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**The Philippines –
The Sick Man of Asia?**

Economic development in the Philippines after 1946

by

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Abstract

The Philippines has been labelled the Sick Man of Asia. In the early 1950s the Philippines was among the richest and most advanced countries in Asia, but has been surpassed by many of its neighbours over the last decades. In this paper we argue that though the political and economical system of the Philippines has been highly inefficient, it is not entirely correct to use the Sick Man label. The Philippine performance has not been much worse than that of other poor middle-income developing countries. Some of its neighbours have, however, departed from import substitution policies at a time that has allowed them to take advantage of the growing demand for manufacturing goods and the spread of industry in Asia.

Non-technical summary

Measured on a GNP per capita basis, the Philippines has been among the poorer half of developing countries in the entire post World-War II area. The average growth rate in the period 1960-1997 was 0.9%, which is marginally better than the average for lower middle-income countries. In this respect the Philippines has neither done particularly well nor particularly poorly the last decades. However, the Philippines had the second highest GDP per capita and the most 'modern' production structure of all Asian countries in the early 1950s, only beaten by Japan. During the following decades the picture changed completely, however, and in this respect something has gone terribly wrong for the country.

In this paper we review the industrial and political climate in the Philippines after 1946, and compares the development in the Philippines with that of Hong Kong, Singapore, South Korea and Taiwan (the first generation of Asian tigers) and Indonesia, Malaysia and Thailand (the second generation of Asian tigers). We then use the new economic geography literature to give a possible explanation of why the Philippines has developed so unfavourably compared to its successful neighbours. Our main argument is that the latter economies departed from import substitution at a time that allowed them to take advantage of the spread of industry in Asia. The increasingly higher cost level in Japan made the relatively open economies Hong Kong, Singapore, South Korea and Taiwan favourable locations from the early 1960s. As these countries experienced higher cost levels along with their rapid industrialization, the industry in the 1980s spread further to Indonesia, Malaysia and Thailand, who had just adopted a more outward oriented trade policy. In this sense it may partly be a coincidence that their trade liberalization policies were so successful. We further argue that since the second generation of tigers still have capacity for more industrial activity, it is not obvious that the Philippines will gain very much by liberalizing trade today.

Some Asian economies have been very successful in attracting foreign direct investments (FDI), and in this paper we also provides a comparison between FDI inflows to the Philippines and the second generation of Asian Tigers. There have been four major waves of FDI flows to the Asian countries in the post-war period. The first wave was motivated by the import substitution policies that most Asian countries followed in the late 1960s, and by the first major revaluation of the yen. During this period FDI inflows to the Philippines were greater than to Thailand, with Malaysia as the largest recipient of the ASEAN-4 countries and Indonesia the second largest. The second wave, which occurred in the 1970s, was mainly caused by the apparently good economic prospects for the region and the availability of cheap

capital. This wave included both import substituting and export-oriented production by American firms, with significant increases in FDI inflows to most of the East and Southeast Asian countries. The third wave started in the mid 1980s, and was caused by a need for firms in Japan and some of the NICs to relocate to countries with lower wage levels. The fourth and ongoing phase is characterized by massive FDI inflows to China.

The Philippines was relatively successful in attracting FDI inflows during the first wave, because it offered foreign investors access to a highly protected domestic market. However, the low income growth in the Philippines implied that the country was not particularly attractive for import substituting foreign direct investments on a large scale. An inefficient and corrupt bureaucracy, together with high tariff barriers, has further made it cumbersome and expensive for firms in the Philippines to participate in international trade. The Philippines therefore missed out on both the second and third waves of FDI to the Asian countries. Despite several attempts to liberalize trade and improve the bureaucracy, the country has been only moderately successful in attracting FDI also in the recent years. A main reason for this may be that the country does not seem to have any clear locational advantages, and is plagued by a very poor infrastructure and a bureaucracy that still has a poor reputation.

Chronology of Significant Economic and Political Events in the Philippines

1946	The Philippines achieves independence. Enactment of the Bell Trade Act providing for an eight-year period of free trade between the US and the Philippines, with gradually rising tariffs thereafter.
1948	Restrictions on imports of 'luxury and nonessential' goods.
1949	Balance-of-payment (BOP) crisis. Imposition of import and foreign exchange control, and full-scale import substitution policy.
1955	Laurel-Langley agreement; acceleration of the rate at which imports from the US would be subject to full amounts of Philippine tariffs.
1957	Adoption of a protective tariff structure. Raised the duties on non-essential finished goods and on goods that could be produced domestically.
1959	Introduction of a 25 per cent margin fee levied by the Central Bank on sales of foreign exchange.
1960-1965	Import substitution policy continues, with higher tariff rates. Devaluation of the Peso, deregulation of the currency market, and decontrol on imports (with some substitution of quotas and import licences for higher tariffs).
1965	Ferdinand Marcos elected President.
1967	Passage of the Investment Incentive Act (IIA) granting special tax privileges to key domestic industries. Investments in pioneer industries could be totally foreign-owned while investments in nonpioneer industries were restricted up to 40 per cent equity. Allowed for full foreign ownership also if at least 70 per cent of production was exported. The Board of Investments (BOI) was created to carry out the provisions of the act.
1969	Ferdinand Marcos re-elected as President. Escalation of radical protests.
1970	BOP crisis. Floating of the Peso. Export Incentive Act; the first step toward redirecting investments away from import substituting industries.
1972	Declaration of Martial Law. Establishing Export Processing Zones (EPZ).
1980	Trade Reform Program (TRP Phase I). Under a World Bank structural adjustment loan, the government embarked on a program to reduce the level and dispersion of tariff rates and remove quantitative restriction over a five-year period. Proceeded broadly on schedule until the 1983 BOP crises.
1981	Lifting of Martial Law.
1983	Reducing capital-cheapening measures such as accelerated depreciation and expansion reinvestment allowances. Gave strong preferences to exports and substituted performance based benefits for capital-based ones. Beningo Aquino assassinated.
1984-1985	Massive demonstrations, for the first time the urban middle class and the business community participated.

1986	February People Power Revolution. Corazon Aquino elected President. Coups attempted in July and November.
1987	Reduced restrictions on FDI (40 per cent foreign ownership allowed even in non-pioneering industries, c.f. the Act of 1968). Income tax holidays for enterprises engaged in preferred areas of investments, and labour allowance for tax deduction purposes. Reintroduced capital cheapening institutions. August coup attempt.
1989	Nearly successful December coup.
1991	Foreign Investment Act. Liberalized the existing regulations by allowing foreign equity participation up to 100 per cent in all areas not specified in the Foreign Investment Negative Lists A, B, and C. List C contains areas in which there already exists an "adequate number of enterprises". Four-year plan intended to reduce the maximum tariff rate to 50 per cent and reduce the effective protection rates in general (TRP Phase II).
1992	Fidel Ramos elected President.
1993	Creation of an independent Central Bank, Banko Sentral ng Pilipinas (BSP). Deregulation of the entry of new domestic banks and bank branching.
1994	Easing of restrictions on the entry of foreign banks.
1995	Liberalization of the private insurance industry.
1997	Asian financial crises break out.
1998	Joseph Ejercito Estrada elected President.

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1. Introduction

The Philippines was one of the most prosperous countries in Asia during the first decade after the Second World War. GDP per capita in 1960 was ten per cent higher than in South Korea, and the Philippines was the largest recipient of FDI inflows in the region (Medalla et al, 1998, Summers and Heston, 1991). Thereafter the economy stagnated. By 1995 GDP per capita in the Philippines was 75 per cent lower than in South Korea, and the inflow of FDI was very modest.

Table 1 shows that the Philippine service sector grew considerably between 1960 and 1995, much more than the industrial sector. This is troublesome, since a large share of the labour force thereby finds itself employed in service activities where wages and productivity are very low (Cororaton and Abdula, 1999). Indeed, nobody who has visited the Philippines can have avoided noting the excess of cigarette sellers on the streets or the surplus of labour in hotels and shops. Though development need not go through industrialization, the slow growth rate of the industrial sector has been taken as a sign of inability to adjust and modernize (see Medalla et al, 1998).

Table 1: Employment by sector (%)

	1960	1965	1970	1975	1980	1985	1990	1995
Agriculture	61.2	56.7	53.7	53.5	51.4	49.0	45.2	43.5
Industry	12.6	11.3	12.6	12.1	11.6	10.7	10.7	16.1
Services	26.2	31.5	32.1	34.1	36.5	40.2	44.0	40.5

Source: Cororaton and Abdula (1999)

There are typically two factors that have been used to explain the poor performance of the Philippine economy. First, political instability and social unrest have plagued the country, and there has been a serious tension between labour and capital. This has partly been caused by an extremely skewed income distribution, and the term ‘crony capitalism’ seems to fit very well for the Philippines. Secondly, the country embarked on an import substitution policy (ISP) soon after its independence. This policy was initially implemented in order to solve balance of payment problems and foster infant industries, but soon took on the character of a permanent protection of the domestic industry. Below, we argue that both these factors have worked negatively, but that the ‘Sick Man’ label may be somewhat misleading. With GNP per capita equal to \$1160 in 1996 the Philippines belongs to the group of lower-middle-income developing countries, and has done so since its independence in 1946.¹ The average annual

¹ The World Bank (1998) classifies low-income countries as those with a GNP per capita of \$785 or less in 1996, while middle-income countries have GNP per capita between \$785 and \$9636. Lower-middle-income and

growth rate per capita between 1965 and 1996 was equal to 0.9%, compared to 0.8% for lower-middle-income countries as a whole (the average growth rate for all middle-income countries was 0.9%). When the Philippines has been called ‘the sick man of Asia’, it is thus important to bear in mind that the development in the Philippines has not been particularly bad compared to other poor countries.

Judged against the so-called Asian tiger economies, however, the ‘sick man’ label makes much more sense. The first generation of tigers had per capita growth rates between four and seven per cent each year between 1965 and 1996, and the second generation embarked on a similar growth path from the early 1980s.² As we see it, the problem is not so much to explain the disappointing development in the Philippines as to explain why its neighbouring countries have done so extraordinarily well. On this background we will concentrate on the Philippine development from its independence in 1946 and until the early 1990s, though we will also comment on the more recent development.

This paper is organized as follows. Section 2 presents a brief survey of some of the most important economic indicators for the Philippines, and compares these with the other ASEAN-4.³ In Section 3 we review the industrial and political climate in the Philippines after 1946, while we in Section 4 use the new economic geography literature to give a possible explanation of why the Philippines has developed so unfavourably compared to its successful neighbours. Our main argument is that the latter economies departed from import substitution at a time that allowed them to take advantage of the spread of industry in Asia. The increasingly higher cost level in Japan made the relatively open economies Hong Kong, Singapore, Taiwan and South Korea favourable locations from the early 1960s. As also these countries experienced higher cost levels along with their rapid industrialization, the industry in the 1980s spread further to Indonesia, Malaysia and Thailand, who had just adopted a more outward oriented trade policy. In this sense it may partly be a coincidence that their trade liberalization policies were so successful. We further argue that since the second generation of tigers still have capacity for more industrial activity, it is not obvious that the Philippines will gain very much by liberalizing trade today. In Section 5 we return to a description of the

upper-middle-income economies are separated at GNP per capita of \$3115. High-income economies are those with a GNP per capita of \$9636 or more. It should be noted that purchasing power parity (PPP) adjusted GNP gives a better impression of the material standard of living compared to the US, and with this measure the per capita income in the Philippines equals \$3550. This does, however, not change their ranking as a lower-middle-income country, see World Bank (1998) for a discussion.

