FINANCIAL RECONSTRUCTION — THE TASK AHEAD*

BY

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I am deeply grateful for the honor of being invited to speak here today. With the elections less than two weeks away, it behooves us who participate in organizing and directing economic activity in this country to assess, according to our best lights, the most pressing problems vexing the economy and suggest possible solutions — in the hope that those whom the people will entrust with the powers of government during the next four years would thereby be assisted in formulating and implementing policies conducive to a healthier economy.

Last week, I was given by another organization an opportunity to diagnose the organic and functional problems confronting the Philippine economy today. On that occasion, I limited myself to the diagnosis and did not attempt prescriptions because diagnosis alone, even in summary form, almost more than sufficed for an entire address. Allow me at this time to suggest a possible cure. I want to say first of all that the suggestions I am going to advance today are by no means the only and final solutions. I offer them in a spirit of free discussion and exploration. In the field of economic policy, there should not be any dogmatism, only enlightened pragmatism. I would be as willing to listen to other proposals as I hope you are to mine. I only hope that we would all examine the problems with greater depth than we have done or been used to before and that we can engage in a discussion of the issues with impartiality, fairness, and civility.

In my previous speech, I traced how, with the advent of decontrol, smuggling and other forms of violations of customs laws and regulations precipitated a pervasive market disorganization and financial distortion throughout the whole economy. Decontrol brought about two distinct changes — a de facto devaluation and a total lifting of all controls over foreign exchange transactions. The change in the rate of exchange by itself was urgent for balance of payments reasons and would have had a healthy effect on the economy as a whole if only

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some complementary measures had been promulgated. Devaluation increased the flow of income into the agricultural sector and this would have helped in creating a rural mass market for the products of domestic industry. This increased income could then have found its way back from domestic industry to the banks and could have lubricated and geared the whole system for higher levels of employment and production.

A rural mass market was indeed created by devaluation but it was spoiled for domestic manufactures by the open invasion of illegal imports which competed ruthlessly with domestic industry and totally frustrated the healthy internal cycle I referred to before. Again, even this invasion could have been met — and met successfully — by domestic industry if only some complementary measures had been taken, among which were: formal devaluation of the peso and fixing of a new par, provision of massive refinancing to the manufacturing sector in recognition of the effect of the new exchange rate on their asset and liability positions, provision of enough relief from taxes and duties to industries to offset the higher cost of exchange, provision of incentives to domestic industries to venture into the export market, provision of effective administrative safeguards to keep illegal importations down to a manageable level. Furthermore, the pressures on the international reserves generated by large-scale smuggling prompted the Central Bank to tighten the squeeze on domestic credit in order to curtail the demand for foreign exchange and to accommodate the needs of the government for credit, deprived as it is of the customs duties that it should have collected on the smuggled items.

As a result of the total failure to hedge against the anticipated adverse effects of decontrol, the economy has been forced to a state of market disorganization and financial frustration. The complexity of the whole situation can be reduced to two principal problems: the problem of profitability and the problem of financing. One involves costs and markets, the other the composition of assets and liabilities. And the general approaches are clear. The problem of profitability can be solved only by creating those conditions leading to an increase in the output and sales of our industries — at prices reasonably competitive with foreign products and at margins providing a reasonable rate of return on invested capital. This must be the prime objective of all our economic policies: to increase output and sales. The problem of financing, on the other hand, can be solved only by the provision of funds that would cushion industries caught by devaluation against its effect on their outstanding foreign exchange obligations, funds that would not only lengthen the maturities of the existing obligations of our industries but also provide fresh injections of working capital.

The set of prescriptions that I venture to offer today are designed to attack both of these problems in one coordinated stroke. I believe that the disorganized state of affairs we find ourselves in today can be corrected only with the implementation of the following measures, not only in bits and pieces, but as part of an integrated strategy.

