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DETERMINANTS OF INFLATION IN THE PHILIPPINES

by

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ABSTRACT

This paper examines the various influences on general price movements in the Philippines since 1965. A model of inflation for small, open economies is developed to serve as the framework of analysis. Based on the regression results, the major determinants of past CPI increases are identified and some implications of the findings briefly discussed.

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*Romeo M. Bautista**

1. Introduction

From 1949, the first year of the Central Bank time series on the consumer price index,[1/] to 1961 the inflation problem was virtually nonexistent in the Philippines. During that period the CPI rose at an average annual rate of less the 1%. In the 1960s CPI increases assumed generally larger values, averaging 5.1% annually during 1962-69, which was still moderate by developing country standards. Indeed, abstracting from the inflationary effects of currency floating during 1962-64, the annual inflation rate averaged only 4.0% for 1965-69.

By contrast the decade of the seventies was characterized by a much higher average annual inflation rate and also by a marked variability of annual CPI increases from one subperiod to the next. Double-digit inflation rates marked the first four years of the 1970s, followed by a return to single-digit rates in the next four years (1975-78) and then a reversion to double-digit rates during 1979-82.

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[1/] For Manila and suburbs. This is the longest and most widely used consumer price index series available, and is the one utilized in the present study. For a comparison of alternative CPIs, see Bautista (1976).

This paper examines the various influences on general price movements in the Philippines since 1965. In Section 2 a model of inflation for small, open economies is developed to serve as the framework of analysis. Section 3 gives a quantitative description of the Philippine inflation experience, including an assessment of the major determinants of CPI increases based on the results of regression analysis. In Section 4 some implications of the findings are briefly discussed.

2. Basic Model of Inflation

The domestic price level (P) is a weighted average of the prices of home-produced goods (P_h) and of foreign produced goods (P_m); in terms of proportionate changes (denoted by a dot over the variable),

$$\dot{P} = s\dot{P}_m + (1-s)\dot{P}_h \tag{1}$$

where s is the share in final consumption of imports and the price variables are expressed in domestic currency. $\dot{P}_m$ embodies changes in foreign currency prices of imported final goods ($\dot{P}^*_m$), exogenous under the small country assumption, and exchange rate changes ($\dot{R}$) which can be considered policy-determined under an adjustable par value regime or even under present currency arrangements (Bautista, 1980).

The bulk of recent empirical work on the determinants of domestic inflation is based on the standard mark-up pricing model which, on the basis of the firm's cost function, hypothesizes that

$$\dot{P}_h = k(r_1\dot{W} + r_2\dot{P}_i) \tag{2}$$

where k is a constant mark-up factor, $\dot{W}$ and $\dot{P}_i$ are the proportionate changes in nominal wage and material input prices, respectively, and r_1 and r_2 are reduced form coefficients of the production function. For present purposes, it is convenient to assume that $\dot{W}$ reflects the change in labor cost not only at the final stage of production but also in the domestic production of material inputs (intermediate goods). Equation (2) may then be rewritten

$$\dot{P}_h = k(r_1'\dot{W} + r_2'\dot{P}_m) \tag{2'}$$

where $\dot{P}_m$ now measures also the change in the cost of imported intermediate goods. Here we are ignoring changes in the relative prices of intermediate and final goods in the world market (but which will be addressed in the empirical analysis below).

Substituting (2') into (1) yields

$$\dot{P} = a_1\dot{P}_m + a_2\dot{W} \tag{3}$$

where

$$a_1 = s + (1-s)kr_2' \tag{3a}$$

and

$$a_2 = (1-s)kr_1' \ . \tag{3b}$$

In (3a) the total effect of foreign price changes on domestic inflation is seen to consist of the direct effect on the prices of final goods and the indirect effect due to the change in the cost of imported intermediate goods.

Thus far, the potential role of excess demand has not been taken into consideration. Based on the quantity theory, a reasonable proxy for excess demand would be the difference between the rates of changes in the nominal money supply and real income ($\dot{M} - \dot{Y}$). This variable would have an independent inflationary effect if money supply were expanded at a rate greater than what is warranted by real growth or required to accommodate cost increases. Equation (3) might than be simply modified as

$$\dot{P} = a_1'(\dot{P}_m^* + \dot{R}) + a_2'\dot{W} + a_3'(\dot{M} - \dot{Y}) \tag{4}$$

A more general specification of the price equation would allow for asymmetrical effects of $\dot{P}_m$ and $\dot{R}$ as well as of $\dot{M}$ and $\dot{Y}$, as has been done in some previous studies, e.g., by Cooper (1971) and Glytsos (1977):

$$\dot{P} = b_o + b_1\dot{P}_m^* + b_2\dot{R} + b_3\dot{W} + b_4\dot{M} + b_5\dot{Y} \tag{5}$$

More recently, Aghevli and Rodriguez (1979) have formally derived a price equation similar to (5) using a two-sector open economy model in which home goods prices adjust in part to the excess supply of money while the price in the import-competing sector is determined directly by the world price and current exchange rate.