² The first generation of Asian Tigers consists of Hong Kong, Singapore, South Korea and Taiwan, while Indonesia, Malaysia and Thailand are known as the second generation of Asian Tigers.

³ The Association of East Asian Nations (ASEAN) consists of Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand. The ASEAN-4 members are Indonesia, Malaysia, the Philippines, and Thailand.

Philippine economy, and discuss why the Philippines apparently has not been a particularly attractive country in which to undertake FDI. Section 6 contains a discussion and some concluding remarks. In Appendix A1 we use the Philippine IT industry as a case study to illustrate some of the structural weaknesses that have plagued the country, while the effects on the Philippine economy of the Asian financial crises are briefly discussed in the Appendix A2.

2. Some Economic Indicators

The Philippines consists of some seven thousand islands stretching over more than a thousand miles from north to south and seven hundred miles from east to west, but only two thousand of these are inhabited. The two official languages are Pilipino (Tagalog) and English. A share of 82% of the population is Roman Catholic, 9% is Protestant, 5% is Muslim, and 3% is Buddhist.⁴

Figure 1: Map of Asia.



Source: University of Oregon

The population in 1996 was 72 million, much smaller than Indonesia but considerably larger than Malaysia (see Table 2). Measured in terms of GNP the Philippines is the smallest of the ASEAN-4 countries, and is ranked as number 36 of the 130 countries covered by The World

⁴ The Muslim population is concentrated in very poor parts in the South of the Philippines, and is fighting for independence. Extreme groups of Muslims have at various times caused major problems for the country, particularly after 1986. There have been several attempts of peace agreements, but the hijacking of tourists from Malaysia in April 2000 shows that the problems are still acute.

Bank's *World Development Indicators*. In terms of GNP per capita the Philippines is ranked as number 70, just ahead of Indonesia and far behind Malaysia.

Table 2: Economic size of the ASEAN-4 countries, 1996.

	Population	GNP		GNP per capita	
	Millions	\$Billions	Rank	\$	Rank
Philippines	72	83.3	36	1160	70
Indonesia	197	213.4	22	1080	74
Malaysia	21	89.8	35	4370	32
Thailand	60	177.5	24	2960	46

Source: The World Bank (1998)

Purchasing power adjusted PPP per capita increased relatively smoothly from independence and until 1983, with an average of approximately one per cent per year (Summers and Heston, 1991). Then the country entered into a phase of economical and political crises after the assassination of Benigno Aquino, who was the leading political opposition leader in the country. In 1986 the People Power Revolution broke out, and the same year Corazon Aquino (wife of the late opposition leader) was elected president. Since then the Philippines has been a democratic country, as it also was between 1946 and 1972.

Though the average Philippine growth rate in the post World War II area does not differ much from the 'typical' lower-middle-income developing country, its economical ranking in Asia has declined substantially. In 1950 the Philippines was one of the most promising Asian countries, only beaten by Japan in terms of educational level and technological sophistication (Medalla et al, 1998), but is now far behind many of its neighbouring countries. This is illustrated by Table 3, which shows PPP adjusted GDP per capita for some Asian countries relatively to the Philippines in 1960 and 1990.

Table 3: GDP per capita (PPP) relative to the Philippines

	Indonesia	Thailand	Korea	Malaysia
1960	0.55	0.63	0.91	1.38
1996	0.93	1.89	3.68	2.92

Source: The World Bank (1998)

In the next two sections we will discuss several possible explanations for the disappointing development in the Philippines compared to the more successful Asian countries, but from a pure accounting perspective it is clear that differences in factor accumulation and factor productivity must play a key role. With respect to the former, the investment ratios (as share of GDP) were quite similar in the ASEAN-4 until about 1985 (Summers and Heston, 1991).

Then the political crises and the subsequent revolution caused a sharp decline in the investment and savings ratios in the Philippines, along with significant positive jumps in Thailand, Korea, and Malaysia. Almost fifteen years of democracy, and nearly ten years of political stability, have not changed this picture very much. In 1996, for instance, the investment ratio was equal to 23 per cent in the Philippines and 40 per cent in the other ASEAN-4 countries (Yap, 1998).⁵

Growth in total factor productivity (TFP) is notoriously difficult to measure, but several cross-country studies confirm the impression that this is an area where the Philippines has not been successful (see Austria, 1998a, for references). An example is given in Table 4, which shows that the Philippines systematically has had negative TFP growth rates over the last decades, while particularly Thailand has fared quite well.

Table 4: Annual growth rates of TFP, ASEAN-4.

Period	Philippines	Malaysia	Indonesia	Thailand
1960-73	0.7	1.0	1.1	1.4
1973-84	-1.3	0.4	0.5	1.1
1984-94	-0.9	1.4	0.9	3.3
1960-94	-0.4	0.9	0.8	1.8

Source: Austria (1998a)

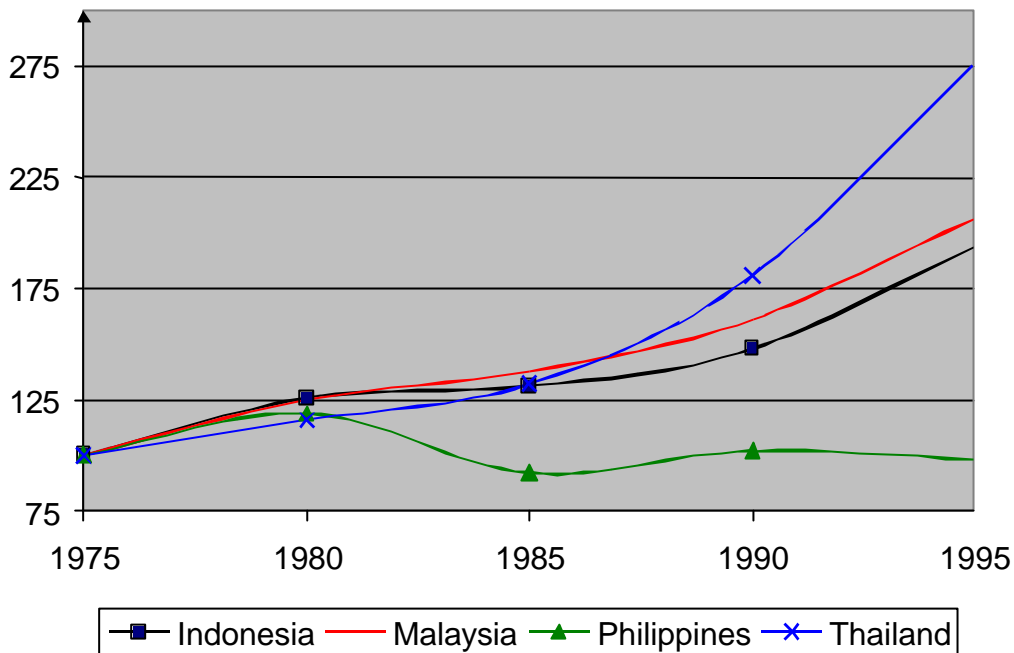
Hand in hand with low productivity growth, the Philippine economy has also been slow to restructure. In 1970 the share of agriculture value added in GDP equalled 30 per cent, and in 1996 it still constituted 21 per cent of GDP.⁶ During the same period the share of agriculture value added in Indonesia decreased from 45 per cent to 16 per cent (World Bank, 1998). Moreover, the growth rate of value added has been slower in all sectors of the economy in the Philippines than in the other ASEAN-4 countries. This is particularly true for industry, where value added increased by an annual average of less than two per cent between 1965 and 1996, against some 9 per cent in Indonesia, Malaysia, and Thailand.

Figure 2, which shows the evolution of overall average labour productivity in the ASEAN-4, is perhaps even more telling. During the period 1975-1995, labour productivity has fluctuated around the same level in the Philippines, while it has increased significantly in the other countries. The picture is the same also if we split up and consider labour productivity in agriculture and manufacturing separately (Yap, 1998).

⁵ Young (1995) and others argue that a higher participation rate in the labour force, caused by demographic factors, was an important factor behind the growth rate in GDP for the NICs in the 1960s and 1970s. That is not the case for any of the ASEAN-4 countries, for which a similar effect may appear early in the next century (see Bloom and Willimason, 1997).

⁶ This can hardly be attributed to any Philippine comparative advantage in agriculture, see Mandelle et al (1998).

Figure 2: Average labour productivity (1975=100).



Source: Yap (1998)

There is little doubt that the disappointing labour productivity in the Philippines is connected with low and inefficient investments, which in turn are an outcome of the general industrial and trade policy that the country has followed (see Yap (1998) and Austria (1998a,b)). While the ASEAN-4 countries historically had followed an import substitution policy, all except the Philippines adopted outward-looking strategies after the mid 1980s. The policy change occurred at the same time as Japan and Taiwan relocated their labour intensive industries to low-wage countries, but due to inward-looking policies the Philippines did not benefit much from this. According to Yap (1998) FDI did increase productivity in Malaysia, Indonesia, and Thailand, but not in the Philippines. Instead the protectionist policy led to inefficient production in sectors where the country did not have any comparative advantages, and to a system “where domestic investors (Filipino or foreigner) were insulated from competition and could earn extremely high profits” (Mercado-Aldaba, 1998:272).

3. Economical and Political Climate since 1946

The Philippines was extremely hard hit by the Second World War, and a large part of the concrete highway was completely destroyed by the Japanese. In 1946 the production levels in the mining and manufacturing sectors were only 1 and 18 per cent, respectively, of what they had been before the war. The fishing fleet was either destroyed or had been taken away by the Japanese, and not a single sugar mill was operating. The consequence of these damages was that total GDP in 1946 was only 35 per cent of its 1940 level (Baldwin, 1975).

Before the Philippines achieved independence from the US, it was enforced to agree on the Bell Trade Act, which granted eight years of free trade between the two countries. In return the US contributed significant amounts of economic aid and war damage payments along with, e.g., military investments. The Bell Trade Act was probably in the spirit of the Marshall Aid Plan, and in aggregate the US expenditures in the Philippines were \$393 million in 1945 and 1946, which more than covered total imports of \$364 million these years (Baldwin, 1975).

Despite the Bell Act the Philippines was allowed to restrict import of 'luxury and nonessential' consumer goods. The idea was not to encourage domestic production of these goods as such, but to permit more import of advanced capital goods to the industry and consumer goods for low-income groups. Due to inefficient policies and falling export prices (not least on coconut products, which constituted 68 per cent of export income in the 1947-49 period) the Philippines did, however, enter into a severe balance of payment crisis in 1949 (Baldwin, 1975). The political outcome of this crisis was that the country adopted a full-scale import substitution policy, and imposed comprehensive control on imports and foreign exchange. The protective system was further strengthened by an overvalued currency through high tariffs and quantitative import restrictions.⁷

⁷ Import substitution typically implies that the local currency - here the Philippine peso - appreciates, because the demand for foreign currency falls.

