Editor's Notes

Who will carry the burden of the negative shocks to investments of private investors in infrastructure projects due to possible fluctuations in the economy in the future? Basically, the government, in view of the guarantees it signified in certain project arrangements with the private sector.

And while the new infrastructure policy environment has led to a surge in private investor interest and investments in various infrastructure projects, there is a possible downside to it: contingent liabilities. This issue’s lead feature draws the attention of policymakers and legislators to the "fiscal risk brought by contingent liabilities arising from explicit or implicit government guarantees."

The paper is authored by Dr. Gilberto Llanto, a senior research fellow at the Philippine Institute for Development Studies (PIDS), which he presented during the 16th EASE in Manila. In the paper, Dr. Llanto recommends six measures that the government should implement to manage the contingent liability.

Contingent liabilities: adding up to the fiscal burden

With the fiscal crisis nearing a full blown state, it seems that a more serious trouble is looming in the background. The crisis is likely to be compounded by the escalating magnitude of contingent liabilities that the Philippine national government continues to absorb.

In a study titled Dealing with Contingent Liabilities: The Philippines, PIDS Senior Research Fellow Gilbert M. Llanto cautioned the government against the serious negative impacts of contingent liabilities as sources of additional financial obligations that could further saddle the country with substantial fiscal burdens.

Contingent liabilities are obligations shouldered by the national government on behalf of private investors to absorb risks incurred from particular events such as insufficient market demand, adverse exchange rate fluctuations, and other negative shocks. These are considered contingent as they may or may not be borne by the government depending on the occurrence or outcome of the event. Contingent liabilities usually arise from the payment of government guarantees.

Why guarantee

Despite the fiscal challenges being faced by the Philippine government, its duty to provide citizens with sufficient and better public services remains. Private sector participation in the provision of public services, particularly infrastructure, is now generally touted as the most logical alternative in dealing with resource constraints and, at the same time, in addressing public sector inefficiency in service delivery.

The government’s commitment to tap private sector expertise and resources in

* A condensed version of the study Dealing with contingent liabilities: the Philippines written by Dr. Gilbert M. Llanto and presented during the 16th Annual East Asia Seminar on Economics (EASE) in Manila from 23-25 June 2005. The full version of the paper is included in the forthcoming EASE Volume 16 tentatively titled Fiscal policy and management (edited by Takatoshi Ito and Andrew K. Rose) from the University of Chicago Press.
infrastructure is manifested in the passage of the build-operate-transfer (BOT) law in 1990 and its subsequent amendment thereafter to increase the scope of private sector involvement. The benefits from the BOT scheme had been seen in the numerous power projects enforced at a quick pace in the early 1990s which helped solve the power crisis.

Encouraging the private sector to invest, however, is very difficult given the highly regulated market environment, the distortions created by price controls and subsidies, and the pervasiveness of political patronage, all of which are real constraints to efficient operation and profitability.

Providing government guarantees covering a wide variety of project-specific and general risks is a way of encouraging private proponents in infrastructure projects. With government guarantee, investors can minimize and, in some cases, eliminate certain risks in financing, building, maintaining and operating public infrastructure projects. Similarly, government guarantee can help to maximize return-to-risk ratio in the face of pressure from financiers, investors, shareholders and others who may want to minimize their own risk exposure to the private sectors’ decision to take on risky infrastructure projects.

Risky business

As Llanto explained, however, these guarantees have hidden fiscal risks. These could create contingent liabilities that may spell financial trouble for the government if not properly managed. Under a guarantee agreement, the government agrees to absorb certain risks faced by the private investors in uncertain infrastructure service markets. The largest share to increases in the contingent liabilities of government usually comes from guarantees that cover market risks, foreign exchange sources and buyouts in the event of project termination. Table 1 shows the largest sources of contingent liabilities in terms of size of exposure in various sectors.

The problem with guarantees is that they are hidden deficits. At the outset, the situation looks worry-free as there is no liability for the government when the guarantee agreement is entered into. In the case of a loan, for example, the guarantee is contingent upon the private proponent failing to repay his obligations. But in the event of a default, the proponent could invoke the guarantee and the national government becomes responsible for repaying the loan.

The contingent liability becomes an assumed and actual liability of the national government after getting the recommendation of the Development Budget Coordinating Committee to absorb the liability. Consequently, the Department of Budget and Management (DBM) prepares to service the liability, using the automatic appropriations provision under the General Appropriations Act as legal basis.