3. The Philippine Experience

Average annual rates of change in the variables appearing in equation (5) are shown in Table 1 during the four subperiods dis-

Table 1: Average Annual Rates of Change in Selected Variables, 1965-82 (in per cent)

Variable	1965-69	1969-74	1974-78	1978-82
Consumer price index (P) (1972 = 100)	4.03	17.32	7.46	14.88
Import price index (P_m) (1972 = 100)	3.71	20.72	3.91	13.85
Effective exchange rate (R) (1972 = 100)	0.19	14.19	4.40	5.70
Wage rate index for unskilled workers (W) (1972 = 100)	7.04	6.85	5.73	4.63*
Gross national product (Y) (at 1972 prices)	4.96	6.20	6.43	4.38
Money supply (M)	10.96	15.21	17.18	8.79

*For 1978-80 only.

Source: See Table 2

tinguished above. Based on a cursory examination of the table, the inflation rate appears to correlate well with changes in the import price index and the effective exchange rate, not as well with the growth in money supply and real GNP, and least of all with wage rate movements. The inflationary subperiods 1969-74 and 1978-82 are seen to coincide with the highest rates of increase in the import price index and the effective exchange rate. The subperiod averages for the changes in money supply, real GNP and the wage rate index are much less variable and do not match the alternate ups-and-downs of the inflation rate; the pattern for the wage rate index is one of continuous decline, while those for the other two are inverted Us.

Foreign currency prices of imported goods are represented, rather inadequately, in an aggregate import price index. This index has been affected significantly by the massive oil price increases in 1974 and 1979-80, which raised the share of oil in the country's import bill from 13% in 1973 to 22% in 1974 and to 30% in 1980. Another effect of the higher cost of imported crude oil was the sharp rises in the local prices of refined petroleum products, the comparative data indicating that the import price increases were fully passed through within a few months and indeed supplemented by upward adjustments in indirect taxes on oil products (Bautista, 1976).[2/] Given

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[2/] Thus, the local price of regular gasoline, for example, had risen from ₱.30 pesos per liter in 1972 to ₱5.05 in 1981.

existing price controls, it is the increase in domestic prices of oil products, not the increased cost of importing crude oil as such, that initiates the adjustment of the general price level. Of course, in addition to such a direct effect, there would be repercussions on the prices of products of oil-using sectors, and further repercussions on other product prices in view of intersectoral linkages. It is remarkable that the three years for which the Philippine inflation rate was highest (1974, 1979 and 1980), as shown in Table 2, were also years of sharply rising oil import prices.

The foreign exchange rate, by which is normally meant the peso-U.S. dollar exchange rate, increased from 3.9 to 6.4 in 1970 with the floating of the domestic currency, which was a policy response to the severe balance of payments problem at the time. It went up gradually to 7.50 by yearend 1975, declined slightly to 7.37 in 1977 and resumed its upward trend to 9.17 in 1982. While the exchange rate depended on the results of interbank trading, commercial banks taking "the initiative in influencing or responding to demand and supply conditions in foreign exchange" (Central Bank, Annual Report 1970; p. 67), the Central Bank or an agent bank acting on its behalf, stood ready to buy or sell foreign exchange at the current rate "to prevent disorderly fluctuations in the exchange rate," in effect maintaining some control over the peso-dollar exchange rate (Bautista, 1977).[3/]

[3/] Exchange rates of the peso with other foreign currencies were determined on the basis of the spot buying and selling rates in New York of these currencies vis-a-vis the U.S. dollar at the end of the day preceding the actual purchase or sale.