In the Philippines, as in other developing countries, the articulated rationale behind import substitution to a large extent relied on the infant industry argument. The belief that it was necessary to adopt a policy that protected ‘new and promising’ domestic industries was not very controversial at the time, and has even been endorsed by John Stuart Mill (1848, see Corden 1997):

The only case in which, on mere principles of political economy, protecting duties can be defensible, is when they are imposed temporarily (especially in a young and rising nation) in hopes of naturalizing a foreign industry, in itself perfectly suitable to the circumstances of the country. The superiority of one country over another in a branch of production often arises only from having begun it sooner. ... But it cannot be expected that individuals should, at their own risk, or rather to their certain loss, introduce a new manufacture, and bear the burden of carrying it on until the producers have been educated up to the level of those with whom the processes are traditional. A protecting duty, continued for a reasonable time, might sometimes be the least inconvenient mode in which the nation can tax itself for the support of such an experiment.

The first years of import substitution apparently worked quite well, with growth rates in real GDP per capita reaching eight per cent in 1953 (Summers and Heston, 1991). Thereafter the economy stagnated, and in 1957 the country adopted a new protective structure that lowered duties on raw materials and intermediate goods not available domestically. Simultaneously, duties on nonessential finished goods and items that could be produced domestically were increased. The result was disappointing; the economy was visibly inefficient and the negative trend continued.

Disillusionment over continuing disappointing growth rates throughout the late 1950s, obvious and widespread corruption, and dissatisfaction over the administration of the control systems, led to a phase of decontrol on imports and deregulation of the foreign exchange market during 1960 and 1965. The currency was devaluated, which presumably was a good thing, but the government also increased the tariff rates in order to maintain the import substitution regime and protect domestic industries. According to Baldwin (1975) this was a bad mix of policy, where better terms-of-trade for the export sector hurt the import-substituting sector and higher costs of imported raw materials and capital goods hindered any new type of export-oriented industries to be fostered. Thus, in the words of Ravenhill (1995), the Philippines “entered into a period characterized by economic and social readjustment where no sector of the economy prospered particularly well”.⁸

⁸ The decontrol period 1960-65 will be further discussed below; there are some indications that TFP improved slightly during this period, despite an overall disappointing economic development.

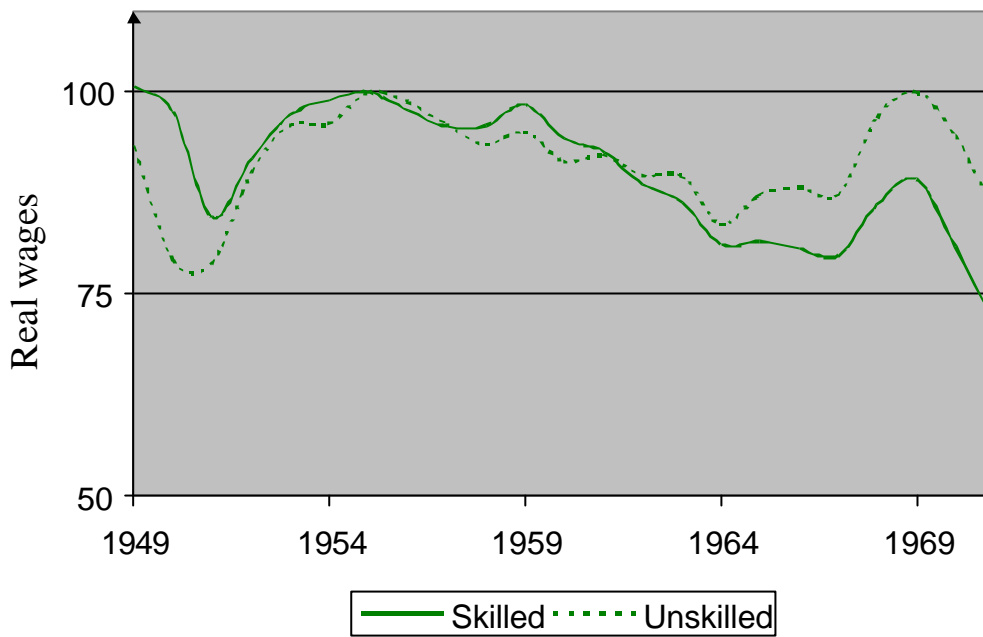
Some of the problems inherent in an import substitution policy will be discussed later,⁹ but at this stage it should be stressed that there is a consensus that the policy measures should be temporary and insulated from pressure groups. None of these conditions appear to have been present in the Philippines. First, according to Medalla et al (1998) the majority of the protected industries have continued to be incompetent even domestically, and the protection took on a permanent rather than a temporary nature. Secondly, the term ‘crony capitalism’ seems to be particularly relevant for the Philippines, more so than has been the case even in countries like Indonesia and South Korea. This led to a system where protectionism increasingly took the shape of protecting the special interests of landowners and the economic élite rather than protecting promising infant industries.

The problem in the Philippine economy in particular, and to some degree with interventionist industrial policies in general, becomes clear from the following statement by a former cabinet minister under Marcos (see Hawes, 1992): “proximity to the seat of power has always been the source of wealth in the Philippine political economy: sugar quotas, dollar quotas, tax exemption, etc., have always been important. With the advent of martial law [in 1972] the government was vastly more powerful, thus the opportunities for corruption were vastly greater.”

According to Ravenhill (1995) the ‘crony capitalism’ started well ahead of the Marcos-era (which lasted from 1965 to 1986), and was a main explanation for the bad performance in the 1960s. Also Baldwin (1975) is highly critical of the efficiency of the Philippine import substitution policy and the distributional consequences of the political system. For instance, both skilled and unskilled labour were worse off in 1971 than in 1949 in terms of real wages (see Figure 3). In a concluding remark on his study of the Philippine economy Baldwin (1975:149) maintains that those who are owning or controlling the firms in the business sector have been the major beneficiaries of the import substitution policy. He further argues that the investment incentive programs (with, e.g., tax holidays) to a large extent did not increase the productive capability, but “merely added to the excess capacity in the economy. [Imports] of such equipment provided jobs for foreign workers, but the equipment itself ended up in the Philippines as industrial monuments.” No wonder the Philippines has had a dismal productivity growth...

⁹ See Baldwin (1969), Corden (1997) and Bruton (1998) for detailed theoretical discussions, and Krueger (1997), Little et al (1970) and Bruton (1998) for empirical analysis.

Figure 3: Index over real wages (1955=100).



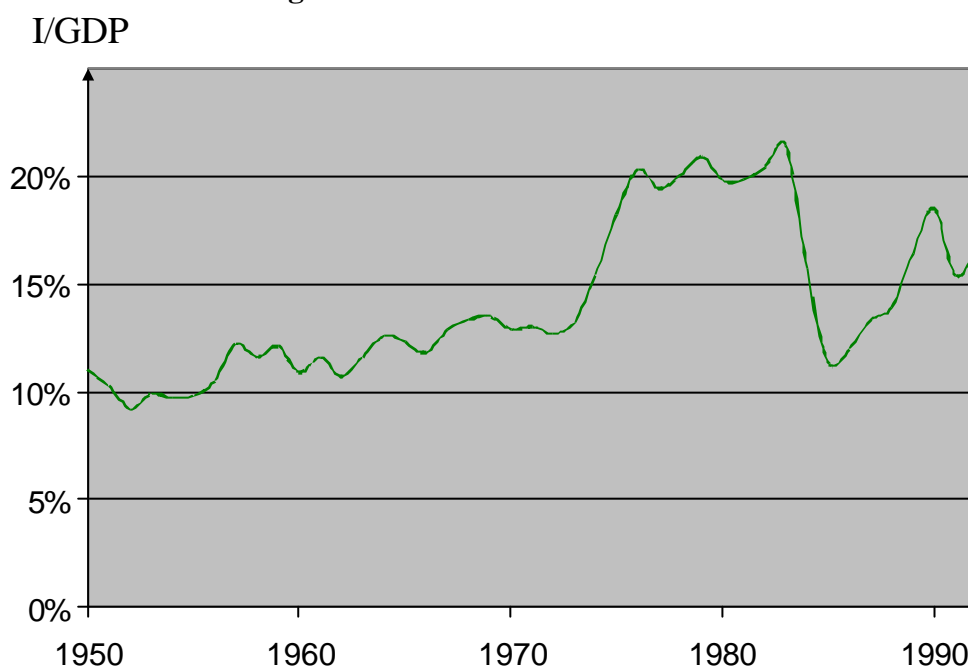
Source: Baldwin (1975)

When Marcos was elected president in 1965 the government immediately undertook measures to speed up the necessary transformation of both the agricultural and industrial sectors, eased access to credit and increased government expenditures and investments. The Investment Incentive Act which granted favourable taxes and reduced tariffs for imported goods in ‘new and necessary industries’ was introduced in 1967. A Board of Investment (BOI), which could allow firms in pioneer industries to be fully owned by foreigners, was created to supervise the Act. The import substitution policy was nonetheless continued, and the country entered into a new phase of balance-of-payment crisis in 1970. The same year an Export Incentive Act was introduced, and Medalla et al (1998) describe this as the first small step away from the pure import substitution policy (in practise the step was indeed very small, according to Mercado-Aldaba, 1998).

The Philippines did observe favourable economic development in some areas under Marcos’ presidency. The share of investments in GDP, for instance, rose sharply in the first half of the 1970s, and Figure 4 shows that the average investment share between 1976 and 1981 was some 20 per cent, compared to some 15 per cent earlier. However, the large income inequalities continued during the Marcos regime and there was a great deal of social unrest. Radical protests escalated in 1969, and a Martial Law was declared in 1972 and lasted until 1981. Marcos did little to redistribute income, and showed an inability (or unwillingness) to reduce the power of the economic élite (see Boyce, 1993, and Hawes, 1992, for discussions).

Moreover, and partly due to unfavourable economic conditions in the world markets during the early 1980s, real wages in the Philippines fell sharply. In 1984 the urban middle class for the first time participated in mass demonstrations against Marcos. The Marcos regime was in a serious lack of confidence, and in 1985 even the business community participated in anti-Marcos demonstrations. The instability led to a sharp fall in the investment ratio in 1984/1985. In February 1986 the People Power Revolution broke out, and later the same year Corazon Aquino was elected president.

Figure 4: Investments as share of GDP



Source: Summers and Heston (1991)

There have been some indications, albeit ambiguous, of reduced income inequalities the last decade, and real wages increased by some 2.8 % on average for the period 1987-1996 (Yap, 1998). What is worrisome, however, is that there has been almost no increase in labour productivity. There are thus clear signs that the Philippines has become increasingly incompetent in labour intensive industries, with too high unit labour costs (Asutria 1998b). This may constitute a serious problem for the Philippines, which hardly has any comparative advantage in high-tech industries, as low-wage countries like Vietnam and China become more integrated into the world economy.

