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THE FOREIGN EXCHANGE REFORM OF FEBRUARY 21, 1970: THE FLEXIBLE  
EXCHANGE-RATE SYSTEM AND THE PHILIPPINE ECONOMY

by

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To correct the balance of payments problems which became especially severe after November 1969, a sweeping reform of the exchange rate was undertaken with the passage by the Central Bank Monetary Board of Circular 289, dated February 21, 1970.<sup>1</sup>

The new exchange-rate policy embodied in this measure is the adoption of a flexible exchange rate for the peso for all foreign exchange transactions, except for the surrender of the export proceeds of the leading export products: logs, centrifugal sugar, copra and copper ore and concentrates. The latter are to sell 80 per cent of all their export proceeds at the established par value (P3.90 to U.S. \$1). Twenty per cent of the receipts can be converted at the "prevailing free market rate".

*Question: Is 80-20 rule still apply nowadays?*

Section 8 of Circular 289, defines the free market (underlines supplied): "The free market rate shall not be administratively fixed but shall be determined through transactions in the foreign exchange market on a day-to-day basis. The authorities shall not intervene in the market except to the extent necessary to compensate for excessive fluctuations but shall not

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<sup>1</sup>Three complementary circulars, 290, 291, and 292, were also passed to supplement this important measure. In addition, detailed regulatory memoranda to implement the circulars, mostly dealing with 289, were also sent to all agent commercial banks of the Central Bank. See {2}.

operate against the trend in the market."

✓ In considering the new policy, there were of course many options available to the Central Bank. The monetary authorities had made an application for the country's third credit tranche from the International Monetary Fund. Following usual practice when a country sought the availment of a third tranche, the IMF explored with the Central Bank the alternative foreign exchange reforms the country should adopt.

In our view, the corrective policy adopted is a superior one. ✓ It avoids the pitfalls of an under- or an over-devaluation. It removes from control by the government of demand for foreign exchange transactions that are the major causes of corruption in government. In other words, it avoids the problem of foreign exchange rationing through controls, to which the economy had gradually moved again in the guise of purely monetary controls and commodity classifications especially in the last three years.<sup>2</sup> Certainly, among the alternatives we have listed in a previous paper (see {17}), the one adopted finally is among the superior policies, which at some time we even felt the government was not prepared to choose. Yet, we were pleasantly surprised that indeed the Central Bank had opted for it.

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<sup>2</sup>The criticism by some quarters that the adoption of the new policy is a "surrender of exchange-rate sovereignty" is at best only a criticism if the new policy were against the national economic interest. In our view, the criticism is wrong, as this paper will show. Governor Licaros of the Central Bank has aptly answered this point in his speech before the Manila Rotary. (See {6}). We have analyzed the narrow limits of such arguments in a paper discussing the ideology of economic nationalism. (See {18}).



## I. THE BALANCE OF PAYMENTS: FOREIGN EXCHANGE SUPPLY (OR RECEIPTS)

### Introduction.

Initially, the effectiveness of the fluctuating exchange rate system is that it corrects a balance of payments disequilibrium by balancing receipts with demand for payments. Under this setup, there is an automatic adjustment of the exchange rate depending on the strength of the market for foreign exchange as reflected by the collective <sup>demand?</sup> supply of foreign exchange (imports, payments abroad, etc.) and the collective supply of foreign exchange (exports, etc.) earned by all domestic industries having trade contacts with foreigners.<sup>3</sup>

### (1) Expansion of exports.

Exports will undoubtedly expand. The magnitude of this expansion is still uncertain. There is some absence of knowledge concerning basic parameters, such as elasticities of demand. Moreover, some export expansion is still basically dependent on complementary measures, such as tariff reform, because tariffs accentuate the effects of price incentives in directions not necessarily complementary with those derived from exchange depreciation. It is essential to point out, however, that with the ex-

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<sup>3</sup>The effectiveness of the correction depends, of course, on the relative price-elasticities of demand and supply. The classical conditions for a correction -- via the wellknown Marshall-Lerner condition -- that supply and demand price elasticities together exceed unity is a condition that is immediately met, as we shall argue elsewhere in this paper.

ception of copra, coconut oil products and abaca products, the Philippines is essentially a price-taker in export trade.<sup>4</sup> Being a fairly negligible portion of world trade in many commodities is an advantage. It means that a country that adjusts its exchange rate to the advantage of its export industries need not affect seriously the pattern of world trade, and, for its own sake, it can device policies without attracting repercussions from other countries.