Table 2: Annual Rates of Change in Selected Variables, 1965-82
(in per cent)

Year	P	P_m	R	W	Y	M
1965-66	5.41	1.66	-.26	7.57	4.35	8.14
1966-67	6.41	2.27	.77	4.59	4.81	12.64
1967-68	2.41	9.11	.00	11.26	5.36	4.77
1968-69	1.91	1.81	.25	4.73	5.33	18.31
1969-70	14.00	3.66	65.32	10.92	4.31	4.56
1970-71	15.06	2.14	.00	6.79	5.77	10.27
1971-72	10.01	4.71	5.38	5.93	4.92	24.92
1972-73	14.00	28.80	-.20	2.60	9.64	12.33
1973-74	33.51	64.29	2.46	7.99	6.34	23.95
1974-75	8.15	3.78	6.47	8.39	5.86	14.51
1975-76	6.20	-1.09	.58	5.08	6.11	17.06
1976-77	7.89	11.00	2.21	5.31	6.97	23.72
1977-78	7.58	1.95	8.35	4.14	6.79	13.44
1978-79	18.83	17.74	.17	5.35	6.09	11.20
1979-80	17.83	23.91	8.99	3.91	5.08	19.60
1980-81	11.83	11.15	4.68	*	3.73	3.52
1981-82	11.02	2.61	8.94	*	2.61	.83

*Not available.

Sources of basic data: Central Bank of the Philippines, Statistical Bulletin, 1980; International Monetary Fund, International Financial Statistics, 1981; unpublished Central Bank data for 1981 and 1982; National Economic and Development Authority, Philippine Statistical Yearbook, 1982; and unpublished national income estimates for 1982.

The entries along the effective exhange rate (EER) row in Table 1 represent the movements of a weighted average of peso exchange rates with trade partner currencies,[4/] which take into account the exchange rate realignments of major currencies since the early 1970s. It would appear that the authorities have allowed the peso to be devalued even after the substantial exchange rate adjustment in 1970. The annual rate of depreciation has varied from year to year, the highest at about 9% occurring in 1980 and 1982.

The subperiod averages for money supply growth contained in Table 1 also mask the wide variability of annual values, especially during the first half of the observation period. Excessive government spending and domestic credit creation in the national election years 1967 and 1969 resulted in double-digit rates of increase in money supply, the latter case contributing to the balance of payments crisis. This was followed by a drastic reduction in 1970 as part of the stabilization policy package that accompanied the February de facto devaluation. Monetary restraint was abandoned in the second half of 1972 "when exigencies of the July-August natural calamities and of the subsequent proclamation of martial law called for a directional shift toward expansion" (Central Bank, Annual Report 1972; p. 1). In 1974 private

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[4/] The trade weights represent the proportions of Philippine imports for which prices are set in the currencies of 12 developed countries on the assumption that world prices of primary agricultural products and fuels are set in U.S. dollars, metals and minerals in British pounds, and other traded goods in the currencies of developed country origin of imports or destination marked for exports (cf. Bautista and Ridel, 1982).

domestic credits grew by 31%, the highest in 25 years, in support of a massive food production program initiated immediately after the food crisis of 1972-73; accordingly, monetary stock expanded significantly, despite a surplus in the government's cash oeprations. 'Mainly responsible for the [accelerated growth of money supply (23.7%) in 1977] was the rise in money of external origin by ₱1,365 million as a result of the overall surplus in the country's balance of payments" (Central Bank, Annual Report 1977; p. 7). On the other hand, the very limited money supply growth (3.5%) in 1981 was due to "the contractionary impact of external transactions as the country's balance payments position remained to be in deficit" (NEDA, 1982; p. 155), reaching a record-setting $560 million. Apparently, the conduct of monetary policy had been made difficult by the unpredictability of the external sector's effect on the overall balance of payments.

Real GNP movements over the observation period have been influenced significantly by exogenous developments. In the early 1970s a series of natural disasters (strong typhoons, floods and plant disease) wrought severe damage to agricultural crop output. To the reduction in the growth rate of agricultural production from 1970 to 1972 (averaging only 2.8% annually as compared to 4.2% during 1966-69) can be largely attributed the observed downturn in GNP growth, given the large share of the agricultural sector (about 30%) in national output. The political unrest leading to the declaration of martial law in September 1972 might also have had a detrimental effect on the country's macroeconomic performance. With much improve weather conditions, the export commodity boom and the start of the massive food

production drive in 1973, agricultural activity picked up, exhibiting a 5.2% increase in that year and contributing to the observed acceleration of GNP growth to 9.6%. Agricultural growth further improved through the end of the seventies, in part due to continued favorable weather. The manufacturing sector, in the meantime, was expanding increasingly rapidly, (from 4.4% in 1970 to 14.8% in 1973) in the aftermath of the devaluation and the adoption of other policy measures promoting new industrial exports (cf. Bautista, Power and Associates, 1979). This was interrupted by the adverse external conditions in 1974-75, but recovery was underway in the following years until declining foreign demand again forced a sharp slowdown beginning 1980. The latter period also witnessed a drastic reduction in commodity prices and in export earnings from primary products, contributing to the steep fall in domestic demand and general economic activity which even the expansionary fiscal policy in 1980 could not prevent.

