

The logo of the Asian Development Bank (ADB) is a dark blue square with the letters 'ADB' in white, serif font.

PHILIPPINES:

CASE STUDIES ON Private Sector Development and Operations

A Case Study from the 2007 Special Evaluation Study
on Private Sector Development and Operations:
Harnessing Synergies with the Public Sector

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Abbreviations

| | |
|--------|---|
| ADB | Asian Development Bank |
| AFTA | Association of South East Asian Nations Free Trade Area |
| ASEAN | Association of South East Asian Nations |
| BOT | build-operate-transfer |
| CFS | complementary financing scheme |
| CSP | country strategy program |
| FDI | foreign direct investment |
| GOCC | government owned and controlled corporations |
| GDP | gross domestic product |
| IPP | independent power producers |
| MWSS | Metropolitan Water Systems Services |
| NBFI | nonbank financial institution |
| NPL | nonperforming loan |
| OCR | ordinary capital resources |
| PIATCO | Philippine International Air Terminal Company |
| PPP | public private partnership |
| PRC | People's Republic of China |
| PSA | private sector assessment |
| PSD | private sector development |
| PSOD | Private Sector Operations Department |
| PSO | private sector operation |
| PSP | private sector participation |
| SAPE | sector assistance program evaluation |
| SME | small and medium enterprises |
| WTO | World Trade Organization |

Note

In this report, "\$" refers to US dollars.

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I. Investment Climate

1. Background

1. In the Philippines, the private sector has always played an important role in the economy. The country has been progressive in East Asia in terms of liberalizing the economy, privatizing state-owned firms, and procuring privately financed and operated infrastructure by using public private partnership (PPP) arrangements. While these programs initially made substantial gains in the early 1990s, the openness of the economy and weakness of institutions created significant problems following the Asian financial crisis. After almost a decade of relative stagnation, private sector-led growth is starting to become apparent again.

2. Macroeconomic Stability

2. Following the Asian financial crisis and political instability in 2001, the exchange rate fell by almost 50%. The economy still has not recovered fully from the instability, and significant structural weaknesses persist. An important macroeconomic policy requirement has been the need to address the fiscal imbalance by raising budget revenues on a sustainable basis. As tax revenue in recent years has persistently remained at 15% of gross domestic product (GDP), and interest costs on public sector debt denominated in foreign currency have risen, the Government has had difficulty investing in adequate levels of physical and social infrastructure. The Government is addressing these concerns through continued restructuring and liberalization of the economy, with an increasing emphasis on improving the enabling environment for the private sector.

3. Competition and Trade

3. The legacy of “crony capitalism” under President Ferdinand Marcos, and the impact of past policies based on import substitution and price controls, led to high levels of industry concentration in many sectors. The resulting vested interests of dominant family business groups, which often are interlinked with banks, have limited the level of competition and discouraged private investment. Despite these constraints, trade policy liberalization and deregulation has been quite successful in the Philippines. Nominal average tariffs fell from 28% in 1985 to 7.2% in 2004, and nontariff barriers have been reduced. The Philippines accession to the World Trade Organization (WTO) in 1994 and participation in Association of South East Asian Nations (ASEAN) ASEAN Free Trade Area (AFTA) have helped to improve the trade regime. Under AFTA, the intention is to create a free trade area that includes Japan and the People’s Republic of China (PRC) by 2010. The Philippines has numerous bilateral trade and investment agreements.



4. Domestic liberalization has been occurring in many sectors. Telecommunications, shipping, air transport, and retail trade have been opened to greater competition since 1987. Despite these reforms, competition laws are not effective at addressing problems of oligopoly. Some parties have expressed concerns about labor productivity, which is seen to be low relative to other countries in the region due to high minimum wage rates and moderately restrictive employment laws. While a consumer protection law is in place, a comprehensive antitrust law does not exist, and unfair trade practices are addressed through ad hoc legislation. Essential items, such as rice, have price ceilings in case of national emergency. Specific regulators handle electricity, water, telecommunications, public transport, ports, and road tolls. These regulators are not independent, and they do not have the ability to set tariffs based on cost recovery principles.