First, the failure to define a new legal par value in January 1962, as I previously pointed out, prevented Section 83 of the Central Bank Charter from becoming operative. Emerging as we were then from a period of exchange controls, it would have been possible to interpret this provision in such a manner that the burden of devaluation would entirely fall on the Central Bank and not on the companies that had a net foreign exchange exposure at the time of devaluation. This would have saved many companies from the need for more peso cash simply to amortize the same amount of foreign obligations. There are grounds for believing that the Central Bank might still be willing, even at this late stage, to give a second look at this type of relief. The circular issued by the Bank, which recognized the validity of restoring, to those companies which lost it in 1963, the prerogative of converting the remaining portion of their foreign deferred obligations at the rate of ₱3.20 to $1 seems to provide these grounds. If the Bank is willing to recognize the ₱3.20 rate, it would involve a very small extension of understanding on its part to concede that the most equitable thing to do would be to recognize the rate prevailing at the time the deferred foreign exchange obligation was incurred.

Second, the problem of large-scale smuggling and other forms of illegal importation must be vigorously tackled. Smuggling takes place because it is profitable for the smuggler to avoid payment of all or part of duties and taxes on the commodities smuggled. The smuggler cannot avoid the payment of the exchange rate and freight charges. Those he has to pay as much as the legitimate importer. On the other hand, tariffs and taxes cannot and should not be totally abolished because they produce much needed revenue for the government and, in a developing economy, are necessary for the protection of domestic industry. In this problem area, there is a host of possible solutions which are classifiable into two general categories, namely, administrative and non-administrative. The administrative measures can range all the way from those that impose heavy criminal penalties on the violator, through those that give substantial incentives to the administrators of customs laws and regulations, a tariff structure and customs regulations that give priority to raw materials, equipment and parts over finished articles, duties and taxes that relate to value rather than volume, a system that gives deliberate incentives to exporters and re-exporters, a system that recognizes the importance of raising revenue which would otherwise be lost through illegal importation from finished goods that are not manufactured in the country anyway — all the way to outright quantitative restrictions and exchange controls. Anyone of these measures would require the employment of organizational and administrative disciplines and skills. Because of our limited experience with customs administration, I agree that we are still far from having exhausted the possibilities of administrative measures in dealing with the problem of illegal importations.

Non-administrative measures, on the other hand, are rather limited in number. There can, after all, be only two variables involved — the exchange rate and the tariffs and taxes (taken together). One could move either or both of the two variables always with the objective of narrowing down the profit area of the smuggler and making it not worth his while to smuggle. The other primordial objective, of course, is to maintain the protection that domestic industry needs and deserves.

Five weeks ago in two television interviews, I stated that inasmuch as the problem is urgent and that inasmuch as no administrative measure seems to have met significant success during the last three and a half years, we should probably try a non-administrative approach — by raising the exchange rate and reducing tariffs and taxes thereby making it unprofitable for the smuggler to continue his nefarious trade and in the same breath achieve the purpose of raising more revenue for government and protect domestic industry from the ruthless competition of illegal imports. I also said that this move must be simultaneously accompanied by other measures calculated to further increase the capability of domestic industry to compete with foreign manufacturers in its home market and in the export field — otherwise it will not be beneficial. I stated further that I consider the reimposition of exchange controls a backward step. My reason for saying this is simply the fact that we have had exchange controls before and we decided it best to give them up. When we did this I was one of the few voices in the wilderness against it. I favored the adjustment of the exchange rate upward but I opposed the removal of the umbrella of exchange controls. I argued that we could not yet afford such a move; that we should raise the exchange rate, yes, but that we should maintain the general framework of exchange controls over the economy; that the raising of the exchange rate should reduce the corruption and the difficulty attendant to the administration of controls; that throwing the whole burden of controlling the entry of foreign imports on the customs is unwise because we have not yet developed the requisite experience and tradition in the public administration of our own resources — the emotional and psychological equipment and patterns — which would make our clerks, appraisers, supervisors, superintendents, division and department heads react, almost instinctively, to protect the patrimony of their people; that in the light of this inexperience our most effective instrument for protecting domestic industry is that of quantitative restrictions; that the financial ability of domestic manufacturers to compete vis-a-vis the foreign manufacturer is limited by the resources and capability of domestic banks — which even if lumped together would not have resources equal to one big bank in the United States, Japan, Germany, France or England; and finally that if the advanced industrial countries of the world, except the United States, have seen fit to maintain exchange controls over their economies since before the war who were we to divest ourselves so early in our march toward industrialization of such an effective protective cover for our infantile efforts to raise ourselves by our own bootstraps.