Increases in the nominal wage rate appear, from Tables 1 and 2, to have lagged behind the inflation rate, except in the subperiod of the sixties. This observation of falling real wages needs to be qualified, however, in view of the payment of various supplementary earnings to workers since 1974 which have not been incorporated in the (basic) wage series.[5/] This includes mandatory cost of living allowances, revised eight times since February 1974, and the 13th

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[5/] For this reason the publication of this and related wage indices has been discontinued as of 1981.

month pay since December 1975. While legislated minimum worker earnings are known, the extent of compliance among employers is not; hence there is no reliable time series on total earnings actually received by workers. It is widely acknowledged that the wage supplements have been used, as a policy response to the erosion of real income of low wage earners, more often than basic wage rate adjustments and that this has resulted in a lower increase in labor cost (cf. Tidalgo, 1983).

No discussion of the potential influences on Philippine inflation would be complete without an examination of the role of government price controls. The Price Control Law was enacted in April 1970 in reaction the sharp price rises after the devaluation, and was extended by Congress in 1971 and by presidential decrees in 1973 and 1975. It established the Price Control Council which was empowered to fix maximum selling prices of wide range of basic commodities,[6/] representing in principle the cost of production (or landed cost, if the commodity is imported) plus specified markups for the producer (or importer), wholesaler and retailer. Price control was also sustained by government subsidies for certain commodities like rice and fertilizer, and rationing had been resorted to in periods of severe shortage.

It is doubtful that the long-term price tends of these commodities were affected by the price control system, considering that

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[6/] The commodity list has included, among others, rice, corn, fresh meat, canned fish, sugar, flour, milk, cooking oil, plywood, common drugs, galvanized iron sheets, laundry soap, writing pads and notebooks, antibiotics, fertilizer and refined petroleum products.

the ceiling prices tended to be revised over time on petitions by local producers and importers. There is reason to believe, however, that it has influenced price changes in the shorter run. It will appear, for example, that the oil price increases in 1974, 1979 and 1980 became the occasion for discrete price adjustments of many products even for reasons unrelated to higher energy cost, including past inflationary pressures which had been repressed by price controls. This would appear to account for a large part of the inordinately high inflation rates in those three years.

Regression results

Table 3 contains the first set of estimated price equations, based on 1965-80 data, with the wage rate included as an explanatory variable in the alternative regression specifications involving other influences on the inflation rate as discussed above. The coefficient estimates for $\dot{W}$ are seen to be consistently negative and insignificant. Not even the addition of a dummy variable D_1 (= 1 for 1974 to 1980, 0 for other years) to take into account, rather imperfectly, the wage supplements beginning 1974 and their subsequent adjustments could alter the perverse sign of the wage coefficient. This would seem to provide support to the statement made earlier about the likely role of the wage rate as a reactor, rather than an initiator, of changes in the general price level. Indeed, in labor-surplus economies such as the Philippines where inflation is observed to co-exist with low labor force utilization, it does not seem appropriate to explain general

Table 3: Regression Results A
(Dependent variable: $\dot{P}$; 1965-80)

Equation No.	Intercept	$\dot{P}^*_m + \dot{R}$	$\dot{P}^*_m$	$\dot{R}$	$\dot{M} - \dot{Y}$	$\dot{M}$	$\dot{Y}$	$\dot{W}$	D_1	$\bar{R}^2$	D.W.
I	7.96	.295 (4.15)	-	-	.197 (0.80)	-	-	-.602 (-0.90)	-	.541	2.24
II	7.01	.283 (3.87)	-	-	.122 (0.46)	-	-	-.518 (-0.76)	2.736 (0.86)	.529	2.17
III	15.54	-	.452 (5.08)	.124 (1.42)	-	-.049 (-0.20)	-1.035 (-0.84)	-.572 (-0.82)	-	.687	1.51
IV	16.48	-	.444 (4.87)	.121 (1.36)	-	-.119 (-0.46)	-1.166 (-0.93)	-.583 (-0.817)	2.239 (0.82)	.675	1.44
V	10.84	.304 (4.41)	-	-	-	-	-	-.813 (-1.35)	-	.554	2.24
VI	8.84	.286 (4.08)	-	-	-	-	-	-.619 (-0.99)	3.225 (1.11)	.563	2.17
VII	7.26	-	.417 (6.22)	.133 (1.64)	-	-	-	-.528 (-0.53)	-	.723	1.67
VIII	6.12	-	.400 (5.54)	.133 (1.62)	-	-	-	-.197 (-0.37)	1.778 (0.73)	.711	1.67