4. Privatization

5. Privatization of Government agencies started in 1986. Significant progress was made—about 450 of the 562 Government-owned and -controlled corporations (GOCC) had been privatized by the end of the 1990s. The private sector plays a leading role in delivering some infrastructure services, such as telecommunications, bus and trucking services, and power distribution in Manila. Privatization has slowed since 2001, as most of the remaining assets constitute the more difficult cases. The Government continues to own substantial interests in companies such as Philippine National Oil, Light Rail Transit Authority, Philippine National Railways, National Power Corporation, five banks, and a state pension system. Most GOCCs have posted sustained deficits, constraining their ability to provide services. The sale of the shares in the Philippine National Bank in September 2005, the biggest privatization since 1995, demonstrated the Government's continuing commitment to reform in this area. Progress in privatizing the infrastructure services include (i) unbundling the power sector to allow independent power producers (IPP) to generate electricity, (ii) privatizing the water supply in Manila, and (iii) privatizing the Manila International Container Terminal in the 1980s.

5. Public Private Partnerships

6. Public sector procurement through PPPs has been an important component of the Government's infrastructure programs. Build-operate-transfer (BOT) laws were enacted in 1990 and 1994 to allow private sector participation (PSP) in the development and operation of infrastructure, especially in the power sector. By 2003, the Philippines had commitments for \$25 billion in private finance using concessions.¹ This program has been substantial, encompassing 45 power-related projects with a total value of \$10 billion, 20 transport projects with an aggregate value of \$6 billion, 17 environment-related projects valued at



¹ N. Kintanar et al. 2003. Locking Private Sector Participation into Infrastructure Development in the Philippines. *Transport and Communications Bulletin for Asia Pacific*. No. 72.

\$8 billion, and 49 other projects in areas such as property development and information technology procurement.

7. While the scale and scope of PPP projects in the Philippines is impressive, some problems have arisen. Ambiguities in the implementing regulations of the BOT laws have led to challenges. The law permits a “Swiss challenge”, which allows a challenger to make a counter bid to an unsolicited proposal. This creates the potential for inefficient litigation. Loopholes in the rules for reviewing projects after award, which can extend beyond technical and contractual considerations, create the potential for expropriation of assets. The Supreme Court has ruled on several PPP contracts, sometimes to the detriment of private firms. While the Government has not unilaterally revised any contracts, it has renegotiated 18 of 35 IPP contracts in the power sector that were signed in the early 1990s. Most of these contracts were negotiated contracts and were not awarded based on transparent competitive bidding, creating concerns among the public about crony capitalism. In 2002, the Government introduced the Government Procurement Act, which was designed to promote competitive bidding, transparency, and accountability. Despite these reforms, the recovery of the PPP program has been slow.

6. Foreign Direct Investment

8. Foreign Direct Investment (FDI) was liberalized in 1991 to allow 100% foreign ownership of Philippine assets, apart from those on two negative lists that included restricted foreign ownership of items such as land. In 1993, legislation was enacted that allowed foreigners to lease land for 50 years, renewable for an additional 25 years. Profits and capital can be repatriated fully, and private firms face relatively few restrictions in borrowing offshore. These reforms led to a significant increase in investment by multinational corporations in manufacturing facilities in the early to mid-1990s. The Philippines established several export processing zones to attract FDI, and made available a complex system of investment incentives. Despite these arrangements, the level of FDI in recent years has been about 0.5–0.7% of GDP, which compares unfavorably with other countries in the region.