That the Philippine development has not been particularly impressive even in the aftermath of the Marcos era, is evident also from Table 5, which measures the share of the

population which has less than \$1 per day (purchasing power adjusted) in some Asian countries. In 1985 some 32 per cent of the population in both the Philippines and in Indonesia fell below this poverty measure. Ten years later there was still 25 per cent of the Philippine population which had to manage on less than \$1 a day, but only 11 per cent in Indonesia. The table further indicates that the last decade China has fared much better than the Philippines in the fight against poverty.

Table 5: Poverty in East Asia.

	Headcount (%), <\$1 per day PPP		
	1985	1993	1995
Philippines	32.4	27.5	25.5
China	37.9	29.7	22.2
Indonesia	32.2	17.0	11.4
Thailand	10.0	<1.0	<1.0
Malaysia	10.8	<1.0	<1.0

Source: Yap (1998)

A number of empirical studies confirm the impression that the Philippines has fared poorly relative to the other ASEAN countries with respect to productivity growth for most of the post World War II period (see Austria, 1998b, for a survey). An example of this was given in Table 4 in Chapter 2. Austria (1998b) uses a co-integration technique in order to investigate how the total factor productivity has evolved during the different trade regimes. The results, which are reproduced in Table 6, are highly suggestive of the costs of the import substitution policy.

Table 6: TFP growth by industrial regime

Period	Industrial regime	TFP estimate (%)
1960-65	Decontrol	0.185
1965-70	Trade protection	-0.186
1970-80	Trade protection	0.093
	Export promotion	
1980-86	Trade liberalization	-2.89
	Macroeconomic crises	
	Political crises	
1986-96	Trade liberalization	0.93
	Investment liberalization	2.12 (excluding 1991-92)
	Foreign exchange liberalization	
	Energy crises (1991-92)	

Source: Austria (1998b)

First, note that a slightly positive increase in TFP was registered for the period 1960-65: in this respect Baldwin (see above) seems to have been unduly negative to the combination of

decontrol of the currency market and higher tariff rates.¹⁰ Secondly, TFP growth in the post Marcos area is quite strong compared to earlier periods.

Several coup attempts and political turbulence marked Corazon Aquino's presidential terms between 1986 and 1992. The situation did, however, stabilize with the election of Fidel Ramos in 1992, who was able to make a piece settlement between the far left and the far right political parties. This led to increased confidence in, and predictability of, the political system. During the same period extensive trade liberalization programs were undertaken, and the effective protection rates declined significantly in most industries (see Medalla et al, 1998). Also the financial sector was reformed and deregulated under President Ramos; it became easier for foreign banks to enter the market, and the supervision of the banking sector improved substantially. This may help explain why the Philippines was not as severely hit by the Asian economic crisis that broke out in 1997 as most other countries in the region (see Appendix A2).

The relatively high TFP growth rates after 1986 presumably reflect both a more favourable political climate and reduced economical distortions. Medalla (1998) has calculated the ratio of domestic resource costs to the shadow exchange rate as a measure of the competitiveness in different industries. The changes between 1983 and 1994 that are shown in Table 7 are remarkable. While 40% of the output was produced in highly inefficient industries in 1983, the number had declined to 13% in 1994. Similarly, the share of output from highly efficient industries increased from 19% to 42% during the same period.

Using the above measures of Austria and Medalla, there is little doubt that the overall efficiency has increased substantially the last decade, but Cororaton and Dueanas-Capras (1999) and Cororaton and Abdula (1999) maintain that the positive development has not been sustained. According to these studies the higher efficiency reflects a movement towards the production possibility frontier rather than technological progress.¹¹ Further empirical studies are needed to settle this matter.

¹⁰ Austria does not discuss the reason for the increase in higher TFP between 1960 and 1965 in particular. A useful hypothesis may be that rent seeking activities decreased as tariffs partly substituted for quotas and import licences, and foreign exchanges no longer were allocated by the bureaucracy.

¹¹ Cororaton and Dueanas-Capras (1999) claims that the agriculture sector has performed relatively good, while particularly service industries have been doing it very poorly with respect to TFP growth.

Table 7: Resource allocation and efficiency

Economic classification	Share in prod. value (%)			
	1983	1988	1992	1994
Highly efficient	19	40	44	42
Efficient-Mildly inefficient	29	23	29	38
Inefficient	12	15	8	7
Highly inefficient	40	22	18	13

Source: Medalla (1998)

4. A New Economic Geography Explanation of the Philippine destiny

The Philippine system of industrialization through import substitution led to the usual consequences of an overvalued currency and capital intensive production, and it opened up extensive corruption and rent seeking activities. Medalla et al (1998) maintain that the country has not been able to specialize according to comparative advantages – on the contrary, it seems that the protectionist system has favoured the sectors in which the country is relatively disadvantaged. The Philippines shares this experience with several countries in Africa and Latin America, and has performed equally poorly the last fifty years in terms of real GDP per capita growth rates. Thus, as argued earlier, the ‘sick man’ label used to describe the Philippines must be seen in relation to the development that has taken place in the NICs and the other ASEAN-4 countries. A thorough theory should therefore shed light both on the experience of the Asian miracle economies, and on the misfortunes of the Philippines.

In a seminal paper Krugman and Venables (1995) have shown how the combination of trade costs and vertical industry linkages can split two otherwise symmetric countries into an industrialized core and an agrarian periphery. Their basic presumptions are that a significant share of the firms in the manufacturing sector operates under internal increasing returns to scale, that there are gains from increased specialization of intermediate goods, and that international trade costs are higher than national trade costs. As with the forward and backward linkages discussed by Hirschman (1958) this may lead to a circular causation, whereby countries with an initial disadvantage in manufacturing tend to stagnate. Puga and Venables (1996, 1998) have later extended this framework to one with several countries and industries, and where the sectors differ with respect to labour intensivities and the strength of the inter-industry linkages. Industrial goods are taken to be income elastic, so that higher

income generates a more than proportional increase in demand for these goods.¹² It is, moreover, assumed that the average income increases over time, partly due to factor accumulation and partly due to exogenous technological progress.

Initially, when international trade costs are fairly high, most of the industrial activity is concentrated in one country only (Japan). This is due to the inter-industrial linkages, which – other things being equal – make it preferable for the industry to be located close to each other in order to save trade costs. As income and thereby demand for industrial goods increases, however, the wage level in the industrialized country (Japan) increases. Thereby the industry sector will grow in some of the other countries (the NICs), as particularly labour-intensive industries with weak linkages may find it profitable to locate in countries with relatively low wages. In the next round, as industrial demand has grown further and wages in the newly industrialized countries have increased, yet another group of countries (Indonesia, Malaysia, and Thailand) becomes industrialized.

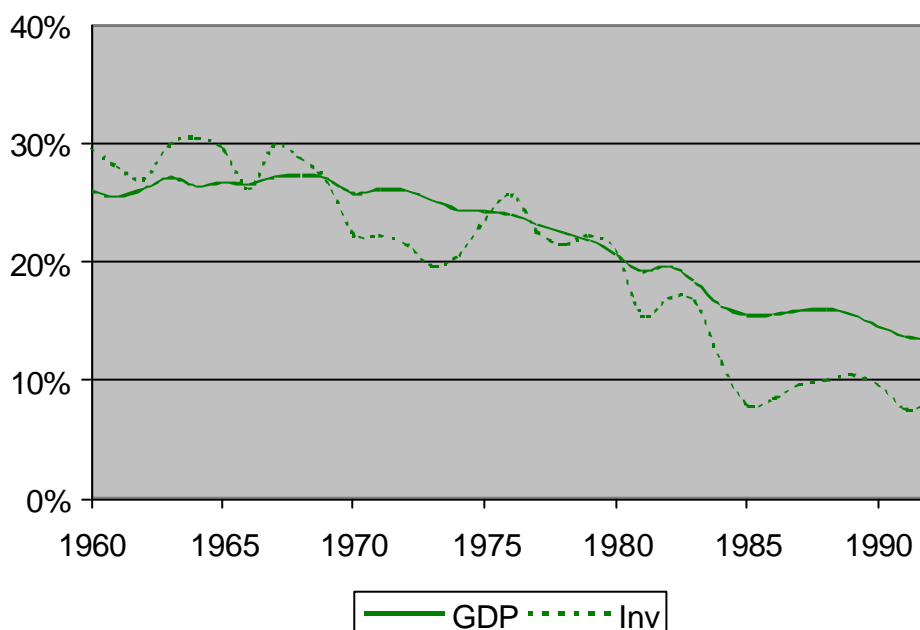
What determines which countries become industrialized? Two factors are of particular importance. First, other things being equal, the countries with the largest domestic markets are the most attractive ones. In this respect the positive income level effect of the high investment rates in the successful Asian countries was important.¹³ Secondly, the lower the level of trade costs, the more attractive a country tends to be. The reason is simply that there is always a cost disadvantage of being located at a distance from other industrial firms when trade is costly and we have inter-industrial linkages. Insight from economic geography models further tells us that even small differences in the trade policy can have catastrophic consequences for the ‘unfortunate’ country. This is due to the self-reinforcing nature of the linkages, which implies that two otherwise quite similar countries (Thailand and the Philippines) may end up on very different development paths if they differ somewhat with respect to the trade policy. The country with the lower level of trade costs (Thailand) may attract some industries from neighbouring economies that have high wages costs, and start to develop its own domestic backward and forward linkages. The country with high levels of trade costs (the Philippines), on the other hand, may even observe absolute de-industrialization because it becomes relatively more disadvantaged.

The prediction from the economic geography literature that GDP in the Philippines will be relatively low and that an increasingly smaller share of the investments in ASEAN-4

¹² It is an empirical fact that industrial goods are income elastic, and this is indeed one reason why import substitution policies were recommended in the 1950s and 1960s. See Prebisch (1950) for a discussion.

will be undertaken in the Philippines confirms very well with data. This is illustrated in Figure 5, which measures the Philippine share of ASEAN-4 GDP and investments. On average there was neither an upward nor a downward sloping trend in GDP or investments before 1970. In the 1970s and 1980s Japan and the first generation Asian Tigers began to outsource some of their labour intensive industries. As first Malaysia and thereafter Indonesia and Thailand began to liberalize trade, the share of investments and GDP in the Philippines declined rapidly.

Figure 5: The Philippine share of ASEAN-4 GDP and investments



Source: Summers and Heston (1991)

5. FDI in the Philippines

The Asian countries differ significantly in their attitudes towards inflows of FDI. At one end of the scale we find the restrictive policies of South Korea and Taiwan, and at the other end we find the highly friendly policies of Singapore. Some economists have argued that Singapore has provided too many incentives for FDI, and that the laissez-faire policy (neutral between foreign and domestic investors) of Hong Kong has been better suited for sustainable development (Young, 1992, 1994). These are questions that will not be address in this paper. Instead we will look at the actual inflow of FDI to the Philippines, and compare with the experience of the other ASEAN-4 countries. Neither of these countries differ much with

¹³ As is well known, the neoclassical growth model predicts that higher savings ratios increase the income level,

respect to policy incentives and restrictions towards FDI (Mercado-Aldaba, 1998), but they do differ with respect to the sector composition of FDI. The larger part of the FDI stock in Indonesia in 1990 was in the primary sector (82%), while the tertiary sector dominated in Thailand (48%). Malaysia and the Philippines have almost the same distribution between the sectors, with the highest share of the FDI stock in the secondary sector (41% and 48%, respectively). From the late 1970s the latter two countries also pursued policies to become hosts for the growing IT industry, and soon became major sites for chip assembly. The chip industry is, however, five times as large in Malaysia as in the Philippines. Moreover, the Philippines has only been able to attract those parts of the IT industry that offer the smallest share of value added, and few possibilities for technological spillovers. According to Mercado-Aldaba (1998) the major reason for this is that the Philippine industry has been unable to develop backward linkages. See Appendix A1 for further discussion.

