

Précis

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The Philippines: From Crisis to Opportunity

BACKED BY STRONG SUPPORT FROM INTERNATIONAL institutions and the donor community, including five structural adjustment operations from the World Bank, the Aquino and Ramos administrations have secured many of the ingredients that have characterized the development path trod by the East Asian miracle economies—macroeconomic stability and flexibility, absence of major price distortions, an educated workforce, and export orientation. Today, the Philippines can boast of more openness to foreign investment, less government involvement in the corporate sector, and a stronger banking system. From the mid-1980s to the mid-1990s, this environment underpinned a more than doubling of GNP per capita and a substantial reduction in poverty.

An OED study* of the relevance and efficacy of World Bank assistance to the Philippines since 1986 (a turning point in the economic and social policy landscape of the Philippines), found that Bank support for reform helped usher in fundamental changes in the policy and institutional environment following the economic and political crisis of the mid-1980s. Bank assistance, however, has only a mixed record in agriculture, the social sectors and infrastructure development, caused by institutional and policy constraints. Nonetheless, considering the exogenous shocks, the Banks' as-

sistance strategy over the past dozen years has been relevant and efficacious, although uneven and below potential.

The government and the Bank, however, have farther to go to improve on the country's achievement of high, sustained economic growth and rapid poverty alleviation. Remaining constraints include low levels of national savings and investment, high import duties, high population growth, a seriously strained infrastructure, an inefficient bureaucracy and judicial system, high incidence of communicable diseases, and declining



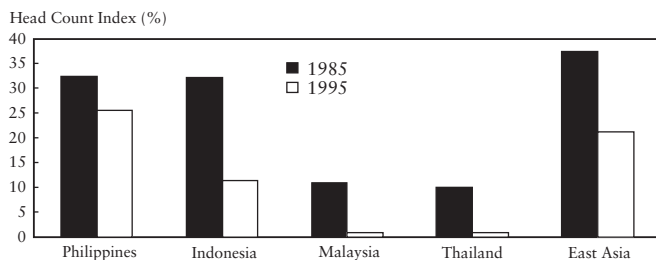
quality of and limited access to social services by the poor.

The country is now “hanging tough” in the financial turmoil which has engulfed East Asia. The resilience of the economy and the commitment of the authorities to sound fundamentals offer an opportunity to move the Bank’s country assistance strategy to a higher plane. OED recommends a highly participatory CAS process involving the government, the development community, and civil society toward achievement of deeper reform, faster poverty reduction, more vigorous private sector development and increased infrastructure, and human capital investment.

A Tumultuous Development Decade

Despite civil unrest, political turmoil, natural calamities, external shocks—and reform fatigue in the mid-1990s—the Philippines has scored substantial economic and social gains since the fall of the Marcos regime. The share of the population living below the international poverty line dropped by 7 percentage points to below 26 percent between 1985 and 1995. The key indicators of health and education achievements also point to substantial progress. In education and gender equality, the Philippines is ahead of most neighboring countries.

FIGURE 1: Poverty Reduction in the Philippines and Neighboring Countries

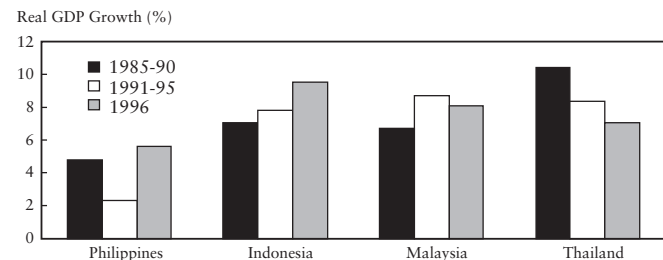


GNP per capita more than doubled, to US\$1,190 in 1996. While growth was modest compared to the East Asian tigers, GDP growth since the early 1990s reached above 5 percent in both 1996 and 1997, despite the fallout from the Asian financial crisis. Price and exchange rate stability were accompanied by rising money demand, reflecting financial deepening. The engine for economic growth, private investment, increased by 6 percentage points to above 20 percent of GDP. According to business surveys, today’s institutional environment compares favorably with other middle-income countries. Underpinning these achievements were improved monetary and fiscal management, substantial structural reforms, including privatization and bank restructuring, sustained educational investments, absence

of major price distortions, export orientation, openness to foreign investment, and labor reform.