7. Infrastructure

9. Due to the Philippine’s weak infrastructure, coupled with persistent public sector funding constraints, the Government has sought private sector investment since 1994 when it enacted the BOT Law. Initially, this legislation was successful, stimulating (mainly foreign) investment of more than \$25 billion to increase capacity in the power and road sectors. This form of investment has largely dried up, partly because of concerns



about corruption and political instability. In addition, contractual and regulatory disputes between the public and private sectors in the power, water, and airport sectors have eroded private confidence. To stimulate private investment, coherent sector plans need to be developed, supported by capable public sector agencies that include independent

regulators, unbundled competitive operations, and clear rules on procurement using PPP instruments, tariffs, and dispute resolution. While sector regulators have been established, Congress typically is responsible for setting tariffs. Politicization of the tariff process has led to tariffs in the power and water sectors being set at levels below cost in some cases, without any compensation provided for private sponsors.

10. Private investment has been most successful in communication infrastructure due to the nature of the technology and ability to rely on greenfield investment in mobile rather than regulation of existing fixed lines to generate competition. The Government deregulated the telecommunications sector in 1993, removing the monopoly of the



privately owned Philippine Long Distance Telephone Company and allowing the development of competitive service providers, particularly in the mobile phone and Internet markets. In the power sector, domestic energy capacity increased substantially following large state investments in geothermal and hydropower generating capacity and private IPPs in the 1990s. The rate of electrification in the Philippines is relatively high by East

Asian standards. However, this is offset by interruptions, and transmission and distribution system losses of about 14% of capacity. Electricity charges are the highest in the region. As noted in the Philippine Power Sector Assistance Program Evaluation (SAPE), and similar to other countries, the restructuring and unbundling of the power sector has been a difficult and time-consuming task.²

11. The transport sector was liberalized in the 1990s, although institutional complexity has hindered progress on reforms to support increased private sector participation. Sixteen agencies are involved in the operations and management of the transport network, which makes coordination and inter-modal planning difficult. Cost-based tariffs administered by independent regulators are needed, but these types of institutions are not yet in place in the transport sector. The Government remains the predominant owner of the physical assets in roads, rail, air, and seaports. A notable exception to Government infrastructure ownership was the successful Manila North Luzon Expressway BOT project, which was financed by Asian Development Bank's (ADB) private sector operations, and the Manila International Container Terminal. In contrast, the Philippine International Air Terminal Company (PIATCO) airport project is embroiled in legal disputes between the Government and its sponsors.

12. The Government has pursued reforms to increase the level of private sector engagement in the water sector with mixed results. Private sector participation has consisted of two concessions in Manila, a concession in Subic, and many small-scale independent providers that serve about 15% of the urban population and 10% of the rural population using technology ranging from pushcarts to small piped water systems. Problems coordinating the wide range of public sector agencies involved in water provision have constrained planning of water projects. The Metropolitan Water Systems

² ADB. 2005. *Sector Assistance Program Evaluation of ADB Assistance to Philippines Power Sector*. Manila (paras. 30–31).

Services (MWSS) regulates two private concessions in Manila, and it continues to have operational responsibilities that create a conflict of interest. The tariff adjustment mechanisms, which became a major issue for one of the Manila concessions (Maynilad), have faced problems. Due to currency mismatches associated with the large amount of MWSS foreign-denominated debt assigned to Maynilad, the concession experienced financial difficulties following the substantial depreciation of the peso and disputes over the timing of tariff adjustment. Because of these problems, the concession was canceled. In contrast, the Manila Water concession has been successful, and provides an excellent example that water infrastructure can be financed privately.³ Apart from the Manila concessions, private sector participation in the water sector has been limited. Local Government units have been unable to sign any contracts with private operators, despite attempts to do so, due to concerns about quality of the system and regulatory framework.