It is not only in the IT industry that the Philippines has been less able than Malaysia in attracting FDI. Table 8 shows that Malaysia has by far the greatest stock of FDI as a share of GDP of the ASEAN-4 countries in 1992, while the Philippines has by far the smallest share.

Table 8: ASEAN-4 FDI stocks

ASEAN-4	Stock, 1992 US\$ mill.	Stock/GDP 1992 (%)
Total	97 291	13.5 %
Indonesia	23 875	22.0 %
Malaysia	19 699	40.3 %
Philippines	3 484	6.9 %
Thailand	12 206	13.2 %

Source: Petri (1995)

There have been four major waves of FDI flows to the Asian countries in the post-war period. The first wave was motivated by the import substitution policies that most Asian countries followed in the late 1960s, and by the first major revaluation of the yen. During this period FDI inflows to the Philippines were greater than to Thailand, with Malaysia as the largest recipient of the ASEAN-4 countries and Indonesia the second largest. The second wave, which occurred in the 1970s, was mainly caused by the apparently good economic prospects for the region and the availability of cheap capital.¹⁴ This wave included both import substituting and export-oriented production by American firms, with significant increases in FDI inflows to most of the East and Southeast Asian countries. The third wave started in the

but not the growth rates.

mid 1980s, and was caused by a need for firms in Japan and some of the NICs to relocate to countries with lower wage levels. The fourth and ongoing phase is characterized by massive FDI inflows to China.¹⁵

Figure 6 shows inflows of FDI in the Philippines from 1949 and until the end of the Marcos area in 1986, and illustrates that the pattern has been highly volatile. The relatively successful economic policy in the early 1950s is reflected in an increase in FDI inflows during these years. The majority of the investments was made to serve the domestic market, and was characterized by a change in the composition of FDI towards sectors protected by the import substitution policy. This resulted in a massive increase in the share of manufacturing in FDI, from 7.6 % in 1940 to 34.2 % in 1966.¹⁶

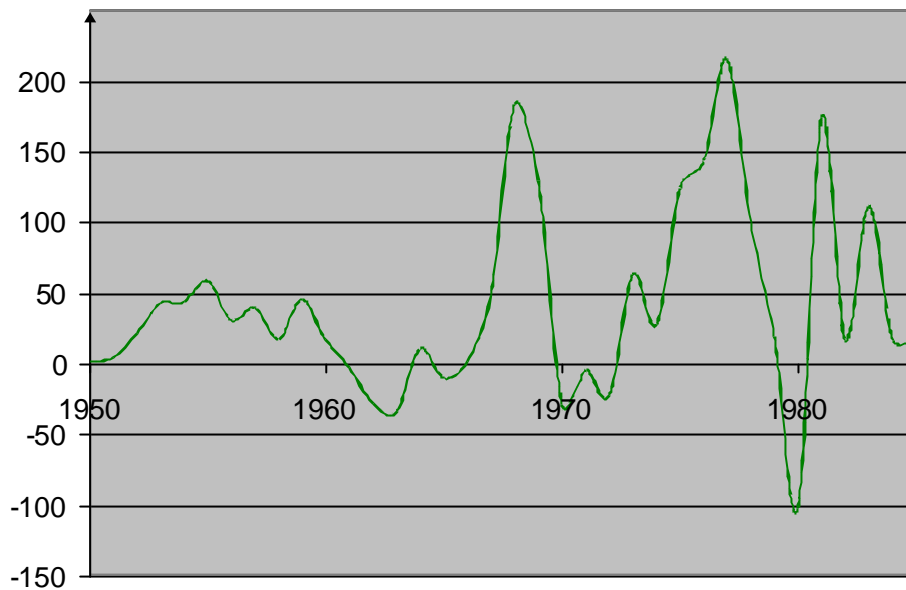
Economical and political problems, anticipation of termination of the special privileges to US investors, and a fee on foreign currency introduced in 1959 resulted in a steep fall in FDI flows between 1959 and 1965. For several years of this period there was indeed a negative FDI flow, as foreign investors drew back capital. This created balance of payments problems, and to attract more foreign capital the Investment Incentive Act (IIA) was introduced in 1967. IIA allowed foreigners to own all the shares in firms that were either established in so-called pioneering industries or that exported at least 70% of their output. Otherwise the foreign ownership was restricted up to a maximum of 40% of the equity. A Board of Investment was created to carry out the provisions of the act (see page 10).

¹⁴ It is an empirical fact that direct investments mainly are financed through local capital markets.

¹⁵ See Petri (1995) for a discussion of the four waves.

¹⁶ These figures are for US, which was practically the only investor in the Philippines until the 1980s (Mercado-Aldaba, 1998).

Figure 6: FDI inflows in the Philippines (in US\$ million)



Source: Mercado-Aldaba (1998)

The Investment Incentive Act resulted in a sharp increase in FDI flows in 1967 and 1968. Despite Marcos' nationalistic and relatively anti-American attitude (Marcos won the election against Sergio Osmeño, who was strongly pro-American), the import substitution policy during this regime was not hostile against foreign capital. Instead, the ISP led to a "framework within which national capital could forge an alliance with dominant foreign capital for joint exploration of a lucrative protected market" (Jayasuriya, 1987: 216). Industrial labour wages were declining, and real wages for peasants fell drastically due to discrimination against agriculture production (Boyce, 1993). The political climate became increasingly turbulent, and in January 1970 the first mass demonstrations and street claits occurred. The instability and uncertainty resulted in an outflow of foreign capital between 1969 and 1972. The political crisis culminated with the declaration of martial law in 1972.

The Philippines observed a sharp increase in inward FDI once the martial law was declared. Presumably this is partly a coincidence, since this was also the time for the second wave of FDI flows to Asia. However, it is also possible that the martial law was hoped to create more order and stability in the Philippines, and thus was welcomed by investors. Perhaps even more important was the change in policy towards easier repatriations of profits and some deregulation and decontrol of foreign direct investments.

It is not easy to characterize the political platform of Marcos' regime. On the one hand Marcos was clearly anti-American and highly sceptical to the alleged power of multinational corporations. His policy of delinking the ties between the Philippines and America meant that he lost the support of his pro-American Vice-President Lopez. On the other hand he was fighting vigorously against left-wing nationalist fractions led by, amongst others, Benigno Aquino. Furthermore, Marcos tried to reduce the skewed income distribution and the power of the economic élite by liberalizing the trade regime. In this his economic advisors who, somewhat ironically, mainly were trained in the USA supported him. His repeated attempts to depart from the import substitution policy cost him the backing of capital owners. The end result was that, as the revolution broke out in 1986, Marcos had lost the support from most classes in the Philippine society. See Jayasuriya (1987), Hutchcroft (1991), and Hawes (1992) for further discussions of the political economy of Marcos' regime.

While the Philippines was not particularly hard hit by the first oil price in 1972, the second oil price shock in 1978-1979 created severe economical problems for the country. The international price of important export commodities – most notably sugar and coconuts – fell sharply, and worsened the terms of trade for the country. Together with a downturn in world economic activity this caused an abrupt change in the positive trend of FDI inflows to the Philippines. For the rest of the Marcos' area the Philippines was unable to attract satisfactory amounts of FDI. The peaks in 1981 and 1983 are partly illusory, because the country's economical problems required that debts and imports were converted into foreign investments.¹⁷ In 1984 and 1985, the years when it became increasingly evident that the Marcos era was coming to an end, both net and gross FDI to the Philippines were close to zero.

Though political instability can help explain the *volatility* of FDI inflows to the Philippines, we must presumably also look at other factors in order to understand the comparatively low *level* of FDI. Why, for instance, did Thailand – with a political system perhaps even more unpredictable than that in the Philippines – observe a surge in FDI inflows in the 1980s?

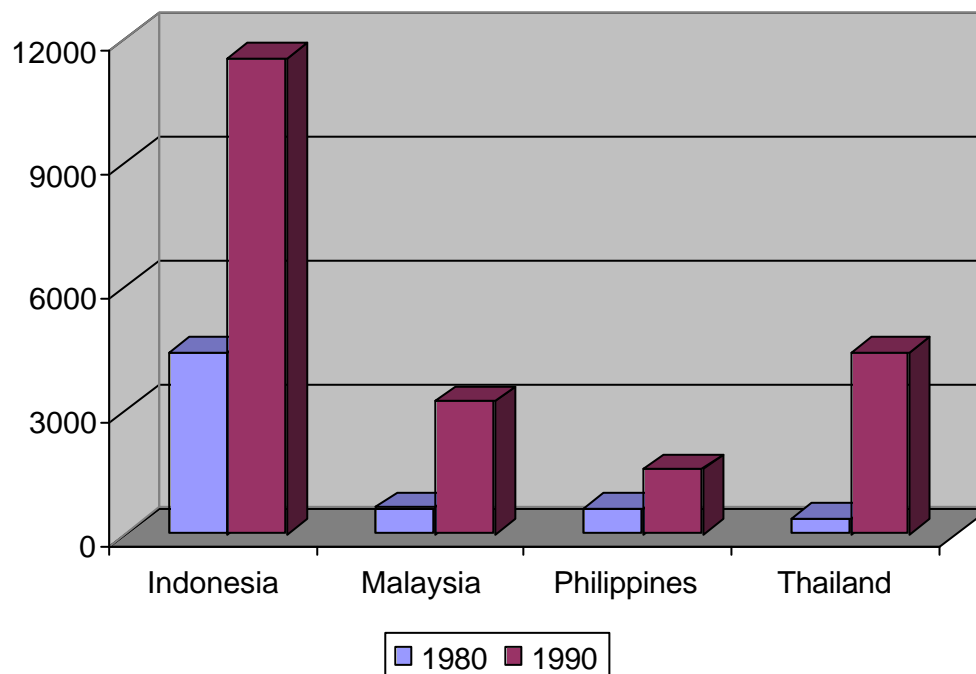
Presumably, part of the answer is to be found in trade and industrial policy. Japan and first generation tigers had high saving rates, and the fast economic progress caused the wage levels in these countries to rise significantly. By the mid 1980s Japan and South Korea were investing massively abroad to take advantage of lower production costs in other countries. At this time all the ASEAN-4 countries except the Philippines adopted more outward-oriented strategies, and promoted FDI in export-oriented sectors (Petri, 1995). Starting with the Export

¹⁷ This was part of a deal negotiated among private investors, IMF, the World Bank and the Philippine government.