(2) Redirection of price incentives within the total framework of the Philippine economy.

The present circular is a stark departure from the error of the 1962 decontrol measure, which penalized across-the-board all exports receipts by requiring all earners to surrender 20 per cent of their earnings at the parity rate of ₱2 to \$1. Under the present setup, any new export product will receive its full measure of peso value (derived from the market-determined exchange rate); the exceptions are discussed below. On the other hand, the import-dependent industries will be forced to pay the full cost of import dependence.

(a) "Non-leading exports."

Leading exports are logs, copper, sugar, and copra.<sup>5</sup> Any

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<sup>4</sup>Thus, provided that industries are able to find that price at which exports can be sold, by adjusting their situation to the new exchange rates, the demand for the export product has high price-elasticities.

<sup>5</sup>All these exports exceeded the "annual average value" of US\$75 million in export receipts for 1966-1968, the numerical basis for separating the leading exports. CB Circular 189 (see {2}).



other export is a non-leading export and gains the advantage of full conversion at the market-determined rate. This incentive will make industries with potential exportables actual exporters, provided they are not impeded by other policies. Insofar as capacity is not fully established yet, the response may take a longer-run period. Insofar as the production of exports involves a purely variable increase in the purchase of non-machinery inputs, when capacity is presently in excess, there can be anticipated an increase in export revenues. But the increase in these depends critically on the nature of monetary policy exercised, so that firms with excess capacity, which are in need of working capital to finance production for export, are able to secure this capital without unreasonable delays or under stringent terms.

The experience of countries like South Korea, Taiwan, and Hongkong reveal that the response of industrial exports, in particular, is price-elastic, contrary to the prevailing viewpoint. (See {15}.) This gives us the confidence that the response can be substantial, if this measure is complemented by a domestic monetary policy which is conducive to export expansion and with other policy reforms mentioned at the end.

(b) The leading exports.

As already pointed out, four major leading exports are not allowed to get the full measure of the exchange-rate incentive. Their effective exchange-rate earnings, assuming 100 per cent compliance with turning over their exchange-earnings receipts,

can easily be computed, using the formula below:

$$p^* = 0.2p + 0.8\bar{p}$$

where

$p^*$  = effective rate of foreign exchange in pesos;

$p$  = the market-determined rate of foreign exchange, at which all other exports are converted;

$\bar{p}$  = the par value of the peso in terms of one US dollar;

0.2 = the proportion of earnings converted at the rate  $p$ ; and

0.8 = the proportion converted at the rate  $\bar{p}$ .

Setting  $\bar{p}$  at ₱3.90 (per US dollar), this formula is easily simplified as

$$(1) \quad p^* = 0.2p + ₱3.13,$$

since  $0.8(₱3.90) = ₱3.13$ . The relationship between  $p^*$  and  $p$  is seen in the accompanying figures. The effective penalty rate is given in Figure 2 which is the ratio  $p^*/p$ . When  $p = ₱3.90$  per dollar, we find that  $p^*/p = 1.0$ . However, when  $p = ₱5.0$ , then  $p^*/p = 0.826$ ; this means that the penalty with respect to the new exports which get the market-determined rate,  $p$ , is 0.1740 ( $=1-p^*/p$ ).