However, after having argued thus, I was overruled. It was considered wisest to increase the exchange rate (with which I agreed) and to remove the controls. And let me remind you, my friends, that at that time this was the apparent consensus. These twin moves or changes were loudly extolled and welcomed by every sector in the business community.

The suggestion I made of curbing smuggling by raising the exchange rate and reducing tariffs and taxes was met with a hostility I never even dreamt it deserved. It was mercilessly pulled out of the context of the other parts of my package proposal and showered under with attacks that went as far as to throw doubts on my loyalty to the cause of the Chamber of Industries and my patriotism. Be all that as it may, it is clear to me that our national community is against further devaluation. This consensus is easy for me to accept and I am willing to be governed by it. But I submit, with all the seriousness I can muster, that we must move — and move effectively and soon to curb illegal importations in some other way. The consequences of allowing the situation to just drift without effective action on our part is — first — financial paralysis and soon thereafter a paralysis of productive activity and vigorous development.

Third, I should like to suggest that whether we adopt administrative or non-administrative measures to reduce smuggling to manageable proportions, we should determine and fix a new par value for the peso. We should have a formal devaluation in other words. What the rate should be is for the Central Bank to determine. This would require serious staff study which, for all I know, may have already been made. The Central Bank has been defending the ₱3.90 rate. This may well be the correct rate. Or it may be ₱4. The reluctance to give up the 20% retention seems to be no longer justified at this juncture. The liquidity which characterized the economy in January 1962 and the months that followed no longer exists. Even the export sector is now hungry for funds. The reputation for profligacy of exporters of raw materials in this country is now completely deserved. Many of them have used the windfalls they received during the past three and a half years in the expansion or improvement of their facilities, if not in the opening of new ventures.

The 20% retention by definition prevents the Central Bank from declaring a new par value. This is because 20% of export receipts are surrendered at the existing par of ₱2 to $1, and a formal devaluation would necessitate the abolition of the retention since the maintenance of a par value implies a single and not a dual rate. I firmly believe that the 20% retention scheme should be remove, constituting as it does a continuous drain on the reserves to the banking system and contributing to the forces that serve to restrict credit.

The floating rate system which we have at present breeds uncertainty and speculation on the part of everyone. Investment decisions, whether short or long-run and whether local or foreign, tend to be distorted by this uncertainty. The sooner this cause of instability is removed, the healthier for the economy.

Fourth, I submit that whether we succeed in curbing illegal importations or not, by any measure that may be chosen, there must be massive refinancing of domestic industry. This has three elements: (1) the rebates, as already mentioned, on payments made in excess of the ₱2.00 to $1 rate; (2) the conversion of short-term liabilities into longer term obligations in order to relieve our industries of the immediate pressure for funds; and (3) the increase in working capital to finance the acquisition of higher-cost inventories and the sale of output on competitive credit terms. This increase in working capital will enable our industries to take care of the balance sheet adjustments made necessary by the shift in the exchange rate. The availability of such financing will enable our domestic industries to compete effectively with foreign manufactured goods.

The refinancing process will entail the imaginative creation of new financial intermediaries. Insurance companies, public and private, are restricted in the use they make of their funds and cannot engage in refinancing on a sufficient scale. There are, of course, a number of new development corporations that dispose of long-term funds, but they are geared mainly to new ventures or to expansion programs; they are not inclined to venture into propping up the financial position of distressed companies. The most logical type of financial institution to embark on large-scale refinancing are investment subsidiaries of commercial banks. Such subsidiaries would be the vehicles of commercial banks for making long-term placements and would serve as their instruments for salvaging and strengthening the troubled accounts that they carry in their portfolios. Such intermediaries would, therefore, be ideally suited for refinancing industries; by doing so they serve the interests not only of the companies they assist but of their parent commercial banks as well.