Note: Numbers in parentheses are t-values.

price increases on the basis of rising wages due to relative tightness in the labor market.

Dropping the wage rate variable and using 1965-82 data, the estimated equations presented in Table 4 yield some interesting results. First of all, the statistically insignificant coefficient estimates for $\dot{M} - \dot{Y}$ and, allowing for asymmetrical effects, $\dot{M}$ and $\dot{Y}$ seperately, indicate that excess demand had not been a major factor in Philippine inflation. The inference would be that monetary policy had accommodated cost and output changes during the observation period. This finding is consistent with those of many other empirical studies that failed to yield a significant effect of demand on the general price level, e.g., Gordon (1975), Bruno (1978), and Blejer and Halevi (1980).

It also appears from Table 4, on the basis of relative goodness-of-fit, that the specification with $\dot{P}_m$ and $\dot{R}$ entered seperately is superior to having their sum as one explanatory variable. About 73% of the variance of the inflation rate is explained by changes in the import price index and the effective exchange rate, according to equation III of the table.

Equation IV introduces intercept and slope dummies (D_2 and $D_2\dot{P}^*_m$, respectively) to allow the function to shift in the three years of drastic price increases of oil imports (1974, 1979 and 1980). As pointed out above, the oil price rises in those years might have had a significant effect on: (1) the operation of the price control system, as producers seemed able to obtain adjustments in ceiling prices beyond

Table 4: Regression Results B
(Dependent variable: $\dot{P}$; 1965-82)

Equation No.	Intercept	$\dot{P}^*_m + \dot{R}$	$\dot{P}^*_m$	$\dot{R}$	$\dot{M}-\dot{Y}$	$\dot{M}$	$\dot{Y}$	D_2	$D_2\dot{P}^*_m$	$\dot{P}_{-1}$	$\dot{R}_{-1}$	$\bar{R}^2$	D.W.
I	5.08	(.269 (4.26)	-	-	.189 (0.99)	-	-	-	-	-	-	.527	1.90
II	9.42	-	.430 (6.09)	.099 (1.37)	-	.016 (0.10)	-.682 (-0.88)	-	-	-	-	.707	1.43
III	11.30	-	.410 (6.70)	.113 (1.73)	-	-	-	-	-	-	-	.732	1.50
IV	6.59	-	.223 (1.64)	.109 (1.77)	-	-	-	4.207 (0.96)	.122 (0.72)	-	-	.766	1.30
V	6.10	-	.301 (3.75)	.113 (1.88)	-	-	-	6.238 (1.91)	-	-	-	.775	1.41
VI	4.44	-	.399 (6.22)	.125 (1.80)	-	-	-	-	-	.148 (1.08)	-	.724	1.83
VII	4.70	-	.294 (3.54)	.123 (1.93)	-	-	-	6.014 (1.78)	-	.135 (1.07)	-	.767	1.7
VIII	4.47	-	.437 (8.47)	.142 (2.59)	-	-	-	-	-	-	.164 (2.98)	.826	1.6
IX	4.59	-	.329 (5.51)	.142 (3.13)	-	-	-	6.182 (2.58)	-	-	.163 (3.61)	.882	1.5

Note: Numbers in parentheses are t-values.

that warranted by the increased cost of oil and, in so doing, effectively compensated for the repression of inflationary pressures in earlier years; and (2) the response of the inflation rate to the induced changes in the import price variable, considering that oil represented only one component (although a significant one) in the country's import basket. The former should lead to an upward parallel shift of the regression equation, implying a higher intercept value. The latter should result in a different value of the $\dot{P}^*_m$ coefficient to the extent that the sensitivity of the general price level to changes in the oil import price is less or greater relative to changes in non-oil import prices.