Additionally, these guarantees are made on the expectation that the high economic growth is sustained in the future and guarantee calls are averted. But what if the opposite occurs? This leaves the government in a no-win or losing situation. Whether the government likes it or not,

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<th>Item Guaranteed</th>
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<td>Buyout or termination price</td>
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<td>Costs of inability to implement toll adjustments</td>
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<td>Cost of principal and interest on old MWSS loans</td>
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the contingent liabilities thus become part of its fiscal obligations.

Recent figures indicate that the government is facing serious problems with contingent liabilities. The Department of Finance, which is in charge of the overall monitoring of contingent liabilities, reported that the estimated total is P1,672 billion (US$30.4 billion) as of 2003. Of this amount, 54 percent come from the infrastructure sector broken down as follows:

- 18.5 percent for BOT projects;
- 35 percent for buy-out costs of independent power producers (IPPs); and
- 43 percent for guarantees on projects and activities of government-owned-and-controlled corporations (GOCCs) and government financial institutions' (GFI) loans.

If liabilities that have become actual are accounted for in the national budget, total liabilities will already amount to P1,455 billion. This amount does not include, however, unfunded liabilities of social security institutions and implicit contingent liabilities that may arise from nonpayment of unguaranteed debts and collapse due to capital outflows....In 2002, the national government...required all government agencies and GOCCs to seek the approval of the DOF before entering into foreign loan negotiations....A task force on debt and risk management in the DOF...serve[s] as the primary unit responsible for monitoring and managing contingent liabilities.

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A wake up call
In 2002, the national government through an administrative order has required all government agencies and GOCCs to seek the approval of the DOF before entering into foreign loan negotiations. A task force on debt and risk management in the DOF was thereupon set up in December 2004 to serve as the primary unit responsible for monitoring and managing contingent liabilities.

In addition, the DBM has prepared a draft bill of the Fiscal Responsibility Act, a salient point of which is the repeal of the automatic guarantees that certain GOCCs can provide under their respective
charters. The bill has been submitted and is now being studied by the Senate. If approved, it can free up the national government of substantial financial burden arising from guarantee calls made by GOCCs. The bill also calls for greater transparency and accountability in the public sector.

However, with the growing scale of contingent liabilities and their pressure on the fiscal crisis, it is clear that the above efforts are not sufficient to address the situation. A comprehensive management strategy in dealing with contingent liabilities is a tall order. A guarantee cover is not a free resource that a government can grant at will. When private investors call on guarantees and the government gives in without concern for budgetary constraints, the government will surely find itself in a state of fiscal shock.

Recommendations
Llanto outlines a set of recommendations that encompass many issues to manage the problem of contingent liabilities. The salient points of these recommendations are summarized as follows:

Develop a framework for granting guarantees
An appropriate framework for managing contingent liabilities should be able to help the government in making sound decisions in the provision of guarantees, anticipating for guarantee calls in the future, and setting reserves for contingent events.

Suggested elements for this framework include:

- treating guarantee cover as a scarce resource that should be efficiently allocated;
- determining the annual of guarantee cover that the government can provide not only to infrastructure projects but also to other guarantee programs implemented by various government agencies, especially those that have the nature of sovereign guarantees;
- setting up a correct pricing of the guarantee according to market conditions and all the possible risks that can affect the project (a risk-adjusted and market-based guarantee is recommended);
- risk-sharing between project proponent and the government;
- establishing core guarantees for selected risks and applicable across sectors and projects;
- integrating exit strategy or fall-away clause in guarantee contracts;
- introducing a guarantee fee based on the duration of cooperation between the government and investors; and
- conducting an annual review of project performance and required guarantee cover.

Program and allocate guarantees
This work is critical to determine beforehand how much guarantee the government can reasonably provide without unduly exposing it to unmanageable liabilities. At present, there is no internally consistent programming of guarantee resources as well as rational provisioning for potential guarantee calls. As a result, in the event of a call, the government may resort to borrowing if only to pay the claims of the affected party.