8. Small and Medium-Sized Enterprises

13. Micro-enterprises and small and medium-sized enterprises (SME) account for 99% of business establishments, 32% of value added, and 68% of employment. SMEs traditionally have been a high priority sector for the Government. In 1991, the SME Magna Carta was enacted, which highlights the importance of lowering the costs of doing business, raising productivity, and improving access to technology and finance. The legislation (i) created an SME Development Council that is responsible for coordinating development of SMEs; (ii) specified mandatory bank credit allocations to SMEs; and (iii) created the state-owned Small Business Guarantee and Finance Corporation, which is part of Department of Trade and Industry. In 1999, the Government required the guarantee agency and the state-owned Philippine Export Import Credit Agency to start direct lending to SMEs. In 2004, President Gloria Arroyo announced a 10-point reform agenda that included provisions to triple available credit for SMEs.

9. Financial and Capital Markets

14. About half of Philippine companies use bank financing for working capital, while the remaining 50% of funding is sourced primarily from retained earnings. Banks dominate the Philippine finance sector, accounting for 64% of financial assets in 2004, followed by the Philippine Stock Exchange with 22% and nonbank financial institutions with 14%. The Government is still an important participant in the finance sector, partly owning one universal bank (Philippine National Bank) and three specialized banks: Development Bank of the Philippines, Land Bank of the Philippines, and a small special purpose Islamic bank. The remaining banks are privately owned, typically by a larger conglomerate that uses the banks as a means of accessing finance. Of the 21 foreign financial institutions, four are large commercial banks.

³ International Finance Corporation. 2006. *Making a Difference, How Private Enterprise is Creating Opportunities and Improving Lives in Developing Economies*. Washington, DC. This report provides an interesting case study on Manila Water Company Limited:

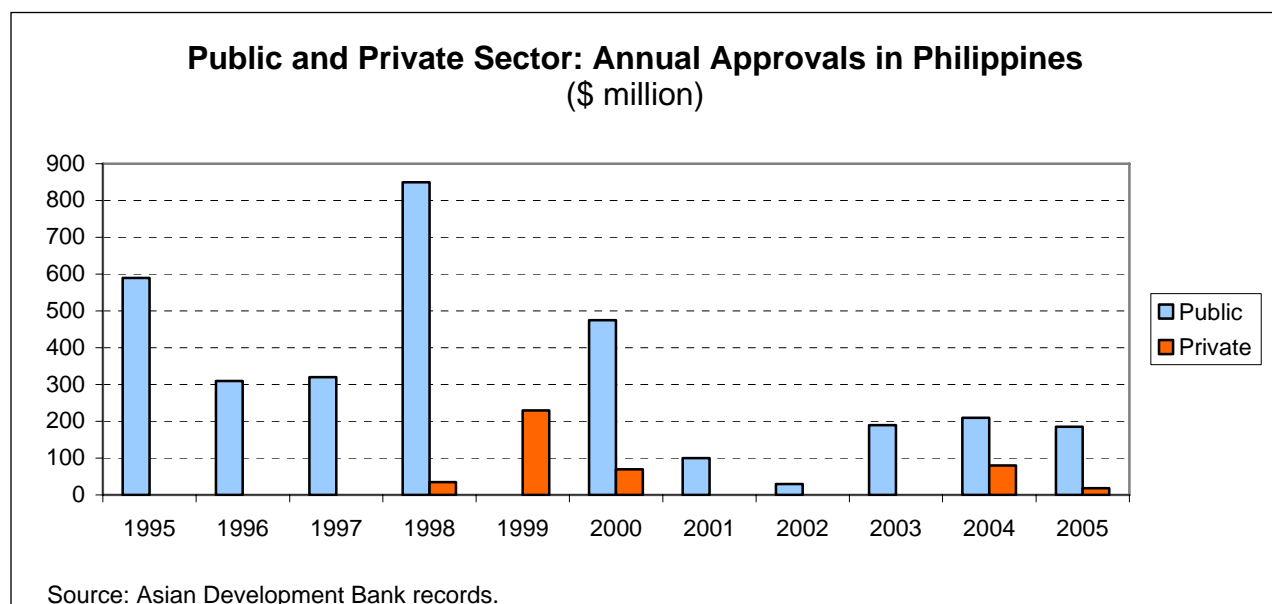
15. Loan portfolios grew rapidly before the Asian financial crisis, but subsequently slowed as economic growth rates fell and credit constraints increased due to the deteriorating quality of loan portfolios. Loan security is weak due to problems related to foreclosing on collateral. At the end of 2003, nonperforming loan (NPL) ratios were estimated to be 15% of bank loans, representing 53% of bank capital. The central bank has initiated reforms to clean up NPLs. This program is making progress, and by 2005 NPLs for commercial banks had declined to 7.5%.