These positive factors notwithstanding, for a number of critical factors for economic and social development, by 1997, the Philippines still fared below the norm for the East Asia region—with lower national savings and

FIGURE 2: Economic Growth in the Philippines and Neighboring Countries



investment, higher import duties, more rapid population growth, inadequate infrastructure, an inefficient bureaucracy and judicial system, corruption, and insecurity. Some of the country’s social development indicators, such as the incidence of communicable diseases and the quality of and access to educational services by the poor, had even regressed in recent years.

On the whole, however, the country’s strengths and momentum outweigh its fragile elements. The Philippines is coping with the region’s financial turmoil better than its neighbors. Most importantly, the government is committed to completing an deepening the reform agenda.

Bank Assistance: Satisfactory, But Uneven and Below Potential

Bank projects over the past dozen years have performed relatively well. Rating for completed projects are almost up to par with the East Asia and Pacific region for outcome and sustainability, and even better for institutional development impact. Remarkably, all five adjustment loans (\$1.2 billion) since the mid-1980s received a satisfactory outcome and likely sustainability ratings. All but one received a substantial institutional development rating. For investment lending (\$1.6 billion), the picture is also positive.

The Philippines had a healthy project portfolio through 1997. It was (and remains to date) the third largest in the EAP region, after China and Indonesia, both in total commitments and in the number of projects. Its performance was in line with EAP averages, which were better than those of any other region. The overall cost of Bank assistance was only slightly above comparators’ ranges, attributable to the higher

Weathering the Storm

IN THE MID-1990S, CARELESS FOREIGN AND domestic investors created bubbles in the real estate, capital, and foreign exchange markets. Suddenly, in the second quarter of 1997, international portfolio investors awakened to the risks and discovered structural economic weaknesses hitherto ignored. It was because of two of its weak fundamentals—low and stagnant national savings and an appreciated real exchange rate—that the Philippines was relying heavily on foreign savings to finance both the large and growing gap between private investment and savings and the smaller (and shrinking) gap in the public sector. Rising dependence on short-term foreign capital inflows and loss of competitiveness left the country exposed to the contagion effect of the Asian financial crisis.

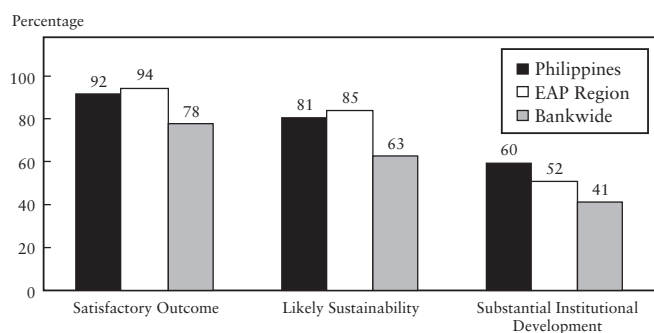
Nonetheless, the impact of the 1997 currency crisis has been relatively contained in the Philippines' young economic recovery and short-lived asset bubble relative to the other Asian countries, its transparent and committed government, and limited moral hazard with respect to private investors and banks. The banking sector was in a relatively strong position, with good asset quality, competent management and a relatively small exposure to a property sector with low vacancy rates—the result, over the last decade, of opening up the financial sector to increased foreign competition, rationalization of financial institutions,

an improved regulatory environment, and the short span and limited scope of the economic boom.

To be sure, the currency crisis is likely to cause a temporary slowdown in economic growth, with some pain for highly leveraged enterprises (and their workers) so dependent on domestic demand. It is also possible that a few (likely small) financial institutions with weak loan portfolios and large short-term exposures in foreign currency will face bankruptcy or consolidation. The fallout on the real economy, however, is likely to be contained, and over the medium-term, growth is expected to benefit from the country's improved competitive position derived from the real exchange rate depreciation.