Develop a more effective system for accounting, monitoring and managing contingent liabilities
As potential liabilities that may never become due and payable, contingent liabilities are not reflected in the balance sheet nor accounted for by governments because of cash-based budgeting. This system, however, is highly disadvantageous in managing a country’s fiscal stability. Lewis and Mody (1998) stress that cash-based budgeting misrepresents and masks the aggregate exposure associated with loan guarantees and government insurance programs, and creates perverse incentives for selecting one form of financing assistance over another. A government loan is actually recorded as an outflow but a government guarantee is not because nothing has been spent during
the accounting period. Only when a guarantee has been called and a payment had been made is the cost of the guarantee reflected. There is clearly a need for a more appropriate accounting system that will take into account contingent liabilities. Failure to account for the true cost of guarantees will only expand the guarantee cover for various activities and infrastructure projects without requiring the government to reserve for future claims or losses. Monitoring the cost of the guarantee claims and appropriating funds to service those claims only when those claims are submitted encourages the extension of guarantees without having to consider the costs, thus heavily indebting future administrations to shoulder huge claims.

Develop efficient regulatory frameworks and promote competition
There should be policies to address reduction of risks and attract private investment without necessarily depending on government guarantees. A crucial component is a credible regulatory and legal framework for the provision of infrastructure services as the country’s existing weak regulatory framework deters foreign investment. The most important policy measure is to expose infrastructure services to competition whenever possible. One essential approach is to have effective, independent and accountable regulatory agencies that ensure the entry of potential competitors in the competitive areas of infrastructure sectors.

Share the risks with the private sector
Although guarantees are needed to encourage private sector financing, construction or operation especially in infrastructure services, the risks should not be borne by the government alone. A practical approach would be to break down the risks into several components and assign specific components to the parties that should absorb the risks. The government and the private sector may agree on which component risk each one will shoulder and the extent of the risk-sharing. For example, the government can guarantee the loans of private sector investors for a limited period of time only. In this respect, it is critical to determine which risks are transferable to the private sector and encourage the private sector to share those risks.

Maintain a sound macroeconomic environment
Low inflation and low interest rates will enable the private sector to easily recover their costs and generate profits from their investment. This will minimize the risks of guarantee calls, especially in instances where the government has been exposed to buyout clauses. To build the confidence of private investors in infrastructure, the government needs to maintain a stable macroeconomic environment and continue with economic and financial reforms that can improve the state of financial and capital markets. Infrastructure projects are vulnerable to currency and maturity risks, a source of uneasiness to the private investor. The maturity structure of bank liabilities cannot simply match the long gestation of infrastructure projects. Hence, there is a need to develop long-term peso debt finance. This will also take care of currency risks that arise because the infrastructure project generates revenues in pesos while the loan exposure is denominated in foreign currency.

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The Philippine Institute for Development Studies (PIDS) mounted an exhibit featuring the Geographic Information System (GIS) on May 11, 2005 at the Heritage Center of the National Academy of Science and Technology (NAST). The exhibit carried the theme of The World of Social Sciences and was geared toward introducing the social sciences to elementary students.

The exhibit, which ran for five days, displayed the usefulness of the GIS in presenting the socioeconomic profile of the Philippines using a simple GIS-based interactive application developed by the Institute’s Management Information System (MIS) and Data Information Resources Program (DIRP) staff.

The exhibit involved the use of two desktop computers, which would eventually be donated to the NAST through the Department of Science and Technology. The exhibit posed questions relating to the social, economic and physical profile of provinces in the Philippines. An initial question required clicking on the correct region. When the provincial boundaries appeared, the correct province should be identified by clicking on the right area. When a correct answer was given, a profile of the province and additional information with maps and pictures in the background were displayed. No map and information were shown when a wrong answer was given.

The second part of the exhibit to be mounted sometime this year will feature an illustration of the macroeconometric model of the Philippine economy to present the relationships of key variables in the economy such as consumption, imports, exports, and net factor income from abroad. Multiple-choice questions will allow students to determine the impact of a 10 percent increase in remittances of overseas Filipino workers to the country’s gross national product such as: a) GNP will increase; b) GNP will decline; or c) no substantial impact on GNP. When students choose the correct answer, a detailed explanation will be displayed and the students will get to see the estimated impact of any changes in each variable on the economy.

A Perspective on Macroeconomic and Economy-wide Quantitative Models of the Philippines: 1990-2002
Josef T. Yap [ISBN 971-564-064-8]
This paper surveys the development of macroeconometric and CGE models in the Philippines during the period 1990-2002, primarily in terms of their structure and applications. Over time, there has been convergence in these two types of quantitative models: CGE models have increasingly used econometric estimates obtained from time-series data while macroeconometric models have been applied to monitor social outcomes like poverty and income distribution. These quantitative tools have become an integral part of policy analysis in the Philippines.