The fifth measure I would propose towards the reconstruction of our industries is an enlightened revision of our tax structure. This would be aimed at two objectives. One is to produce sufficient revenues for the government in order to put the fiscal sector on a sound financial basis and to eliminate the distortions created by the government's need for large-scale Central Bank credit. The other would be to provide tax reliefs and incentives to save our existing industries from crippling costs, to provide inducements towards new productive ventures, and to give our industries sufficient competitive advantage in the export market. Our present tax structure is obsolete from the point of view of our development requirements; it places the burden of taxation on the sectors where development must take place rather than on those sectors that stand in the best position to absorb these burdens.

The sixth measure is a systematic strategy for expanding our exports, particularly of Philippine manufactures. Suitable incentives can be provided in the form, for example, of exemption from duties and taxes for new exports, the provision of special credit supports, and even outright subsidies. This strategy is an indispensable element in the reconstruction of our existing industries and in the development of new productive enterprises. Inasmuch as the principal factor that would rehabilitate our existing enterprise and make feasible the installation of new ones is the presence of a sufficient market to absorb their output, and inasmuch as the domestic economy at the present level and distribution of income does not provide such a market, our only alternative is to effectively generate an international demand for our finished products. It is also in this manner that we can generate the necessary foreign exchange earnings to bolster our reserves, to finance our importations, and to strengthen the exchange rate itself, thus obviating the need for further devaluation in the future.

The seventh measure that must be undertaken — and I venture to say that this is necessary with or without devaluation — is the rationalization of the government's price policy. The subsidies given to the imports of prime commodities by the NAMARCO and other agencies may be an effective means of keeping these goods within the reach of consumers, but the promulgation of this policy on a permanent basis could be seriously injurious to the development of our own industries. As long as the government stands as a potential competitor with domestic producers of rice and processed foods, for example, the development of local food industries would be severely impaired.

It is, therefore, imperative that the government tailor its consumer subsidy program with the plans of local entrepreneurs to venture into projects that would produce at competitive prices the products to substitute for these subsidized imports. As such industries develop, it will then be possible for the government to phase out of its subsidy programs and use its revenues for more productive purposes. A policy of encouraging rather than competing with domestic industries will provide rather than use up government revenues, and will generate income and employment for domestic labor rather than for foreigners.

Finally, in order to provide a rational and intelligent basis for the formulation of a total financial policy, the institutions of the government, particularly the Central Bank, should organize themselves for conducting a continuing study of money flows in the Philippines. It is often distressing to realize that our monetary and credit policies are based on the analysis of such broad aggregates as the money supply, domestic credits and international reserves, rather than the hard realities reflected by corporate balance sheets, income statements, and flows of fund, and by the patterns of household incomes and expenditures. Such a study, among others, would give a more meaningful basis for the formulation of financial and credit policies other than the chronic phobia of inflation. It would also prevent or minimize the possibility of the economy's degenerating again into a state of total financial disorganization, where the search for remedies has shown a considerable lack of imagination and realism. One must look to a detailed money flows study rather than to meaningless aggregate figures for the premises on which to build our financial policies.

I have attempted during the past few minutes to present an integrated approach calculated to ease the economy from the frustrating financial posture it has assumed and to enable it to take a stance that would permit resumption of productive activity on a sound and stable basis. The restoration of order and stability to our economic affairs is imperative in order that we may be able as a nation to address with self-confidence some very important problems demanding our energy and attention in the foreign economic policy field. The normalization of our relations with Japan, the formulation of new arrangements that would govern future relationships with the U.S., the proposed Common Market and the Asian Development Bank are examples of such problems. Our relations with other nations surrounding us in this area of the world and elsewhere must command our increasing attention and sustained interest. In order to tackle these problem areas successfully, we must arrive at a clear consensus of our long-run aims in the domestic front and the methods by which we would seek consistently to achieve these aims. We can tarry no longer and inasmuch as we are firm in our determination to preserve the private enterprise character of our economy and maintain its integrity, it is incumbent on the private sector to make its wishes known to government as to the lines of action that should be followed in attaining a full development of our rich potential.