16. The stock exchange is small relative to others in South East Asia, with only 237 listed companies and an average of about four initial public offerings per year. The corporate bond market is virtually nonexistent, and large Philippine companies prefer to list offshore to take advantage of better liquidity and pricing. Weaknesses in minority shareholder rights, restrictions on foreign ownership, and high transaction costs constrain growth in demand for equities. To help resolve these issues, the Securities Exchange Commission, in association with the Capital Markets Development Council, recently prepared a blueprint to strengthen the capital markets on a wide range of fronts.

II. ADB's Country Strategy and Development Program

1. Overview

17. ADB started operations in the Philippines in 1969. Traditionally, ADB has focused on a mixture of public sector-financed infrastructure projects designed to support growth and other operations to meet rural development, and social and environmental objectives. As illustrated below; the public and private sector financing levels have been volatile and trending downwards.



18. Annual public sector lending, which peaked at \$851 million in 1998, has averaged \$170 million per year since then. From 2003 through 2005, public sector lending ranged between \$175 and \$213 million. Volatility has been associated with the Asian financial crisis in 1997, political instability in 2001 and 2002, and the Government's fiscal situation that made debt service increasingly difficult. During 1995–2005, lending has come almost exclusively from non-concessional ordinary capital resources (OCR), with a shift from project to program lending.

19. Private Sector Operations (PSO), which ADB began in 1986, have been much more limited than public sector operations. ADB has approved 29 PSO projects for \$579.8 million on ADB's own account, yielding an average project size of \$20 million. In addition, loans totaling \$233.6 million were approved under the complementary financing scheme (CFS) for two projects in transport, one in water distribution, one in energy, one in manufacturing, and two in the petrochemical industry. Like public sector lending, PSO has been volatile. In the 11 years since PSO began, ADB made private sector loans in 5 of these years. ADB did not have any PSO in the Philippines in the balance of the period. The early investments in the Philippines related to manufacturing. ADB then moved into telecommunications and power. A significant expansion in PSO took place during the early 1990s when ADB played an important role in the Government's "fast track" approach to solve the acute power shortages.⁴ ADB invested in three of the 10 IPP projects that were put in place. At the end of 2005, Private Sector Operations Department's (PSOD) country exposure totaled \$112 million, which represented 6.6% of the PSO portfolio. These PSO investments were made almost exclusively to financial institutions.

2. Country Strategies

20. In the early 1990s, slow economic growth was the primary concern of the Philippines. Reflecting the Government's priorities, the ADB's 1993 country strategy focused mainly on infrastructure development, supported by social and environmental initiatives, such as employment generation and environmental protection. The Asian financial crisis slowed economic growth and precipitated a substantial depreciation of the peso. The exchange rate adjustment created pressure on inflation and the financial performance of projects that generated local currency receipts but were financed in foreign currency.

21. The 1998 country strategy program⁵ (CSP) concluded that ADB's strategy in the Philippines should focus on five areas: (i) upgrading the country's infrastructure by improving efficiency in public provision and laying the groundwork for private provision through policy and institutional reform, particularly by (a) enhancing BOT bidding procedures and creating a project pipeline, (b) strengthening PPP capacity at local Government level, and (c) developing capital markets; (ii) rural development through microfinance; (iii) human resource development in areas such as basic education and

⁴ ADB. 2005. *Sector Assistance Program Evaluation of ADB Assistance to Philippines Power Sector*. Manila.

