on those differences. A related question was that of the capital/output ratio, which was unusually high in the Philippines.

The fiscal performance and the balance of payments situation were more worrying, Mr. Abiad considered. Both the budget deficit and the balance of payments deficit had been large by historical standards. The widening of the deficit in the 1981 budget had in part been reflected in the stagnation in revenues and the decline in the ratio of tax to GDP. While there seemed to be grounds for the concern expressed by the staff about the need for strengthening tax administration, improving the tax/GDP ratio, and raising the elasticity of the tax structure, the less than satisfactory fiscal performance in 1981 could have been appraised more objectively in a medium-term perspective. The Philippines was a relatively small, open economy, in which the impact of an international recession and high interest rates had been marked. Given the authorities' preoccupation with maintaining a certain growth rate, and other noneconomic constraints, the countercyclical fiscal stance was understandable.

As Mr. Legarda had mentioned, the budget deficits in the previous four years had varied between 0.1 per cent and 1.7 per cent of GNP, and up to 1980 had always been below program levels, Mr. Abiad continued. However, the 1981 deficit had been unusually large; in addition to the favorable effects of the expected recovery in the world economy, a sustained budget improvement would require positive fiscal measures by the authorities. For instance, there appeared to be some scope for raising additional resources through taxation.

The size of the balance of payments deficit showed the impact of adverse developments largely beyond the authorities' control, Mr. Abiad concluded. Although the current account deficit remained within the target set in the 1980-81 stand-by arrangement, a deficit of that magnitude would be difficult to sustain over the years. In the area of monetary policy, he welcomed the further reforms introduced by the authorities, which should contribute to enhancing the effectiveness of monetary policy. He had also noticed the rather erratic behavior of the velocity of circulation, which raised questions about the stability of the demand-for-money function and the use of velocity as a policy variable.

The staff representative from the Asian Department recalled that several Executive Directors had raised questions about the internal consistency of some of the policy recommendations made by the staff to

the Philippine authorities. The staff and the authorities were in basic agreement about the framework for Philippine policy, much of which had been developed by the authorities themselves over a period of years, and on which there had been a substantial measure of agreement with the World Bank. It was true that there were some differences about the timing of measures, the pace of adjustment, and the scope for certain measures in a particular situation.

The authorities agreed with the staff that a reduction in the current account deficit was important, the staff representative said. They recognized that they had to contain the recent rapid rise in the debt service ratio, but they pointed to the deterioration in the terms of trade that had taken place in recent years as one of the reasons why they had some difficulty in containing the current account deficit, which had risen from about 4 per cent of GNP three or four years previously to about 6 per cent in 1981. The authorities were also attempting to reduce the rate of inflation, which had risen sharply after the second round of oil price increases, and they had succeeded in bringing it down, although the staff hoped that it could be brought down substantially further.

The most important objective of the authorities was ensuring growth, the staff representative continued, and the Fund staff as well as the Bank staff were interested in that objective being attained. As some Executive Directors had observed, it was somewhat surprising that in the light of the high investment ratio in the Philippines the growth rate had been rather low, although not in comparison with the average growth rate of non-oil developing countries. Perhaps more important, the growth rate had declined substantially during the previous few years. Several Executive Directors had referred to the productivity of investment in the Philippines, and the authorities recognized the need to ensure greater productivity both in the public and the private sectors, as shown by the measures of structural reform that had been initiated in many areas with the support of the Bank and the Fund. The measures designed to influence private investment included tariff reforms, import liberalization measures, interest rate reforms, and proposals under study for reforming the present system of fiscal incentives that had resulted in unduly capital-intensive projects being undertaken. There was also a strong feeling in the World Bank that there had to be greater selectivity of investment projects in the public sector: while the World Bank staff felt that the broad sectoral investment programs seemed appropriate, they had questions about specific projects, about their cost effectiveness, and the appropriateness of some projects from the point of view of the economy's needs.

Some structural adjustment policies had been specifically directed to improving the balance of payments, the staff representative went on. The authorities recognized that export prices were depressed and that the terms of trade had deteriorated. The measures taken to promote nontraditional exports had met with some success: nontraditional manufacturing exports in particular had grown fairly rapidly. The program to diversify



energy resources, which required substantial investments, was also directed toward improving the balance of trade, particularly through reducing oil imports.