Incentive Act in 1970 also the Philippines did in principle promote exports, but this policy did not seem to bear fruits. In fact, research indicates that the approvals by the Board of Investments throughout the 1980s were biased towards the sectors that were most heavily protected and not towards export oriented sectors (Mercado-Aldaba, 1998). Capital-intensive industries were, moreover, favoured over labour-intensive sectors and Philippine labour costs were high relative to those of its neighbours. This has continued until this day (Austria, 1998b).

Even if the Philippines had offered a large home market to foreign investors – which it did not, since the growth rates of the manufacturing sector fell dramatically once the domestic market was saturated – the country thus followed a policy that was ill suited to attract FDI from the richest Asian countries. Just how unsuccessful the Philippines was in this respect is illustrated by Figure 7, which shows that the Japanese stocks of FDI were almost of the same magnitude in the Philippines, Thailand, and Malaysia in 1980.¹⁸ In 1990 the Japanese FDI stock had increased by a factor of 2.5 in the Philippines, compared to 5 in Malaysia and 11 in Thailand.

Figure 7: Japanese FDI stocks in ASEAN-4 (US\$ million).



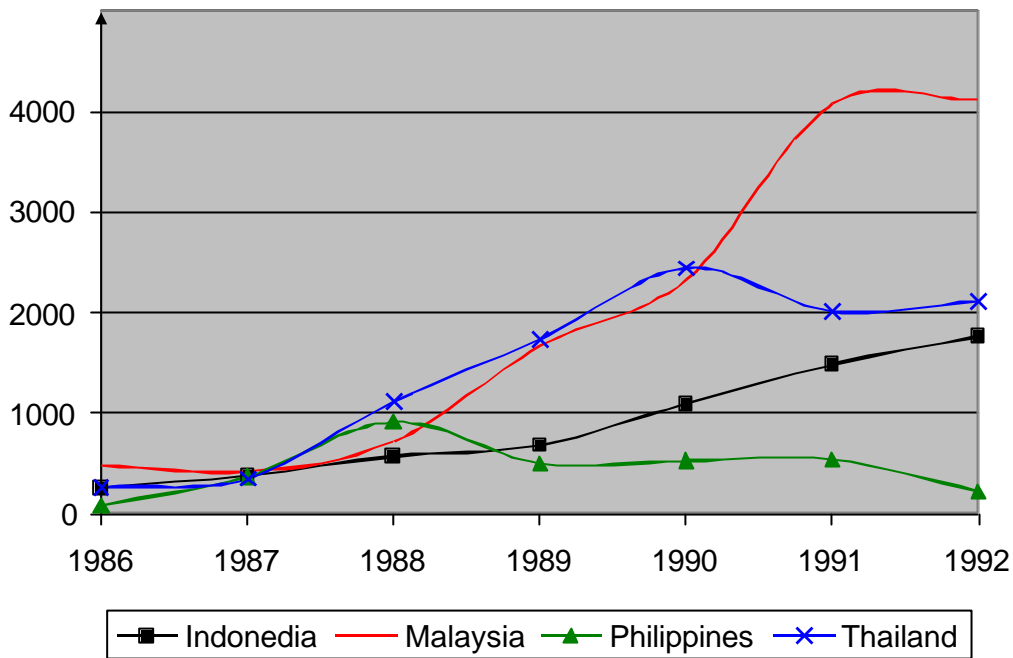
Source: Mercado-Aldaba (1998)

¹⁸ There has always been a close relationship between Japan and Indonesia, so there are presumably important historical reasons why Indonesia had a large stock of Japanese FDI already in 1980.

The Philippine inability to attract FDI after the revolution is evident also from Figure 8. Due to debt conversion there was an increase in FDI inflows in 1987 and 1988, but a new downward sloping trend between 1988 and 1992. Mercado-Aldaba (1998) claims that this largely was due to political instability (there was a nearly successful coup in 1989) and inconsistent trade policies. However, the economic geography literature suggests that even if the Philippines had followed a reasonably good policy after 1988, it may still have been unsuccessful in attracting new industries. Due to inter-industry linkages the other ASEAN countries may have achieved an advantage over the Philippines, which presumably it will be very difficult to overcome in the foreseeable future. That the Philippines has been unable to develop inter-industrial linkages and a competitive domestic support industry is revealed by several empirical studies. One example is Tecson (1995) who found that the Philippines has the smallest share of local content of parts and components of the ASEAN-4.¹⁹ Another example is Cororaton and Abdula (1999:6) who claim that garments and electronics, which are the two most important export articles for the Philippines, “add only a thin slice of value added to import components, and then re-export them. Thus the manufacturing export sector is in effect an enclave with surprisingly little linkage to the domestic industry.” This may also help to explain why FDI in the Philippines does not seem to have contributed much to the technological progress of the manufacturing sector; the processes that have been used have been very simple and there has been minimal technological diffusion to local firms (Yap, 1999).

¹⁹ See Austria (1998b) for this and other references.

Figure 8: FDI inflows in ASEAN-4 (US\$ million)



Source: Petri (1995)

Olson (1993) and others have argued that «capital often flees» dictatorship, moving to stable democracies. Basically the arguments are that foreign direct investments (as opposed to portfolio investments) typically have long-term time horizons and thus require predictability and respect for property rights that dictatorships with their lack of legitimacy and independent judiciaries cannot provide. However, there does not seem to be any strong empirical relationship between regime type and FDI flows. This may partly be explained by the fact that the rates of returns to capital have tended to be relatively high in some authoritarian countries, offsetting some of the disadvantages of higher long-term risk (see Oneal, 1994).²⁰ Resnick (1998) has, moreover, found some evidence that young democracies seem to do particularly badly with respect to FDI inflows. He does not deny that democracies tend to be more attractive to investors than do dictatorships, but argues that the uncertainty is particularly high during transformation phases. The large number of coup attempts during Corazon Aquino's presidency evidences that this is likely to be true in the case of the Philippines. But apart from these political considerations, which advantages and disadvantages has the Philippines offered as a site for FDI?

²⁰ See also Young (1994) who maintains that foreign investors have earned unusually high rates of returns in Singapore, one of the more undemocratic countries in Asia. Above we argued that the extraordinary high profit earned by foreign investors in the Philippines to a large extent was a side effect of the import substitution policy.

5.1 Location specific FDI advantages and liabilities in the Philippines

There is quite strong evidence that the trade policy in the Philippines – as in the majority of countries following ISP – has been biased toward protecting industries that are “weak” in the sense of being, and remaining, internationally uncompetitive. With high tariff barriers it has thus become profitable for foreign companies to replace export to the Philippines with FDI, presumably without telling us which advantages the Philippines has relative to other Asian countries as a site for foreign firms. This presumption is supported by Table 9, which shows the export propensity for US MONANUS firms in ASEAN-4.²¹ The export propensity is substantially lower in the Philippines than in Malaysia and Indonesia. Except for the purpose of serving the local market, there is consequently no reason to expect the Philippines’ stock of FDI to reveal much about the country’s location specific assets.

Table 9: Export propensity (%) for US MONANUS.

	1982	1986	1987	1989	1994
Philippines	15.7	25.0	24.9	22.3	25.5
Malaysia	47.4	59.5	59.8	38.5	42.1
Indonesia	66.1	82.3	83.1	43.8	63.4
Thailand	17.5	19.0	21.2	31.8	27.1

Source: Mercado-Aldaba (1998) and Lipsey (1999)

5.1.1 Location specific Philippine assets

Due to the low income growth in the Philippines the country is not particularly attractive for import substituting foreign direct investments on a large scale. The home market is simply too small, and the trade liberalization programs moreover implies that import substituting FDI will become increasingly less important. If the country aims to attract more FDI it must therefore adopt a more outward-oriented strategy than in the past. Thereby the country’s international competitiveness and the advantages it can offer investors will be decisive.

At the time of independence in 1946 the Philippines had the second best educated labour force in Asia (after Japan), and a relatively advanced industrial sector. Despite the unfavourable economic development over the last decades, the educational quality is still good compared with most other Asian countries. The average years of schooling, for instance, equals 7.6 years; in Thailand, Malaysia, Singapore, and Indonesia the corresponding numbers

Additionally, it may also reflect that high returns were necessary in order to attract investors during the politically most turbulent periods.

²¹ MONANUS is an abbreviation for Majority Owned Nonbank Affiliates of Nonbank US parents.

are 3.9, 5.6, 4.0, and 4.1 years (Medalla et al 1998: 91).²² The larger share of the Philippine labour force moreover speaks English, and so a multilingual labour force of reasonably good quality may constitute the major comparative advantage for the Philippines (Austria 1998b). This is particularly likely to be true to the extent that the Philippines will compete for export oriented FDI with a high content of labour against countries like China and Vietnam in the future.

5.1.2 Location specific Philippine liabilities

Even though the Philippine labour force has an average year of schooling almost twice as long as that for developing countries as a whole, the country is not well endowed with scientists and technicians engaged in R&D. Some indicators of this are given in Table 10. While developing countries on average have 3.0 R&D scientists and technicians per 10 000 people, the Philippines has only 1.3. Note that also Thailand performs badly in this respect. We find the same pattern also with respect to R&D expenditures as percent of GDP, and the overall impression is that none of the ASEAN-4 countries has invested sufficiently in higher education (Young, 1994). This important difference between the first and the second generation of the Asian tigers indicates that it will be much more difficult for the latter to achieve a sustainable development.

Table 10: R&D indicators.

	R&D Scientists and Technicians (per 10 000 people) 1986-1989	R&D Expenditure as percent of GNP
Philippines	1.3	0.12
Indonesia	-	0.33
Malaysia	4.0	-
Thailand	1.6	0.37
Singapore	18.7	0.89
Developing countries	3.0	0.54
Developed countries	41.0	2.62
World	12.0	2.22

Source: Medalla et al (1998)

From the above it is quite clear that the Philippines will not be able to attract massive FDI investments in R&D intensive production in the foreseeable future. It is, however, possibly

²² The low educational level in Thailand will possibly constitute a main obstacle to future development in the country. For the sake of Singapore it should be noted that even though an average of 4.0 years of schooling may seem disappointing, the improvement in the educational level has been impressive. For instance, the illiteracy rate in the labour force was close to zero in 1990 compared to 55% in 1966 (Young, 1995).

even more troubling in an early phase of development that nor does the country seem to be able to attract labour intensive industries. This has partly been a result of the ISP and the general industrial policy, which have favoured capital-intensive production. Additionally, there is a strong conflict between labour and capital in the Philippines, and the country has a reputation for having militant trade unions and periods with massive unrest in the labour markets. This is not particular for the Philippines – indeed, labour unrest has been prevalent in several of the Asian countries (South Korea is the prime example of this). Such problems are, however, more difficult to solve for a democracy than for dictatorships like Vietnam and China which the Philippines presumably will have to compete with in order to attract FDI in the future. Related to this, the Philippines is also handicapped by an increasingly higher wage level (along with a high unemployment rate), both absolutely and relative to its most important competitors (Austria 1998b). This makes the problem of weak inter-industry linkages even more acute.

In a comprehensive study of the Philippine economy between 1970 and 1986, Tolentino (1993) argues that the Philippines lacked adequate locational advantages, and was plagued by an undesirable investment climate, caused by rising trends in nationalism and social unrest. “As a result of the declining locational advantages and the more conducive investment climate offered by other Southeast Asian countries such as South Korea, Thailand, and Taiwan, the Philippines experienced substantial outflows of FDI while those countries experienced substantial inflows from the latter part of the 1960s and early 1970s.”