⁵ ADB. 1998. *Philippines: Country Operational Strategy*. Manila.

primary health for the poor; (iv) more balanced regional development, with a special focus on Mindanao; and (v) environmental management. Infrastructure continued to be a priority as investment during the 1980s had lagged other parts of South East Asia, and electricity shortages were widespread in the 1980s and early 1990s.

22. In 2001, the country strategy was revised. It noted that private sector development (PSD) assistance would focus on (i) SME support; (ii) increased private sector participation in rural infrastructure, railroads, tollways, telecommunications in rural areas, power and renewable energy, water supply, and waste management; (iii) restructuring of Philippine National Railways; and (iv) privatization of National Power Corporation. In 2005, ADB published a private sector assessment (PSA) that identified specific measures to implement the PSD strategy in Philippines. Following early findings of the PSA, resolving NPLs, enhancing local government access to finance, and increasing PPP in areas such as housing were emphasized. Judicial reform was identified as an important enabling environment objective. PSOD focused on supporting privatization, especially in power infrastructure, and developing the finance sector in areas such as NPL resolution. More recently, PSOD has been looking for ways to mobilize local currency finance, particularly through the use of swaps. In October 2005, ADB issued a local currency bond in the Philippines of P2.5 billion.

3. ADB Assistance Program

23. Table 1 provides a breakdown of public sector lending in the Philippines that is relevant to PSO. Infrastructure appears to have gradually declined in importance relative to finance sector assistance.

Table 1: Sector Allocation of Public Sector Loans
(\$ million)

| Year | Public Administration | Power and Energy | Transport | Water and Urban Development | Finance | Total |
|--------------|-----------------------|------------------|------------|-----------------------------|------------|--------------|
| 1995 | 30 | 244 | | | 150 | 424 |
| 1996 | | 5 | 167 | 50 | 20 | 242 |
| 1997 | | 191 | 93 | | | 284 |
| 1998 | | 300 | | 320 | | 620 |
| 1999 | | | | | 3 | 3 |
| 2000 | | | | 175 | | 175 |
| 2001 | | | | 30 | 75 | 105 |
| 2002 | | 40 | | | | 40 |
| 2003 | | | | 34 | 150 | 184 |
| 2004 | | | | | | 0 |
| 2005 | | | | | 175 | 175 |
| Total | 30 | 781 | 260 | 609 | 573 | 2,253 |

Source: Asian Development Bank records.

24. Apart from two large public sector loans for urban redevelopment projects in Manila, the major volume of lending during 2000–2005 was directed to capital markets,

SMEs and microfinance. The public side of ADB was not involved in the telecommunications sector, and it has gradually disengaged from the transport and water sectors. ADB provided extensive assistance to MWSS, which resulted in one highly successful water concession. The other water facility that ADB intended to finance through PSO was canceled. Public sector lending in the power sector shifted from project to program lending to support ongoing efforts to restructure the industry. Key issues addressed included unbundling the sector, improving the legal framework, developing an independent regulator, promoting privatization, and addressing tariff issues. Restructuring the power sector, which should create more business opportunities for PSO, has been a long and difficult process.

25. PSOD has followed a broadly similar strategy to the public sector, with several large water- and transport-related infrastructure PPP projects being the main priorities in the late 1990s—all of which were negatively impacted by the depreciation of the peso and political uncertainty. PSOD was not active in the Philippines from 2000 through to 2004. In 2005, PSOD initiated a series of NPL transactions and obtained approval to invest in a credit bureau, although these transactions were small.