\* Thus, this should be a powerful disincentive against some unprocessed exports and against a fall in terms of trade for exports <sup>with</sup> inelastic demand schedule. It will be well to examine brief-

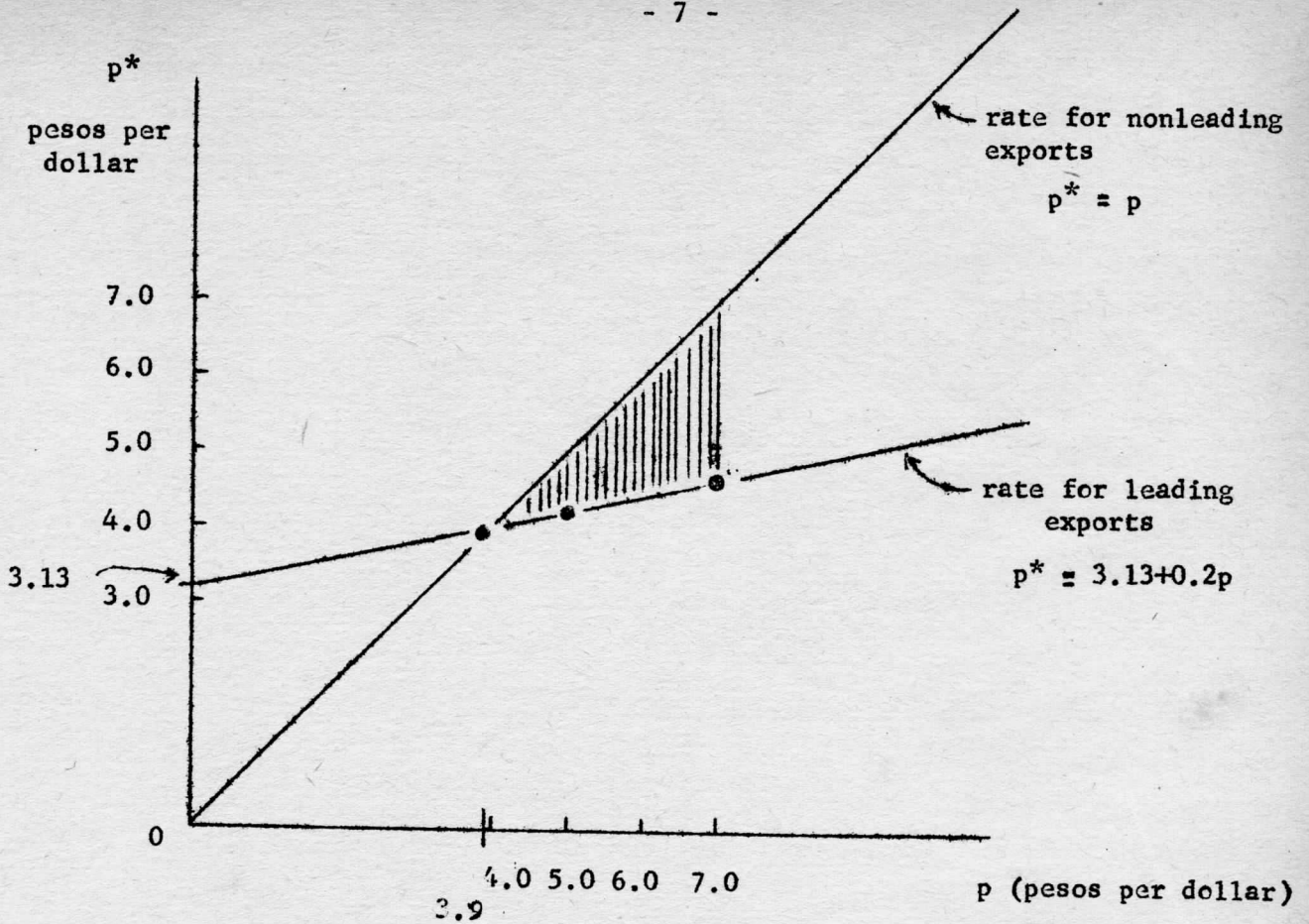


FIGURE 1. EXCHANGE RATES FOR LEADING AND NON-LEADING EXPORTS

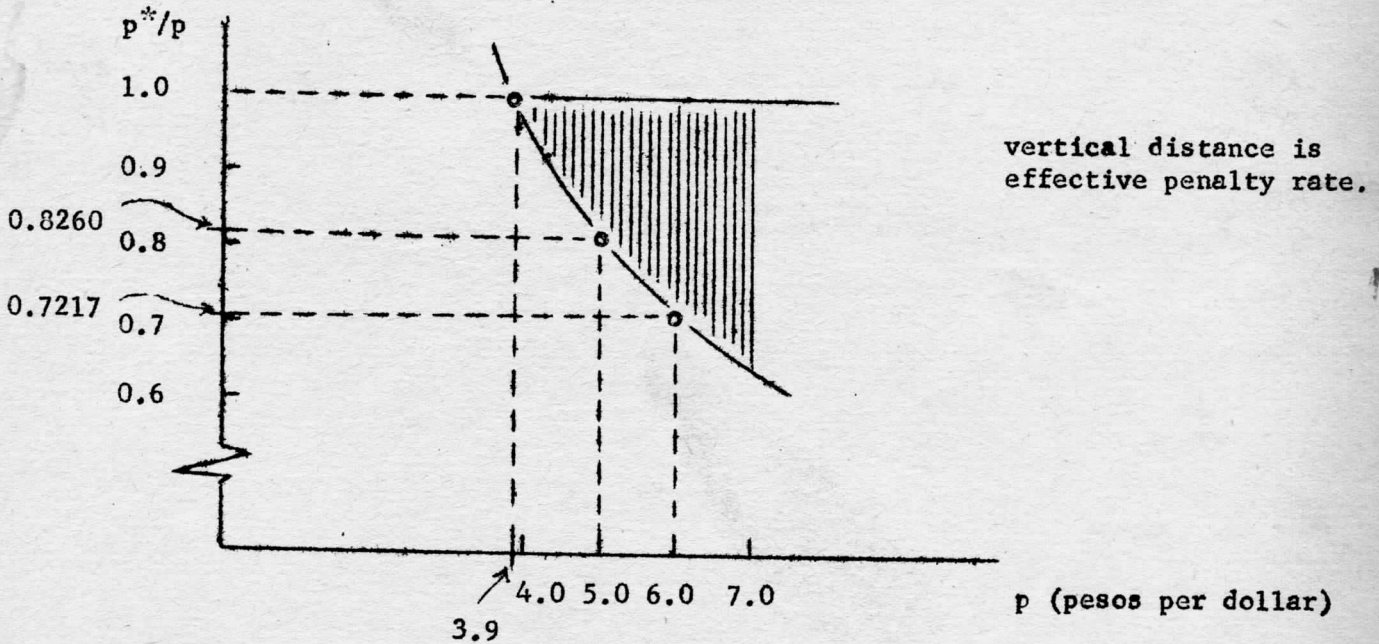


FIGURE 2. EFFECTIVE PENALTY RATES FOR LEADING EXPORTS



ly their implications on the other exports.

Sugar.

Because of the sugar premium in the US market and the protected price for sugar in the domestic market, the sugar industry will be affected only to the extent that the retention of 80 per cent of its export earnings at P3.90 to \$1 squeezes that export premium or its domestic windfall from protection. This squeeze is reflected in the relative profitability of a specific sugar product -- its present form as an export. If sufficiently strong, it may be able to encourage the building of capacity in sugar-using industries which might be able to compete with the candy factories of Europe and the United States for world consumption. Sugar-related industries, which further processes sugar from its centrifugal form, may become more attractive. These are food industries, like candies, chocolates, and other products which have a very high sugar component.