The authorities recognized the importance of restrained fiscal policies, the staff representative stated. In 1981, as Directors had noted, the problems for monetary policy had been mainly of budgetary origin. Although the estimated budget deficit of 4 per cent of GNP in 1981 was perhaps not inordinately high in comparison with that of some other countries, the sharp deterioration that had taken place in the fiscal position during the previous year was naturally cause for some concern. The authorities themselves had referred to the need for additional measures of resource mobilization. In the most recent five-year plan (1978-82), they had projected that revenues as a proportion of GNP would rise; in contrast, they had fallen quite sharply during the previous few years. Apart from measures to raise additional budgetary revenues, the authorities were contemplating measures to raise resources in the public corporations, in particular an increase in electricity tariffs and an increase in other public sector fees and charges. The policy of freeing interest rates would probably also help to improve financial savings.

There was no disagreement in principle between the authorities and the staff on the Philippines' exchange rate policy, the staff representative considered. At the time of the mid-term review of the 1981 program, a statement had been made that flexible exchange rate policies would be pursued by the authorities, who intended that the real effective exchange rate should depreciate during the following 12 months. In the following months, the real effective exchange rate had depreciated significantly; more recently, although the authorities had continued their policy of depreciating the peso against the U.S. dollar, the real effective exchange rate appeared to have appreciated. Inflation in the Philippines had been declining, but it had probably not declined as fast as inflation in trading partner countries; together with the appreciation of the U.S. dollar against other major currencies, that development accounted for the probable appreciation of the real effective exchange rate in the most recent period.

There was also agreement in principle between the authorities and the staff on the debt service burden, the staff representative went on. The authorities had their own self-imposed controls on external debt. Having noted the projected rise in the debt service ratio, they had adopted an external borrowing program that entailed a reduction compared with the 1981 program.

Although the Philippines was experiencing some disequilibria because of weak export markets, weak private investment, and declining economic growth, the country still had a growth rate of 3.8 per cent, the staff representative observed. There was thus some capacity for revenue mobilization. The staff tended to feel that since there had been moderate growth, the revenue effort should not have been allowed

to decline to the extent that it had. Even if it were conceded that some countercyclical stimulus might have been necessary, there could be different views on the form that the stimulus could take. The staff had felt that some restraint in the capital expenditure program of the public sector was appropriate, not only because it would have the most immediate impact on the current account of the balance of payments, but also because such restraint would have been accompanied by an improvement in the efficiency of investment. A smaller reduction in current expenditure, particularly on maintenance, would then have been both feasible and appropriate.

The question had been raised whether the projected 7.5 per cent increase in revenue in 1982 was feasible, the staff representative said. The estimates had been developed during the recent staff mission to Manila. The expectation was that the revenue projection could be achieved, provided that certain measures being considered by the authorities were in fact implemented. For example, the authorities had already adopted gross taxation of employment income and a greater withholding of taxes at the source, measures expected to simplify tax administration and to release the manpower resources of the taxing authorities to concentrate on business income, which would continue to be taxed on a net income basis. The authorities planned to raise some administrative fees and collect P 800 million of import duties owed by the Philippine National Oil Company. Increases in the excise duty on liquor were expected to contribute about P 200 million. Together with some improvements in tax administration, those measures were expected to ensure the target of a 7.5 per cent increase in revenue, which was moderate compared with the growth in nominal GNP.

Expenditures had been reduced, so that overall expenditures were expected to increase by approximately 1 per cent, the staff representative explained. Cash disbursement ceilings had been set to contain outlays at the newly proposed levels. Moreover, a mechanism was in place under which some of the allocations were held in reserve accounts. There was P 1.9 billion left in the reserve accounts, and the amount could be withheld in case revenue performance did not come up to expectations. The principal cuts already imposed were on maintenance expenditures, personal services, and other capital outlays including those for housing projects, equity contributions, and lending. The view of the staff was that maintenance expenditure had perhaps been cut too drastically, a view shared by the staff of the World Bank.

A question had been asked whether the rescue operation undertaken in 1981 would continue in 1982, the staff representative recalled. The authorities had no plans to do so; the Industrial Rehabilitation Fund had been wound up, and no further emergency advances from the Central Bank were contemplated. On the other hand, the Central Bank had opened its discounting window for medium-term and long-term lending by the newly established universal banks, which were authorized to engage in investment banking. Such lending would provide support to enterprises that were in temporary financial difficulties or that had sound investment programs and needed investment financing.