The institutional and economic reforms introduced with the support of the Bank since the mid-1980s, including those that restructured the central bank and strengthened the financial sector, were instrumental in enabling the country to contain the contagion from the still unfolding East Asian crisis. The economy would have been even more resilient, however, if the authorities had heeded the Bank's early warnings (since 1994, and including at the senior management level) of the economy's increasingly risky exposure to volatile short-term capital flows. During 1995-97, however, the strong vote of confidence by international investors and reform fatigue by the government contributed to a slowdown in institutional and policy reforms.

FIGURE 3: Completed Project Ratings (by commitments FY 86-97)



cost of supervision. The performance of the most current portfolio (24 projects, \$2.2 billion, as of October 1998), however, has deteriorated over the last year in both absolute and relative terms, due to the effects of the financial crisis. Only 84 percent of projects (by value) under supervision are rated satisfactory, down from 93 percent. The country's portfolio performance, which continues to trail that of the region (86 percent), has recently fallen

below the bankwide average (88 percent). The most common general reasons for poor performance remain project management and procurement problems.

Nonetheless, the whole is less than the sum of individual projects. The assistance strategy has moved effectively from economic recovery to poverty alleviation, in line with Government and Bank priorities. But this shift is not yet complete, as it took root only in the mid-1990s, with new operations in support of elementary education and agrarian reform.

During the past dozen years, Bank assistance has been relevant and efficacious at the macro level, in private sector development (including of small and medium enterprises), and in municipal development. The Bank supported the structural adjustment reform process with a wealth of high-quality economic and sector work, effective and, on the whole, harmonious policy dialogue, good aid coordination, and judicious reinforcement of covenants in investment projects. Bank lending assistance provided \$1.2 billion to fund five major and successful quick-disbursing operations covering critical reform areas in public

sector and debt management, trade and capital account liberalization, internal competition, private sector participation in infrastructure, and banking sector strengthening. The overall strong intellectual contribution of the Bank's analytical and advisory work, however, was somewhat weakened by inadequate participation and in-country dissemination, and, in some cases, poor timing or insensitivity to the concerns of government officials and Bank resident staff.

The Bank's relevance and efficacy in other sectors have been uneven, despite good project-specific outcomes. Assistance has ranged from relevant and marginally satisfactory in some sectors (water and sanitation, and transport) to poorly relevant and/or unsatisfactory in others (health, education, agriculture, energy, decentralization). In the power sector, Bank support was only partially helpful in coping with the serious crisis during 1990-92 and in resolving institutional and financial weaknesses with the public generation and transmission utility. In agriculture, the Bank fell short in pushing the government on agrarian reform, which, when considered against high protective barriers on food products, has had little impact on improving the performance of the agriculture sector or the welfare of the poor. Also, Bank assistance did not focus, until recently, on access to educational services among the poor, and it has been limited in health and family planning.

Finally, in recent years, surging private capital inflows, complacency, and reform fatigue by the government contributed to a reduction of the Bank's role and in the volume of its lending commitments. In aggregate, for the period 1986-97, the total net resource flow out of the country and to the Bank was a staggering US\$2.7 billion, and was projected (as of mid-1997) at US\$536 million for 1998 (and rising) for subsequent years. Adjustments to the lending program since early 1998 have temporarily corrected this problem. However, this past large net negative resource flow and the winding down of adjustment lending in the mid-1990s represent a missed opportunity in the face of a large unfinished agenda of structural reform, low national savings and inadequate public investment.

The Unfinished Development Business

Just as the Philippines has emerged stronger from the economic and social disarray that prevailed before 1986 it is likely to successfully meet the challenge posted by the current regional crisis. The resilience of the country and its people—tested repeatedly by a variety of domestic, natural, and global exigencies—augurs well for deeper and more rapid economic and social advancement in the wake of the Asian crisis. Its fallout provides an opportunity for policy and institutional reforms to

fuel the economy's renewed competitiveness. The authorities have received a strong reminder of the critical need to strengthen the financial sector, boost national savings, and correct the perverse tax and reserve incentives that favor dollar intermediation by banks through foreign currency deposits. If, as expected, the authorities act on these signals, speculative capital flows will be discouraged in favor of longer-term portfolio, and direct investments and the banking sector will emerge strengthened and more savvy.