The Poverty Fight: Has It Made an Impact?
Celia M. Reyes [ISBN 971-564-065-6]
This book examines the performance of the Philippines in its fight against poverty. It reviews the trends in poverty using various human development indicators. It shows that the Philippines has achieved modest success in the area of poverty reduction and human development. Life expectancy has gone up, mortality rates have gone down, malnutrition prevalence has declined and school participation rates have improved. Poverty incidence has been reduced but the actual number of the poor has gone up due to the high growth in population.

**The Philippines in the Global Trading Environment**  
*Myrna S. Austria* [ISBN 971-564-066-4]  
This book reviews the industrial policy environment during the past 25 years and analyzes the impacts of the substantial trade and investment policy reforms that the government has implemented. The reforms have resulted in improvements in domestic resource allocation, increased productivity, increased competitiveness of manufacturing industries, expansion of exports, and increased integration of the country in the global market. Yet, the growth of the industry sector, particularly manufacturing, has not been as robust as many have expected, leading some sectors to question the reforms.

**Philippine Competition Policy in Perspective**  
*Erlinda M. Medalla* [ISBN 971-564-067-2]  
The Philippines has undertaken major reforms in what could be considered the first layer of competition policy—trade reforms. It has also implemented steps in what could be considered the second layer of competition policy—deregulation. This perspective paper recommends, however, that a lot more needs to be done to move it a step further and develop more rational competition rules.

**Central Banking in the Philippines: Then, Now and the Future**  
*Mario B. Lamberte* [ISBN 971-564-068-0]  
The country’s central bank has a profound impact on the lives of all residents of the country. This book attempts to put some policy issues on central banking in the country in certain perspectives so that policy debates on these issues can proceed with greater focus. More specifically, it examines central banking in the Philippines from three perspectives—past, present and future.

**Financial Services Integration and Consolidated Supervision: Some Issues to Consider for the Philippines**  
*Melanie R.S. Milo* [ISBN 971-564-069-9]  
This book examines the trends in Philippine banking regulation in the past 25 years. In particular, it notes that the Philippines has followed a policy of despecialization in the banking sector by widening the range of permissible activities and bank products to enhance competition and efficiency, beginning with the introduction of universal banking in the 1980. However, there has been no corresponding adjustment or change in the regulatory framework until very recently. The book then raises the issue of the appropriate institutional structure for financial sector regulation.

**Infrastructure Development: Experience and Policy Options for the Future**  
*Gilberto M. Llanto* [ISBN 971-564-078-8]  
This book presents in broad strokes a chronicle of infrastructure development in the Philippines in the last 25 years. It covers the infrastructure experience across the Marcos regime to the Estrada (2001) and Arroyo (2003) administrations. Its main objective is to flag the gaps and issues for future research, policy analysis and policy formulation. It calls particular attention to several constraints such as large budget deficits faced by the national government, among others.

**The Quest for a Better Environment: Past Experiences and Future Challenges**  
*Danilo C. Israel* [ISBN 971-564-070-2]  
This perspective paper reviews the country’s natural resource and environmental problems across ecosystems, per ecosystem, and per critical resource. It also highlights the Philippine Agenda.
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Research Information Staff  
Philippine Institute for Development Studies  
Room 304, NEDA sa Makati Bldg., 106 Amorsolo Street, Legaspi Village  
1229 Makati City, Philippines  
Telephone numbers 892-6059 and 893-5705  
Telefax numbers (632) 893-9589 and 816-1091  
E-mail address: publications@pidsnet.pids.gov.ph

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This book provides a detailed discussion of the performance and contribution to Philippine development of the education and labor markets in the past 25 years. It analyzes the interaction of the two markets and uses the results in appraising the sector’s performance and problems. It also critically reviews the proposals to improve the performance of the sector offered by several studies done during the period. Finally, it identifies the critical research areas to help move the reform ideas forward.

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Economic growth is determined by how well a country mobilizes its resources to improve productivity in order to increase production of goods and services. Generally, resources include labor and human skills, capital, land and natural resources, while major factors affecting productivity are technology, research and development. The latter is the focus of this perspective paper.

Rethinking Institutional Reforms in the Philippine Housing Sector

Marife M. Ballesteros [ISBN 971-564-073-7]
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