The question had been raised whether the characterization in the staff appraisal of credit policy as fairly restrained was appropriate, or whether it might better be described as an accommodative credit policy, the staff representative said. The authorities had acted promptly to resolve the financial crisis: support had been given to the financial institutions, and attempts made to strengthen their financial position by a variety of measures. In addition, support had been provided to enterprises that were in distress because short-term financing on which they relied had been cut off. The authorities had also taken steps to ensure that weak management in some of those industrial enterprises was replaced; one condition for financial support had been that the enterprises should be restructured. For those reasons, the staff felt that the Central Bank had exercised prudence in providing credit support to the institutions affected by the crisis. Such support had been important as a means of improving confidence.

Some Directors had asked whether the authorities' monetary projections were too high for 1982, the staff representative recalled. The authorities had revised downward both their liquidity projections and their projections for net domestic credit expansion between February and April. The staff was basically willing to accept the more recent projections, except that the staff believed that the authorities could possibly do with lower inflation targets. If the authorities found that acceptable, they could lower their projections for both liquidity and net domestic credit expansion.

With regard to the current account deficit, questions had been asked whether the authorities' projections for export growth in 1982 were realistic, the staff representative noted. The authorities' projections were based on the assumption that there would be some upturn in the world economy in the second half of 1982, and that therefore export prices would improve, export volumes would increase, and the country could have an 11 per cent growth in export value. The Fund staff had no basic disagreement with the projected lower current account deficit for 1982, but it did feel that it was possible that the export projections might not be attained. On the other hand, perhaps there was a little fat in the authorities' projections for import growth, so that the staff was not overly concerned about the possibility that the current account deficit in 1982 would be substantially larger than projected.

Several Directors had asked whether the external debt was sustainable, the staff representative said. The staff had not taken the position that the present level of external debt servicing was beyond the capacity of the authorities, given appropriate policies. Rather, the staff had asked whether a continuation of the deficits at current levels would raise questions about the sustainability of the external debt burden. Happily, the authorities themselves were recognizing the need for reducing the current account deficits; however, there were some differences with respect to the appropriate pace of adjustment.

A question had been raised by Mr. El-Khoury about the tax measures suggested by the staff to the authorities, the staff representative went on. Tax elasticity had declined along with tax buoyancy in 1981, partly because some of the excise taxes were specific; one possibility would be to shift some of them to an ad valorem basis. Increases in administrative fees and charges, reforms in fiscal incentives--which had resulted in excessive loss of revenue--and increases in some indirect taxes to compensate for the losses due to tariff reform were also being considered. The scope for additional measures was indicated by the relatively low ratio of tax to GNP.

With regard to inflation targets, some Directors had wondered whether the staff was being consistent in seeking both a reduction in inflation and a flexible exchange rate policy in the Philippines, the staff representative noted. Actually, the authorities' inflation target was substantially higher than the projected average inflation rate in trading partner countries. The authorities had been talking of a much higher inflation target, which would allow scope for exchange rate depreciation and would also allow for the considerable adjustments in domestic prices that the authorities intended to undertake. It was the staff's view that the authorities' inflation target of 11 per cent could be reduced still further, despite the needed pricing adjustments and the appropriate exchange rate policy that the authorities intended to implement.

The question had been asked whether the real effective exchange rate was the best indicator of a country's competitiveness, the staff representative recalled. Mr. Polak had asked whether the staff had also made comparisons with competitor countries of the Philippines, not just trading partners. The staff had indeed made such a comparison in the reports presented at the mid-term review, which had shown that there had been a relative deterioration in the real effective exchange rate of the Philippine peso in comparison with the currencies of several important competitors since about 1978. The staff would also have been keen to consider unit labor costs, but not enough data had been available. The real effective exchange rate was also the indicator used by the Central Bank in monitoring exchange rate developments.

The authorities planned to continue a depreciation of the peso against the intervention currency, the U.S. dollar, the staff representative continued. They did not intend to institute a policy of predictable depreciations because they had no wish to reward speculators, but it was their firm intention over time to ensure that a depreciation did occur. They were willing to accept some temporary deviations in the nominal effective exchange rate, in the expectation that over several months the policy would lead to a depreciation. The staff believed that the increased flexibility of exchange rate policy had helped the export competitiveness of the country much more than the earlier, less flexible policy. The staff had not claimed, however, that competitiveness had improved in 1981: there had been some loss in the first half of the year, and in the early months of 1982 there again had been a setback, but the

latest information showed that the exchange rate had moved to P 8.40 to the U.S. dollar compared with P 8.20 in December 1981. If the analysis could be updated, it might show that the appreciation of the nominal effective exchange rate in the first quarter of 1982 had probably fallen from the earlier 3.7 per cent to about 1 per cent.