The Philippines must now mobilize the key ingredients—political stability, broad consensus, government commitment, support from the donor community, an educated, skilled, hard-working and English-speaking population, and a 12-year record of good economic management—to gather more momentum and make the leap needed to join the ranks of the newly industrialized countries.

While expanding its already liberalized environment—a valuable distinction from its neighbors—the country should apply the lessons of the East Asian miracle as well as those painfully drawn from the most recent crisis. Investment levels should be increased and sustained with higher domestic savings and less volatile sources of foreign savings. The country should shift the composition of foreign savings by tapping underutilized external sources of long-term funds, so as to reduce the economy's dependence on future short-term capital flows. Beyond the trickle-down benefits from accelerated, broad-based growth, poverty reduction programs should target the truly needy. Remaining policy and institutional constraints in the social sectors, agriculture, national resource management, and infrastructure should be addressed. Finally, implementation capacity must be improved. Such an effort could help the Philippines race ahead in social and economic progress on the strength of excellent, not just good, policies and institutions.

Towards a New Country Assistance Strategy: Moving to a Higher Plane

To help the economy reach its growth potential, fortify its resilience to shocks, and deliver greater benefits to the poor the Bank should focus its assistance on helping the government pursue and deepen its unfinished reform agenda. The challenge ahead for the Bank is fivefold:

- help the government address known macroeconomic and governance weaknesses in the banking system, capital markets, public sector management and judicial system;
- mount an integrated Bank/IFC/MIGA assistance program for private sector and infrastructure development, including completing the regulatory frame-

- work, further privatizing power and water supply, and scaling-up lending for municipal development;
- adjust human development strategies and programs, leaving lending to donors providing concessional funds as preferred by government, while maintaining its lending analytical and advisory role;
 - mobilize efforts for a rural action program and an improved agricultural policy framework, including support for import tariff reductions on grains and the completion of land reform;
 - improve selectivity of Bank lending and nonlending assistance and strengthen partnerships by expanding participation and explicit coverage of donors and the NGO community in strategy, ESW and project preparation.

The Bank should help in the design, financing, coordination and implementation of a medium-term, broad-based development effort. A new compact among the government, the NGOs, the Bank and the rest of the donor community to mobilize and effectively use external assistance is needed. It should support a strong medium-term development program, backed by long-term sources of foreign savings and minimal wasteful competition among donors. The Bank should increase the selectivity of its nonlending assistance to improve the depth of its analysis and to increase participation. Lending assistance should also be selective, in coordination with other donors, but also larger, so as to support the unfinished reform agenda and the additional investment needs through a diversified set of instruments—quick-disbursing operations, financial intermediary loans, sector in-

vestment loans, guarantees, and new adaptable lending instruments. It appears that an expansion of budgetary resources allocated to the Philippines would be required to support such assistance.

Bank Management, in its response, agreed on most of the findings but disagreed with OED's less-than-satisfactory judgement of Bank efficacy in the power, agriculture, and social sectors. It also disagreed with OED's recommendations to leave lending to other donors in the social sectors, as it believes that there is a lending role for the Bank, including in the reform of the vocational and higher education sectors, if the government were to take some difficult decisions. While Bank management thought that a joint CAS was not feasible, it agreed to undertake a highly participatory CAS involving all stakeholders and taking fully into account other donors' activities.

The World Bank Executive Board's Committee on Development Effectiveness endorsed the analysis and most of the recommendations of the OED study, including resumption of lending for adjustment and financial intermediaries. It, however, agreed with the management's response in that it would be premature for the Bank to withdraw from lending to the social sectors. The Committee also did not fully endorse the recommendation of a joint CAS with donors by 1999, but instead directed management to prepare a participatory CAS taking fully into account other donors' activities.

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*Country Assistance Review: "The Philippines" by Gianni Zanini, Report No. 17417, March 1998. Available to Bank Executive Directors and staff from the Internal Documents Unit and from regional information service centers, and to the public from the World Bank InfoShop:
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