4. PSO Transactions in the Philippines

26. Table 2 presents a summary of ADB's PSO investment approvals for the Philippines from 1995 through 2005. During this period, 11 projects were approved for a total of \$613.1million, including CFS loans for \$193.58 million and a partial guarantee for \$18.4 million. Investments approved for the finance and capital market sector dominate the country portfolio.

Table 2: PSO Investment Approvals in the Philippines (1995–2005)

| Name | Sector | ADB Financing (\$ million) | | | | | Year Approved | Status |
|---------------------------------|-----------|----------------------------|--------|--------|-------|--------|---------------|-----------------------|
| | | Loan | CFS | Equity | PCG | Total | | |
| Management Company ^a | Finance | – | – | 0.05 | – | 0.05 | 1995 | |
| Mutual Fund Company | Finance | – | – | 3.85 | | 3.85 | 1996 | |
| Oleochemicals ^a | Industry | 19.42 | 8.58 | 5.84 | - | 33.84 | 1998 | Investment liquidated |
| Water Services | Water | 45.00 | 120.00 | – | – | 165.00 | 1999 | Canceled |
| Air Terminals | Transport | 40.00 | 40.00 | – | – | 80.00 | 1999 | Canceled |
| Tollways Corporation | Transport | 45.00 | 25.00 | – | – | 70.00 | 2000 | |
| Peso Swap and Financing Project | Finance | 200.00 | – | – | – | 200.00 | 2004 | Canceled |
| Guarantee Corporation | Finance | – | – | 2.00 | – | 2.00 | 2004 | |
| Disposal of NPLs | Finance | 33.00 | – | 1.00 | – | 34.00 | 2004 | |
| Housing Finance | Finance | 29.24 | – | – | – | 29.24 | 2004 | |
| Bank Disposal of NPLs | Finance | 5.00 | – | – | – | 5.00 | 2005 | |
| Facility and Credit Information | Finance | – | – | 1.00 | 18.40 | 19.40 | 2005 | |

– = not applicable, ADB = Asian Development Bank, CFS = complementary financing scheme, NPL= nonperforming loan, PCG = partial risk guarantee, PSO = private sector operations.

^a Includes initial investment.

Source: Operations Evaluation Department staff compilation.

27. Several large projects that were canceled after approval distort these figures. The Maynilad Water Services project did not reach financial close due to the financial difficulties experienced by the company. The investment in PIATCO air terminal was canceled as implementation and operational disputes emerged between the sponsors and the Government before the commissioning of the completed terminal. The Government canceled the peso swap facility. While the justification for this move is not clear, it was probably because the Government believed it could access sufficient foreign currency on a more flexible basis through the local foreign exchange market. These cancellations totaled \$445 million, or 73% of gross approvals. ADB did not approve any investments in 2000–2003, and 50% of the transactions by number have occurred since 2004.

28. Following the cancellations, the remaining portfolio is \$168.1 million, consisting of \$102.5 million in loans on ADB's own account, \$33.6 million under CFS, and \$18.4 million under partial risk guarantee. ADB's equity exposure is \$13.7 million, or a reasonable 8% of the country portfolio. Of the projects that were not canceled, one infrastructure and one industrial project account for \$103.4 million, or 61% of the gross total; the remaining eight (\$60.9 million) were financial and capital market transactions.

29. The Philippines has benefited from some of PSOD's regional funds. Over more than 10 years, 48 SMEs in a wide variety of sectors have received equity investments from these funds totaling \$16.64 million. The average size of the investment has been about \$350,000, with the smallest being \$20,000 and the largest \$3.56 million.

30. An OED evaluation of the PSO projects in the Philippines, based on a mixture of desk-based reviews and company visits, derived the indicative project performance results shown in Table 3.