With regard to a question by Mr. El-Khourî, the staff did not have specific information on the share of capital goods imports financed by concessional credits, the staff representative explained. Nor did the staff have a breakdown of capital goods imports by the public sector and the private sector. However, the staff had learned, from its discussions both with the Philippine authorities and with World Bank staff, that public sector capital expenditure did have a large import component. That knowledge provided the basis for the statement that restraint in the program of public investment expenditure would have a direct and immediate impact on the trade balance. The share of external debt from multilateral and bilateral sources had remained relatively constant in recent years at about 25 per cent of outstanding debt. The World Bank was engaged in discussions with the authorities, particularly about a second structural adjustment loan; and the Bank staff also believed that additional measures for resource mobilization were extremely important, because the current account deficit had to be narrowed and the ambitious capital expenditure program could not be financed by concessional loans from abroad. The interest burden was expected to double between 1981 and 1982 because of the rising share of floating interest rate debt. The authorities had been relying on commercial borrowing to a substantial degree, and they would like to reduce their reliance in the future.

A number of Directors had asked whether there was further scope for increasing the financing of the Treasury by the nonbank sector, the staff representative recalled. The authorities had in fact budgeted for increasing interest payments on the domestic debt, and they had decided on a deliberate policy of replacing central bank financing of the budget deficit by commercial bank and nonbank financing. They hoped that by offering the going rate of interest they would be able to sell government securities to the nonbank sector. If their plans materialized, bank financing of the 1982 budget deficit could be reduced below the level projected by the authorities.

The staff representative from the Exchange and Trade Relations Department recalled that Mr. Casey had inquired whether a move by the Philippines to Article VIII status had been discussed with the authorities during the consultation mission. It had not been discussed because, at the time, the staff had been more concerned with the prospects and scope for eliminating the existing restrictions subject to Fund jurisdiction. The strategy normally followed by the staff on that subject had been set out in Decision No. 1034-(60/27), in which the Executive Board had said that before a country considered a move to Article VIII status, it would be desirable that, as far as possible, it eliminated existing restrictions that required the approval of the Fund.

A number of Executive Directors had asked about the long series of stand-by arrangements of the Philippines with the Fund and its relationship with the long-term balance of payments performance, particularly the current account performance, the staff representative went on. In particular, Mr. Laske had been prompted to wonder whether previous Fund programs had perhaps been too biased in favor of financing external imbalances at the expense of adjustment. In that context, Mr. Jayawardena had already mentioned in his intervention that there were a large number of factors to be taken into account when actual balance of payments performance was compared with the targets set in Fund programs, and that there was not a one-to-one relationship between the record of observance of performance criteria and the achievement of objectives under stand-by arrangements. That being said, there could be no doubt that that was an area of concern, and the staff planned to devote some time to seeing what lessons could be drawn from the experience of the Philippines. Mr. Erb and Mr. Polak had also referred to that broad question from the perspective of investment, a critical subject because it provided the link between short-term adjustment and longer-term development in an economy. The process of improving balance of payments performance and keeping the current account deficit on a sustainable path could not be separated from the issue of the productivity of investment. The staff would like to make further inquiries in that area.

Several Executive Directors had remarked that the Philippines had concluded a substantial number of financial arrangements with the Fund over a long period of time and that the record of observance of performance criteria had been quite good, the staff representative observed. In that respect, the staff did not wish to take a dogmatic view, either when performance criteria were being observed, or when they were not being observed. The main function of performance criteria was to give the staff and the country authorities an indication of how developments were evolving in the economy. It was presumed that the observance of performance criteria provided a signal that the economy was moving in the desired direction. In the many stand-by arrangements with member countries that the staff had examined, the broad experience had been that the balance of payments, rather than growth and inflation, had been the variable that had performed more closely to targets, but that observation should not be interpreted to mean that the latter two variables were unimportant. Significant progress had been made in those areas by the Philippines and, as Mr. Polak had put it, it would be unwise to say that because a sustainable balance of payments position had not yet been attained, the financial arrangements with the Philippines had been unsuccessful.