Neither of these two effects appears significant, based on the estimated coefficients for the two dummy variables in equation IV, which display t-values of less than one. However, exclusion of the slope dummy resulted in a higher t-value not only for the coefficient estimate for the intercept dummy but also for the exchange rate variable,[7/] as shown in equation V. It also raised the value of $\bar{R}^2$ and greatly reduced the $\dot{P}^*_m$ coefficient from .41 (in equation III) to .30, which appears more credible. It is puzzling, however, that the estimated coefficient of $\dot{R}$ is so low (only .11), implying a much greater responsiveness of the CPI to changes in foreign currency import prices compared to exchange rate changes.

[7/] Retaining the slope dummy and dropping $_2D_2$ produced statistically inferior results, in terms of a lower $\bar{R}^2$ as well as lower t-values for the estimated coefficients of $\dot{P}^*_m$ and $\dot{R}$.

Equations VI and VII of Table 4 examine the possibility of lagged adjustment of the general price level to changes in costs, imposing a Koyck-Nerlove lag structure on the specifications with and without the dummy variable D_2, respectively. Not much improvement is evident in either equation, suggesting a rejection of the hypothesized lag pattern.

The last two equations, VIII and IX, test for the significance of $\dot{R}$ lagged one year. As has been argued by Blejer and Halevi (1980), lags for $\dot{R}$ are consistent with no lag for $\dot{P}^*_m$: "Import prices are recorded at the time of entry of the goods, which is usually at least several months after the decision to import was made at the prices then known to importers; on the other hand, the relevant effective rate of exchange is that prevailing at the time of payment" (p. 120).

This seems to be borne out by the regression results, which show significant estimates for the $\dot{R}_{-1}$ coefficient as well as substantial improvements, over previous specifications, in $\bar{R}^2$ and t-values of the coefficient estimates for $\dot{P}^*_m$, $\dot{R}$. and D_2. In what may be considered as the "best" estimated equation (IX), 88% of the variance of the dependent variable is explained; this seems remarkably high considering that the variables are expressed in percentage changes. Also, the estimated coefficients of $\dot{R}$ and $\dot{R}_{-1}$ are seen to sum up to .305. While this appears to be smaller than the coefficient estimate of .329 for $\dot{P}^*_m$, they are not statistically different at the 5% level. This result would suggest that the inflationary effects of increases in

foreign prices and the effective exchange rate are of the same magnitude, taking into account the relatively substantial lagged component of the latter effect.

4. Concluding Remarks

A large part of the Philippine inflation since 1965 has been found to be mainly attributable to foreign price increases and the depreciation of the peso. Both sources have had a disruptive effect on general price movements on specific occasions associated with the two oil price shocks of 1973-74 and 1979-80 and the de facto devaluation at the beginning of the decade.

The inflationary effects of the OPEC-administered oil price increases were quickly transmitted to the domestic economy, with apparent accommodation of macroeconomic policy. This was compounded by the upward adjustment of ceiling prices of a wide range of basic commodities subject to government regulation, not only covering the higher cost of oil but also giving in to the inflationary pressures that were repressed in previous years. The wisdom of maintaining the system of price controls for basic commodities, which has increasingly taken on a largely income redistributive function, can be questioned. Apart from the likely adverse effect on long-run supply of price-controlled commodities, efficiency losses due to resource misallocation and ineffectiveness of the price control system (relative to other policy instruments) to protect the real purchasing power of low-income

groups, the large, abrupt changes in the prices of basic commodities resulting from the cumulation of inflationary pressures, as demonstr in the recent experience, give cause for policy concern.

The floating of the domestic currency in February 1970, wh led to a 63% devaluation, was mainly responsible for that year's hig inflation rate. It must have contributed also to the sustained rapi inflation in the following year, in view of the lagged response of t CPI to exchange rate changes as observed above. The Philippine exch rate regime has continued to be one of managed floating and, in cont with the earlier system of adjustable peg, is not expected in future to lead to sharp, disruptive changes in the effective exchange rate.

The estimated inflationary effect of currency depreciatio given the conduct of macroeconomic policy during the observation per does not appear so large as to make nominal exchange rate adjustment ineffective instrument in improving the international competitivenes domestic industry. Past experience indicates a strong tendency towa overvaluation of the Philippine peso, the unrealistic exchange rate propped up by numerous restrictions on the country's foreign trade a payments, which contributed to the perpetuation of external disequil and inefficiency in domestic resource use (cf. Bautista, Power and A ciates, 1979). Based on the results of the present study, it is reassuring that the improved competitiveness and other benefits fro a real exchange rate adjustment can be sustained, since the induced in the general price level is relatively moderate.

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