The poor quality of the infrastructure is, and always has been, one of the major disadvantages of the Philippines. The number of main telephone lines, for instance, is still inadequate, despite the fact that access to telephones has been much improved since the telecommunication sector was privatized in 1992.²³ Moreover, only 60 percent of the population had access to electricity by the mid 1990s, and Metro Manila has had severe problems with power generation (Yap 1998). This was particularly acute in the early 1990s, when the capital regularly was disclosed from the electricity network several hours each day. Such problems are still present in the Philippines, though they have become significantly reduced. The biggest problem in the capital is perhaps the traffic congestion, which is said to be the worst in Asia after Bangkok. In more rural areas the problem is not so much congestion as a lack of roads, and the overall paved road ratio is only 20 per cent (Manasan and Mercado, 1999). According to IMD’s (1997) International Competitiveness Study only Russia and India

²³ In 1992 the typical Philippine consumer had to wait 8.9 years to get a telephone installed, while the corresponding number for Indonesia was 0.4 years. Six years later the business sector could usually get phones

perform worse than the Philippines with respect to the quality of the infrastructure (the study covers 46 countries).

6. Discussion and conclusion

Measured on a GNP per capita basis, the Philippines has been among the poorer half of developing countries in the entire post World-War II area. The average growth rate in the period 1960-1997 was 0.9%, which is marginally better than the average for lower middle-income countries (World Bank, 1998). In this respect the Philippines has neither done particularly well nor particularly poorly the last decades. However, the Philippines had the second highest GDP per capita and the most 'modern' production structure of all Asian countries in the early 1950s, only beaten by Japan. During the following decades the picture changed completely, however, and in this respect something has gone terribly wrong for the country.

In this paper we have emphasized two factors that have inhibited the performance of the Philippine economy. First, the political system has been very vulnerable to pressure from special interest groups. Secondly, the country's trade policy has made the Philippines an unattractive location for the expanding industrial sector in Asia.

After the February People Power Revolution in 1986 there were high hopes that the Philippines would share the growth experiences of the Asian Tigers, but the economic development so far has been rather disappointing. The country does not, for instance, seem to have become much more attractive to foreign investors. This is perhaps not very surprising. First, as noted above, we do not have any clear evidence that democracies are more successful than dictatorships in this respect. Secondly, Resnick (1998) emphasizes that there are many reasons to expect that young democracies will find it particularly hard to attract FDI; the uncertainty is high and the new political leaders vulnerable to popular sentiments. This latter point may be particularly important for the Philippines, with its high level of conflict between labour and capital. The country, moreover, seems to lack any clear locational advantages that are attractive to foreign investors. According to the World Bank (1999) the Philippines still fares below the norm for the East Asian region, and compared to its successful neighbours the country has "lower national savings and investment, higher import duties, more rapid

installed within a few days, while the waiting time for consumers were reduced to between 14 and 385 days (Yap 1998).

population growth, inadequate infrastructure, an inefficient bureaucracy and judicial system, widespread corruption, and a high incidence of communicable diseases.”

During the whole post World War II period the Philippines has had a bad reputation with respect to corruption and bureaucratic inefficiency. To what extent has this inhibited a more sound economic development? A study by Mauro (1995) may help to shed some light on this question. Mauro has categorized countries according to indices of corruption, amount of red tape, inefficiency of the judicial system, and political instability. The score goes from zero for very bad performance to ten for good performance. The results for the Philippines and the Asian Tigers are reproduced in Table 11 below. Note that Singapore scores the maximum value of ten on all the indices, and that all the first generation tigers achieve higher values than the Philippines.

The question of how corruption affects economic performance has received much attention, and some of the early theoretical literature argued that corruption might raise the growth rates. For instance, this may happen if corruption increases the working efforts of those that are bribed and makes the bureaucracy move faster (“speed money”). However, empirical work quite unambiguously finds that corruption worsens economic performance.²⁴ In an econometric analysis based on his dataset, which comprises 114 countries, Mauro (op. cit.) finds that corruption significantly reduces the level of *investments*.²⁵ With regard to the Philippines Mauro’s analysis predicts that the investment share (I/GDP) between 1970 and 1985 would have been five percentage points higher if the Philippines had had a corruption level as in, say, Taiwan. Mauro’s finding is particularly interesting because the impressive economic development in the Asian tigers has mainly been caused by high investment shares and not by productivity growth (e.g., Young, 1995). Thus, the indices highlighted by Mauro sheds some light on why the Philippines did not experience similar progress as Singapore, South Korea, and Taiwan in the first wave of industrialization in Asia.²⁶

²⁴ Indeed, corruption is possibly a major reason why the bureaucracy works slowly in the first place; in countries which have developed a culture for corruption artificial delays may be implemented until a bribe is received (see Mauro, 1995).

²⁵ Mauro found a similar relationship also for the other indices, but we focus on corruption because the literature on the Philippines typically emphasizes the problem of a corrupt bureaucracy.

²⁶ Productivity improvements have not been impressive in Hong Kong either, but unlike the other tigers the high growth rates were not almost entirely in investment-led.

Table 11: Political and institutional indices.

	Judicial Efficiency	Red Tape	Corruption	Political stability
Philippines	4.75	5	4.5	6.08
1. Gen. Tigers				
Hong Kong	10	9.75	8	9.50
Singapore	10	10	10	10.00
South Korea	6	6.5	5.75	7.50
Taiwan	6.75	7.25	6.75	8.58
2. Gen. Tigers				
Indonesia	2.5	2.75	1.5	7.46
Malaysia	9	6	6	8.42
Thailand	3.25	3.25	1.5	5.63

Source: Mauro (1999)

It is more difficult to use Mauro's analysis to explain why the Philippines missed out on the second wave of industrialization. Judicial efficiency, the amount of red tape, and the level of corruption have been perceived to be higher in Indonesia and Thailand than in the Philippines. In this paper we have argued that the most important difference between the second generation of tigers and the Philippines is that the former countries departed from import substitution in the 1980s – like the first generation of tigers did twenty years earlier. This is what we have put forward as a main explanation for why the Philippines has been unsuccessful relative to its neighbours, and it sheds light on both the growth epochs in Asia. The theoretical framework has been the new economic geography literature, which predicts that with inter-industry linkages and growing demand for manufacturing goods (due partly to high factor accumulation) industry will gradually spread to the most open developing countries over time. During the 1960s strong industrial activity caused wages in Japan to become high, and so industry was spreading to Hong Kong, Singapore, South Korea, and Taiwan. As the wage level rose in these countries, along with further increases in demand for manufacturing goods, the import liberalizing countries Indonesia, Malaysia, and Thailand became industrialized.

The Philippines missed out on both waves, because the protective system implied that it had very weak linkages with foreign industry customers and suppliers. Since the home market in the Philippines is relatively small, and factor costs relatively high, the country was not particularly attractive as a site for FDI.

Finally, a word of caution. We have not argued that liberalization of the trade regimes necessarily causes developing countries to become industrialized. Neither have we argued that import substitution and government interventions are necessarily bad. Indeed, it is quite possible that government interventions in South Korea and Taiwan were successful (see

Rodrik, 1995, for an interesting discussion). What we have argued, is that the Philippine trade system served to delink the country from its neighbours so that it was not a suitable location for the expanding industrial sector in Asia.

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8. Appendix

Appendix A1: The Philippine IT industry

The IT industry has been on the Philippine Investment Priority Plan (IIP) for several decades, and there is no doubt that the country has had some success in this sector.²⁷ This is illustrated by Table 12, which shows that by 1997 the share of IT in total exports was higher in the Philippines than in China or any of the tiger economies. Note also that Indonesia has been quite unsuccessful in this respect, and that only Singapore comes close to the Philippine figures.

Table 12: Share of IT to total country export.

	1991	1992	1993	1994	1995	1996	1997
Philippines	38.0	26.3	29.4	34.5	41.8	51.1	58.3
Indonesia	0.7	1.4	1.5	2.7	3.0	4.2	3.9
Malaysia	22.8	24.2	27.4	30.1	33.3	37.2	na
Thailand	14.9	16.2	16.8	19.1	20.7	na	22.1
Singapore	31.5	43.6	39.2	51.6	50.3	52.7	53.0
South Korea	17.4	18.4	18.7	21.1	24.1	23.3	na
Hong Kong	na	21.5	22.1	22.3	23.6	22.6	22.1
China	na	5.6	6.5	8.0	9.6	10.9	11.7

Source: Austria (2000).

The production process for IT services and goods can be split into a large number of sub-processes, and is therefore well suited for outsourcing to different countries according to their comparative advantages. Mercado-Aldaba (1998), Austria (2000) and others thus argue that the IT industry constitutes an interesting case study of how the growing Japanese economy initiated a spread of industry in Asia. Large MNCs from Japan, and subsequently from America and Europe, developed production sites in several Asian countries as the Japanese cost level increased and the yen appreciated after the Plaza agreement in 1985. This strategy required extensive intra-regional trade, and relatively open economies with good international infrastructures were able to build up a domestic base of support industries. The most advanced countries (Hong Kong, Singapore, South Korea and Taiwan) soon developed their own hi-tech IT firms, while Malaysia and Thailand became the hosts for production of standardized products. The Philippines, on the other hand, has specialized in the lower end of the

²⁷ This section builds on Austria (2000). Note that, by definition, the only segment of the electronics industry that is not included in the IT industry is consumer electronics.

production chain, mainly in labour intensive activities like assembly and testing, with little connection to the domestic industry. Table 13 reveals some of the structural problems that plague the Philippines. First, note that the Philippines has only been able to penetrate the semiconductor segment of the IT industry, while the other Asian countries have penetrated at least two of the major segments. Due to this concentration the Philippines was very vulnerable when demand for semiconductors began to fall sharply in 1997. Secondly, the Philippines has been far less successful in building a base of domestic support industries than most of the other Asian countries. In fact, it is almost completely specialized in assembly and testing. These activities are characterized by very low value added and a high intensity of unskilled labour, offering only a limited scope for technological diffusion. It is therefore not surprising that the import content is high, and that the trade balance for the IT sector typically has been negative. There are, moreover, clear signs that the Philippines is losing momentum to low-wage countries like China and Vietnam.

Table 13: Structure of IT exports (%), average 1991-1997.

	Computer hardware	Semi-conductors	Tele-communications	Other IT products
Philippines	8.2	80.6	9.2	2.0
Indonesia	25.2	12.1	39.0	23.7
Malaysia	24.5	54.4	18.5	2.7
Thailand	44.0	29.0	14.2	12.9
Singapore	49.1	29.6	12.2	9.1
South Korea	19.2	52.0	14.6	14.3
Hong Kong	23.8	34.3	20.7	21.2
China	23.5	13.4	19.5	43.6

Source: Austria (2000).

Appendix A2: Structural reforms and consequences of the Asian financial crisis

“The challenge faced by policymakers in the 1990s was to turn the illusion of the 1980s – the transformation of the Philippines into an outward oriented, export led economy – into a reality. ... [By 1999 the Philippines has becomes] one of the more open, transparent, deregulated and democratic economies in the region.” Milo (1999).