Referring to the relationship between inflation developments and the recommendation for a progressive devaluation of the currency, Mr. Legarda had said: "The various policy elements at best lie in uneasy juxtaposition and at worst might be said to be inconsistent," the staff representative from the Exchange and Trade Relations Department remarked. He himself was not sure that "inconsistent" was the appropriate term. After all, it was clear that a relationship existed between both the level and

the movements in domestic prices relative to those in foreign prices, and also that the exchange rate played a role in keeping both the level and the movements in the two sets of prices in an appropriate relationship. The prevalence of an exchange rate that made the pattern of movements consistent between domestic and foreign price levels did not necessarily ensure that the relationship between the two price levels had initially been appropriate. If that had not been the case, it could be argued that an exchange rate adjustment might be necessary to bring the relationship between the two price levels into balance, even if the first impact of the exchange rate adjustment on domestic prices would be to raise them. Such an impact, in any case, would be of a once-and-for-all nature rather than a continuous influence so that it could not affect the rate of domestic inflation permanently.

Mr. Legarda thanked the Executive Directors who had commended the Philippine authorities for implementing policies oriented in the right direction, despite the difficult state of the world economy, and those who had understood the necessity for certain measures taken under the countercyclical policy, despite some philosophical reservations about the wisdom of a small open economy indulging in such measures. He also expressed thanks to those who had pointed out the substantial achievements of the real economy as compared with the financial sector. A number of Directors, not least Mr. Polak, shared his own reservations about the measure of competitiveness used by the staff. The staff had explained that the measure was also used by the Central Bank; he wished to point out that the Central Bank used an unspecified basket and did not really set targets. The officials of the Central Bank tended to look more at such factors as inflows of capital, building of plants, and outflows of exports. In any event, they did not elevate the real effective exchange rate to the main altar in the shrine of econometrics.

An observation had been made by the staff representative from the Exchange and Trade Relations Department about the uneasy juxtaposition of inflation developments and the progressive devaluation of the peso, Mr. Legarda recalled. His own remarks had been intended to apply not only to that paragraph but also to the previous paragraph, in which the staff had maintained that lower investment was supposed to bring about higher growth. He would appreciate knowing under what circumstances higher growth could be achieved with lower investment.

Many Directors--Mr. Schneider, Mr. Erb, and Mr. Polak, among others--had pointed to the problem of the effectiveness of investments and productivity, Mr. Legarda went on. He would transmit their observations to his authorities. Mr. Erb and Mr. Casey had also mentioned the debt-carrying capacity of some investments. He believed that his authorities would accept those constructive observations, which he would be pleased to transmit. On the debt service ratio, the voices of caution raised in the Executive Board had also been raised within the Philippine Government.

It had been said of some European countries regarding inflation that once burned, twice shy, Mr. Legarda observed. Some of those countries had been burned after each world war; therefore, their recent record of

fighting inflation had been good. In the case of the Philippines, he recalled having accompanied the previous Governor of the Central Bank in 1970, when the authorities had faced a serious external debt situation. They had vowed that they would never again allow themselves to be in a position in which they had to go from bank to bank asking that their debts be rescheduled. Having gone through such an experience once, his authorities did not wish to go through it again. As many Executive Directors had observed, the authorities had set limits on the Philippines' debt service ratio; being self-imposed, the limits were taken seriously, and the authorities had no intention of relaxing them.

As to interest rate deregulation, Mr. Legarda remarked, he had recently received a cable from the Prime Minister saying that the Governor of the Central Bank had reiterated that interest rate behavior was being monitored and that ceilings would be lifted when it could be ascertained that such action would have no adverse effects. The authorities did have certain legitimate preoccupations; if the authorities finally lifted the ceilings on short-term loans at a time when they were trying to promote long-term placements, long-term borrowing, and long-term deposits, they might lose the mechanism whereby they could direct flows of funds into the long-term end of the market. There was thus at least some foundation to the fear that complete deregulation might have some adverse effects. The authorities did not believe that complete deregulation would be a magic cure. The money market for many years had been, in effect, a market in which loans had been made without security and without interest caps. When the collapse had come, the private sector had not saved itself; rather, the Government had intervened to ensure stability. Mr. Feito had made the perceptive observation that the rescue operation must have been successful because the effects of the financial crisis had hardly shown up in the real sector. Another point on regulation was that everyone talked of interest rate levels, but no one talked of risk factors. Many bankers had informed him that the borrowers who were willing to pay the highest rates were those with the shakiest enterprises. Therefore, the authorities were correct in carefully monitoring developments in banking.