Table 3: Summary of Evaluated Project Performance in the Philippines (1995–2005)

| Project | PSD | Investment Performance | Comments/Issue |
|---------------------------------|----------------|------------------------|-----------------------------|
| Management Company | Satisfactory | Marginal | – |
| Mutual Fund Company | Unsatisfactory | Unsatisfactory | – |
| Oleochemicals ^a | Unsatisfactory | Unsatisfactory | Investment liquidated |
| Water Services | Canceled | – | Project canceled |
| Air Terminals | Canceled | – | Project canceled |
| Tollways Corporation | Excellent | Excellent | – |
| Peso Swap and Financing Project | Canceled | – | Canceled by client |
| Guarantee Corporation | Satisfactory | Satisfactory | – |
| Disposal of NPLs | Excellent | Satisfactory | – |
| Bank Disposal NPLs | Excellent | Satisfactory | – |
| Facility and Credit Information | Satisfactory | Satisfactory | Project not yet operational |

– = not applicable, NPL = non performing loan, PSD = Private Sector Development.

^a Including initial investment in 1993.

^b Source: Operations Evaluation Department staff compilation.

III. PSD Issues in the Philippines

31. The Philippines is a country that has high potential for PSO as it is strategically located in East Asia, has a large relatively well-educated population that speaks English, and has an open economy and a political and legal system based on American standards. The private sector accounts for about 95% of GDP and 70% of fixed capital formation. Despite these advantages, growth has been volatile and low by regional standards; and investment, especially from FDI, has fallen dramatically.

32. Because of the Asian financial crisis and the derived fiscal problems, ADB's public sector lending has been limited since 2002, and PSO has been marginal throughout the period of review. Power sector reform and urban development projects have been the dominant areas of public sector lending. In the country strategy documents, PSD has been a high priority, with infrastructure being the focus in the 1998 CSP. In subsequent updates of the CSP, the focus started to shift to SMEs and NPL resolution, coupled with a continued focus on power sector reform. The Country Assistance Program Evaluation prepared in 2003 concluded that only 29% of public sector projects had been successful during 1986–2001, and some private infrastructure projects had run into serious difficulties. The PSA published in 2005 set out a clear strategic framework for facilitating private investment, focusing on strengthening competition, pursuing corruption eradication efforts, strengthening the judiciary and the legal framework, establishing independent regulators, and strengthening capacity to procure privately financed infrastructure. While the CSPs (and updates) have a strong PSD orientation, the level of cooperation between the public and private sector sides appears to have been poor. PSOD staff had limited involvement in the preparation of the last CSP.



33. Despite a strong private sector orientation in the CSP, and calls for increased levels of cooperation between public and private sector departments, the results on the ground were disappointing. Public sector lending has been declining, and PSO has not taken off. In public administration reform, the public sector provided advice to the LGU Guarantee Corporation in 1996, which might have helped pave the way for a PSOD investment of \$2.0 million in 2004. The public sector has been heavily engaged in the power sector, and it appears to be putting in place the policy and institutional framework that will support increased levels of private sector participation in the sector. ADB's public sector operations were heavily involved in the MWSS privatization program, which was followed by a PSOD loan approval. Conversely, in the transport and urban development sectors, the regional department appears to have provided little advice or technical capacity building to support greater PSOD involvement. ADB's public and private sector operations have been heavily involved in the finance sector. However, the public sector appears to have focused primarily on nonbank financial institutions and capital markets, while PSOD has concentrated on NPLs.

34. The size of the PSO portfolio in the Philippines is small at \$111.9 million, or 6.6% of the ADB's PSO portfolio as of 31 December 2005. The quality of the portfolio appears to be deteriorating, mainly due to legacy funding facilities provided in high-risk manufacturing sectors, such as agricultural process, that was discontinued in the early 1990s. The Asian financial crisis and subsequent macroeconomic instability also have undermined the quality of investments, and the ability to close transactions. Infrastructure investment has almost ceased following problems with Maynilad, PIATCO, Manila Electric Company, and Manila North Tollway. PSO has sought to turn these difficult circumstances to its advantage by putting in place a series of innovative NPL transactions that acts as an important constraint on SME's ability to access funds.