The Philippine economy has undergone several periods with severe balance of payment problems, resulting both from bad policies and external terms-of-trade effects, since its independence in 1946. The crisis in 1949, for instance, was caused both by a fall in the

international price of coconuts – which was the most important export article for the country – and poor macroeconomic performance. The political outcome of this crisis was, as discussed above, implementation of an import substitution policy. The crisis in 1978-79 was caused by inefficient trade policies, macroeconomic instability and a sharp increase in the import prices of oil. In the aftermath of the latter crisis, the Philippines received structural adjustment loans from the World Bank under the condition that the trade system was comprehensively reformed. The government thus embarked on a program to reduce the level and dispersion of tariff rates, and set up a plan to remove all quantitative restrictions on imports over a five-years period (Milo, 1999). This agreement signalled an important change to a more outward-oriented economic policy, but was interrupted by the political and economical crisis that started in 1982 and eventually culminated in the People Power Revolution. Meanwhile the ratio of external debt to GDP had risen from 25% in 1975 to 95% in 1986.

With the election of Corazon Aquino in 1986 the government adopted a more prudent financial and monetary policy than has usually been the case in the Philippines. Inflation was brought down, and the trade liberalization programme from 1980 was continued. However, the outbreak of the Gulf War combined with highly adverse weather conditions for the agriculture sector hit the Philippine economy hard, and the GDP growth rate decreased from around five per cent in the late 1980s to between zero and two per cent during the period 1991-1993. Immediately after the outbreak of this crisis the international risk premium on Philippine debt increased from eight per cent to almost fourteen per cent, but it subsequently fell to approximately two per cent in 1994 (World Bank, 1996).

In order to avoid a sharp recession in the early 1990s both monetary and fiscal policy became less strict than in the first post-Marcos area. This resulted in a higher inflation rate, and Table 14 shows that only Indonesia of ASEAN-4 comes close to the Philippine inflation during the period 1991-1996. However, Indonesia devaluated their currency by 20 per cent against \$US between 1991 and 1996, while the Philippines and Malaysia revaluated by six to nine per cent (the nominal value of Thailand's currency changed only slightly). The Philippines therefore experienced by far the strongest real appreciation in the region, as shown by row two in Table 14. The Philippine export growth rate was nonetheless high during this period, and unlike the other ASEAN-4 countries it even experienced higher export growth rates in 1996 than in 1991-1995.

Table 14: Selected macroeconomic indicators 1991-1996, ASEAN 4.

	Indonesia		Malaysia		Philippines		Thailand	
	1991-95	1996	1991-95	1996	1991-95	1996	1991-95	1996
Inflation (%)	9.6	6.6	4.3	3.6	10.4	8.4	4.7	5.8
Real appr. over the period (%)	3.3	5.1	7.8	4.2	36.9	5.9	4.7	5.2
Export growth rate	11.4	10.3	20.3	5.8	16.6	17.8	19.7	1.3
Trade balance*	0.8	-1.1	-1.5	0.6	-6.7	-9.4	-5.6	-6.6
Central government balance*	-0.2	1.0	0.1	0.7	-1.6	-0.4	2.8	2.3
Public debt*	37.2	27.7	21.8	15.9	113.0	88.0	17.2	10.1

*Note: * indicates per cent of GDP. Source: Intal and Medalla (1998), Corsetti et al (1998).*

Despite a relatively good export performance the Philippine trade balance was negative throughout the period 1991-1997, and measured as a share of GDP the deficit was larger in the Philippines than in any other Asian countries. This is not surprising, given the strong real appreciation of the Philippine peso. Besides, the Philippines significantly reduced the effective protection rates on a number of imported goods in the first half of the 1990s. This further served to reduce the domestic price of foreign goods, and it is widely believed that real appreciation and trade liberalization at the same time are a bad policy mix. However, it also meant that the Philippine economy was less heated than it would otherwise have been. This is perhaps one reason why the Philippines was not particularly hard hit by the Asian financial crisis that broke out in 1997. In fact, the Philippine GDP growth numbers did not turn negative until the second quarter of 1998, and returned to a positive path already in the first quarter of 1999 (Milo, 1999).

“The Philippines seems to be out of place in Asia. Before the Asian financial crisis, the Philippines was usually excluded from studies that analysed the East Asian miracle because of its lacklustre performance in the 1980s and the early 1990s. During the financial crises, the Philippines was again excluded from studies that analyzed the depth and magnitude of the effects of the crises because it was the least affected economy in the region.” Lamberte (2000)

Besides being less overheated than the other ASEAN-4 countries, the major reason why the Philippines managed the Asian crises relatively well is that the country had been through several structural changes over the last decade. Due to the sharp increase in the inflation rate in the aftermath of the 1990-crises, the government created an independent Central Bank in 1993. Thereby the confidence in the Philippine monetary policy increased, despite the strong real appreciation of the peso (Milo, 2000). Perhaps more important is the fact that the quality of the financial sector was relatively good by 1997. The interest rates were gradually deregulated from 1981, and the capital requirements in the banking sector were increased. However, due to a number of investment frauds, and the deep political and economical crises in 1983-86, the reforms came to a halt. The reform program was resumed after the People

Power Revolution in 1986, with the most important changes taking place in the first half of the 1990s. The supervision of the banking system improved, and in 1993 there was a deregulation on the entry of new domestic banks and bank branching. Subsequently, the restrictions on the entry of foreign banks were eased in 1994, and the private insurance industry liberalized in 1995. The Philippines financial sector was thus among the strongest in Asia by the mid 1990s (Corsetti et al, 1998, World Bank, 1998, Milo, 1999). In fact, only one large commercial bank in the Philippines has been forced out of business after the Asian financial crises broke out.

Table 15 gives an overview of some of the most important macroeconomic indicators for the Philippines from 1994 to 1999. Note that the annualized real GDP growth rate never fell below minus two per cent, which is a very favourable number when compared to countries like Indonesia and Thailand. Moreover, there seems to be a consensus that the major reason for the negative growth rate in 1998 was the bad weather conditions that year; first there was heavy rain and then there was a period with draught. The poorer part of the Philippine population was particularly harmed by the problems in the agriculture sector, and substantial government assistance was required. This fact has been put forward as a main explanation for the government deficits in 1998 and 1999 (Milo, 1999). However, one should be careful not to underestimate the negative consequences of the Asian financial crises on the Philippines. After the crises broke out in Thailand in April 1997, the Philippine Central Bank (BSP) had to increase its overnight borrowing rate from 11 per cent in May to 20 per cent in June and 32 per cent in mid-July. During this period BSP managed to maintain the currency rate at P26/US\$, but in August the peso was devaluated to P30/US\$ and further to P45/US\$ in early 1998 (Milo, 1999). This naturally caused major problems for companies with dollar denominated debt since their foreign liabilities almost doubled within a few months. The situation was also dramatic for companies with peso denominated debt, since the domestic interest rate reached an annualised value of thirty per cent. The bank sector thus experienced that the share of nonperforming loans to total loans increased from 3.4 per cent prior to the crises and to 14.4 per cent in the third quarter of 1999 (Milo, 1999).²⁸ Together with less availability of credit this has further led to a significant fall in investments, and a sharp fall in demand for imported investment goods. Even best-case scenarios thus indicate that it will take

²⁸ There is little doubt that large inflows of short-term capital negatively contributed to the depth of the Asian crises, but this is typically not mentioned as a major cause of the Philippine economic downturn (even though the level of foreign portfolio investments to the Philippines rose sharply in the early 1990s). The moderate importance of foreign short-term capital may partly be due to the restructuring and improved supervision of the

several years before the Philippines has regained the economic momentum it had before the crises. One should also recall that the Philippines is much poorer than the “miracle” economies, and that the economic downturn therefore may be considerably more dramatic for human welfare than a pure study of statistics suggests. Indeed, several researchers argue that everything that had been gained in the fight against poverty between 1986 and 1997 has been lost (e.g., World Bank, 1998, and Lamberte, 2000). Many poor families have, for instance, taken their children out of school in order to make money on poorly paid jobs, and there has been a seven per cent yearly slowdown of school enrolment in 1998 and 1999 (World Bank, 2000).²⁹

Table 15: Macroeconomic indicators, 1994-99.

	1994	1995	1996	1997				1998				1999		
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Real GDP*	4.4	4.7	5.9	5.5	5.6	4.9	4.7	1.1	-1.0	-0.1	-2.0	1.2	3.6	3.1
- Pers. cons.*	3.7	3.8	4.6	5.0	5.1	5.0	4.9	4.5	3.9	2.9	2.6	2.5	2.6	2.6
- Gov. cons.*	6.1	5.6	4.1	4.5	7.3	6.2	0.4	-5.4	-2.4	-1.3	0.6	7.6	6.2	3.7
- Gross inv.*	9.0	3.7	13.3	14.9	7.1	9.3	15.0	-6.0	-18.2	-19.1	-22.3	-9.7	6.2	-5.3
- Merch. exp.*	15.2	16.2	9.6	8.6	15.2	15.0	14.8	10.6	-1.4	3.9	-14.4	0.7	3.0	8.0
- Merch. imp.*	15.6	16.0	16.9	3.0	2.7	10.2	15.0	-2.3	-12.1	-13.1	-33.9	-16.7	2.4	1.9
By sector:														
- Agr o.a.*	3.4	1.2	3.9	4.9	1.8	0.4	4.1	-3.8	-11.5	-3.1	-7.8	2.9	11.1	5.6
- Industry*	5.8	6.8	6.4	5.1	7.6	6.4	5.6	0.2	-0.7	-2.0	-4.7	-2.2	-0.7	0.2
- Manuf.*	5.0	6.8	5.6	2.3	5.3	4.3	4.7	2.0	-0.9	-1.5	-3.5	-1.0	0.9	2.2
- Constr.*	9.4	6.6	10.9	21.3	18.5	18.1	7.6	-12.8	-5.1	-7.5	-8.5	-6.0	-5.3	-5.9
- Services*	4.3	5.0	6.4	6.2	5.8	5.5	4.4	4.5	3.6	2.8	3.2	3.0	4.0	4.4
Inflation rate	8.3	8.0	9.1	5.3	5.3	5.9	7.3	7.9	9.9	10.4	10.6	10.0	6.8	5.6
Trade balance	-12.2	-12.1	-13.7	-13.7	-12.6	-15.5	-12.2	-7.2	-1.6	3.3	4.3	3.1	0.8	...
Gov. surplus	1.0	0.6	0.3	-0.1	0.8	0.1	-0.4	-1.9	-1.9	-0.3	-3.2	-4.9	-2.6	-4.8

Note: * indicates growth rates compared to last year. Source: Milo (1999)

financial sector, and partly due to the fact that the Philippine economy was less heated than many of its neighbouring countries. See Lamberte (1999, 2000) and Milo (1999) for discussions.

²⁹ In Indonesia, which had a somewhat higher PPP adjusted GDP per capita than the Philippines before the crises, the enrolment rate quickly dropped by almost twenty per cent (World Bank, 1998).