As pointed out by Mr. Kharmawan, the Philippines had recently achieved self-sufficiency in rice, an objective that had eluded the Philippines ever since it had become a net rice importer in 1870, Mr. Legarda noted. Furthermore, from 1977, nontraditional manufactures, which had then represented one third of principal primary products, had grown until at present they almost equaled the principal primary products. When nontraditional manufactures were added to other nontraditional exports, total nontraditional exports exceeded the principal primary products that were the traditional exports. The authorities believed that the expansion of nontraditional exports represented a substantial adjustment by the Philippines. Perhaps in the year that he had been at the Fund, the concept of supply-side adjustment had faded and the staff had returned to concentrating on demand management. He believed that for developing countries, supplyside adjustment was important. Some Executive Directors had said in interventions on previous occasions that there could be no real adjustment without growth.



Some Executive Directors had mentioned the energy program of the Philippines, Mr. Legarda said. During a conversation with the Prime Minister the previous week, he had mentioned that the adjustment in energy had begun in 1974 and was expected to continue through 1987. In 13 years, the country would reduce its dependence on imported energy from 95 per cent to 46 per cent, but the reduction would not be linear. At present, the Philippines was about 80 per cent dependent on imported energy. However, the energy adjustment required steady investment that should not be interrupted. The authorities had undertaken supply-side adjustment, realizing that they could not concentrate on demand management alone.

The staff had spoken of adjustment as if only the Philippines was required to adjust, Mr. Legarda observed. Adjustment should not include the subject country alone but should also include its main trading partners, especially in a protectionist world. The large countries accounted for some 79 per cent of world output and trade, while the less developed countries accounted for some 21 per cent. Yet according to the World Economic Outlook tables, for two consecutive years the imports of the large industrial countries had been in decline. Any failure that had occurred was a failure not of Fund policy but rather of the world system as a whole. Perhaps some critics were speaking of the failure of an institution as a mechanism for surveillance over international monetary matters; he preferred to believe that the world economy was in an evolutionary stage. However, adjustment could not be unilateral. During the war years, he had lived through a period of unilateral adjustment that had been stagnationist. In today's world, unilateral adjustment in some low-income countries might be not only stagnationist but also starvationist, an unacceptable outcome.

The Philippines had never had an inoperative program, Mr. Legarda recalled. The growth record, the compliance record, and the sincerity of the authorities were recognized. The authorities had opted for growth, and the present world environment was unfavorable to growth. In fact, the present environment was probably inauspicious for making adjustment, but the Philippine authorities were discussing adjustments with the Fund. They were willing to continue that interaction.

Mr. Feito, referring to the comment made by the staff representative from the Exchange and Trade Relations Department, observed that he had been supporting Mr. Legarda's warning against a further acceleration of the devaluation trend in the Philippines. The staff representative had pointed out that a further devaluation could be used as an instrument to bring domestic prices in line with international prices; the downward adjustment in domestic prices was supposed to be achieved in the medium term after a once-and-for-all rise immediately following the devaluation. That line of thought assumed, first, that the exchange rate was the relative price of national products, or more precisely, the price of a basket of goods used to indicate the purchasing power of money. As was well known, the principle of purchasing power was not universally supported on theoretical grounds. Second, even assuming the validity of the trend,

it might take considerable time to become operative. Therefore, he would support an adjustment of the inflation rate on the basis of monetary policy rather than a nominal devaluation.

The Chairman made the following summing up:

Executive Directors acknowledged the difficulties experienced by the Philippine economy since the previous Article IV consultation. Largely as a result of oil price increases, depressed export markets, and a financial crisis, the rate of real economic growth declined in 1981 to less than 4 per cent--its lowest level in a decade--but it should be added that this performance was relatively high by international standards. Notwithstanding the difficulties, the authorities had a reasonable measure of success in attaining the objectives of the last program. Directors welcomed the progressive reduction in inflation and were appreciative of the progress made in the multifaceted structural reform program, despite the constraints imposed by the difficult economic situation. They noted, in particular, the measures taken to liberalize interest rates, reform tariffs, relax payments restrictions on imports, and diversify energy sources.

Directors commended the authorities for the prompt steps taken to contain the financial crisis. They noted that although the net domestic assets ceiling for 1981 had been slightly exceeded, the authorities had pursued a fairly restrained credit policy. They welcomed the return to positive real interest rates, which had contributed to the growth of real financial savings with the banking system. Several Directors encouraged the authorities to complete the interest rate liberalization by removing the remaining ceiling on lending rates. A number of Directors referred to the need to raise output by improving the productivity and efficiency of investment. In this connection, the unusually high capital/output ratio in the Philippines was noted, and the debt-carrying capacity of some major investments was questioned.

It was noted that prudent budgetary policies had been followed until 1980, but that a marked deterioration in the fiscal position had taken place in 1981. Some Directors observed that the weak revenue performance reflected sluggish economic conditions, and they felt that the countercyclical stance of a widened budget deficit was appropriate in the circumstances. A number of Directors, however, expressed concern about this development and, in particular, about the declining ratio of tax revenue to GNP, which indicated a need for additional revenue measures as well as improvements in tax administration. All Directors welcomed the intention of the authorities to reduce the budget deficit in 1982 to 2.8 per cent of GNP. Several Directors believed that this reduction should be achieved primarily by increasing revenues and postponing some investment outlays, rather than by cutting certain current expenditures as the authorities proposed to do since, in their view, maintenance and other important operating expenditures have already been drastically

reduced. Directors welcomed the planned reduction in central bank financing of the public sector and the intention to rely more on domestic nonbank financing. The fiscal projections appeared fragile to several Directors. They stressed that developments should be monitored very closely in order to ensure the achievement of the needed improvement. It may well be that additional measures will be needed to achieve the targeted reduction in the government budget deficit.

Directors noted the rising external debt burden of the Philippines. They observed that the sharp rise in the debt service ratio in 1981 and the further rise expected in 1982 were partly the result of adverse external developments, i.e., recessionary conditions and protectionism in the major industrial countries which limited export growth, as well as high international rates of interest. Directors considered that the debt service burden was still manageable, but a number of them argued for the adoption of policies to reduce the current account deficit and thereby to reduce the need for large-scale external borrowing. In this connection, they noted that the current account deficit had continued to widen over a number of years. They welcomed the decline in the deficit projected for 1982 and stressed the need for further substantial reductions in future years. The hope was expressed by a number of Directors that exchange rate policies should continue to be used flexibly to improve the competitiveness of the Philippine economy, while fiscal and monetary policies are used to contain inflation, although others preferred to concentrate on bringing down the inflation rate as the means of promoting competitiveness, with exchange rate policy in a subsidiary role. Some Directors wondered if the flexibility in exchange rate policy shown thus far had been sufficient. Several Directors commended the authorities for continuing with the program of liberalizing exchange restrictions on imports despite the regrettable trends abroad toward increased protectionism.

With regard to use of Fund resources, it was noted that over the years the Philippines had made use of Fund assistance while strengthening its development potential and achieving a steady growth rate and, hence, fostering the resilience of its external sector. However, it was stressed by several Directors that since 1977 there had been a continued deterioration in the current account over the course of successive financial programs with the Fund. Those Directors were concerned that Fund resources might have been used to too great an extent, in their view, to finance deficits rather than to promote adjustments, and they were not convinced that conditionality had been properly tailored in the circumstances.

Finally, I would like to say that I heard no dissent from the view that the Philippines has to be cautious, especially in the present difficult circumstances in the world, in handling its demand management policies. The legitimate desire for continued sustained

growth must also be subject to the need for domestic financial soundness and for a viable balance of payments and debt position over the medium term. Directors hoped that a fruitful collaboration between the Fund and the Philippines would continue.

The Executive Board then took the following decision:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision relating to the Philippines' exchange measures subject to Article VIII, Section 2, and in concluding the 1982 Article XIV consultation with the Philippines in the light of the 1982 Article IV consultation with the Philippines conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Philippines maintains restrictions on payments and transfers for current international transactions as described in SM/82/62. The Fund welcomes the recent steps taken by the authorities to liberalize the purchase of exchange for a large number of import items, and for travel abroad by residents, as well as the intention of the authorities to continue to liberalize exchange restrictions. In the circumstances of the Philippines, the Fund grants approval under Article VIII, Section 2(a) of the restrictions on payments and transfers for current international transactions until July 31, 1983, or the completion of the next Article IV consultation, whichever is earlier.

Decision No. 7103-(82/62), adopted  
April 30, 1982

APPROVED: October 19, 1982

JOSEPH W. LANG, JR.  
Acting Secretary