Of course, a major factor that will determine any future directions for the sugar industry depends on the new text of the still to be negotiated US-Philippine trade treaty affecting relations after 1974. There are some ponderables that might simply be mentioned. Recently, huge commitments of national and private resources have been made to support the expansion of milling capacity in the sugar industry. This means that the economy's dependence on sugar has increased, at least in an absolute (if not relative) sense. Thus, the country's bargaining position is weak-

ened to the extent that sugar's interests have to be protected in every bargaining moves. Second, there is a small segment of the US Congress which has begun to think of how the sugar premium to quota nations can be more effectively used as an "aid" instrument. If this thinking gains force in the years to come, a more direct taxation from the source -- the US premium market -- could lead to a further squeeze of the US premium. The US tax proceeds would then be used to defray some direct US aid to the Philippines. But all these are in the long run, post 1974.

We turn briefly to the analysis of the sugar premium. Let  $p_s^w$  the sugar price per lb. in the world market. The US sugar premium is given by

$$p_s^{US} = p_s^* + p_s^w.$$

Dividing by  $p_s^{US}$ , we get

$$1 = s^* + s_w$$

where  $s^* = p_s^*/p_s^{US}$  and  $s_w = p_s^w/p_s^{US}$ .

What are the values of  $s^*$  and  $s_w$ ? In recent years the price of US-sold sugar has been in the order of 1.5 to 2.5 times more than the world price. Thus, a reasonable conservative value is  $s^* = 0.25$  and  $s_w = 0.75$ , i.e., for every dollar of sugar export receipt, about 25 US cents represents the premium price.

Given a realistic exchange rate and assuming that sugar can be profitable even when sold at the world price, the effects of the sugar premium on the net exchange rate earned for sugar can be quanti-



fied. This quantification depends on the extent of the sugar premium and the effective rate at which sugar exports are exchanged. Inserting now the weights from the world price of sugar and the US price premium into equation (1) but retaining  $\bar{p}$ , which is the "par" value at which 80 per cent of proceeds are exchanged, we get

$$(2) \quad p^* = 0.2(s^* + s_w)p + 0.8(s^* + s_w)\bar{p}.$$

Since  $s^* + s_w = 1$ , the equation is not at all affected. Equation (2) may be rewritten as

$$p^* = \{0.2s^*p + 0.8s^*\bar{p}\} + \{0.2s_wp + 0.8s_w\bar{p}\}$$

or

$$(2a) \quad p^* = s^*\{0.2p + 0.8\bar{p}\} + s_w\{0.2p + 0.8\bar{p}\}$$

$$= \text{US price premium} + \text{"world" price}$$

of sugar exports converted at the "effective" exchange rate. "World" price need not mean the price in the world sugar market which has been rightfully referred to as a "dumping market".<sup>6</sup>

The critical question now is whether the cost of production plus "normal profits"<sup>7</sup> are equalized or shifted in favor of

<sup>6</sup>One way of doing this is by using the price of long-term sugar contracts of Malaysia and Taiwan with Japan and comparing it to the sugar price in the US. Professor John Power has done this in computing the "effective rate of protection" for the sugar industry. (See {8}).

<sup>7</sup>Defined as those profits which would be equivalent to the average private rate of return to all export industries.



new exports. What is the rate at which the penalty is just equal to the premium, if the sugar is sold at the world price but is converted at the market-determined rate? This means that the "penalty" is just compensated for if there were no US price premium, or

$$p - s_w p = p - p^*$$

which is the same as

$$s_w p = p^*;$$

that is,  $s_w p$ , the revenue without US premium at  $p$ , is equivalent to  $p^*$ . This implies that

$$(3) \quad s_w = p^*/p,$$

or

$$s_w = [s^*\{0.2p + 0.8\bar{p}\} + s_w\{0.2p + 0.8\bar{p}\}]/p.$$

This result leads us to some obvious interpretations. If

$$(4) \quad s_w < p^*/p,$$

the exchange rate received by sugar yields a positive premium, although smaller now compared to the US sugar price premium. If

$$(5) \quad s_w > p^*/p,$$

the sugar export sector is receiving a net exchange-rate penalty.

We may define the net premium or penalty, depending on the case, as

$$(6) \quad p' = p^*/p - s_w.$$

Obviously,  $p'=0$ , when equation (3) holds;  $p' > 0$  when inequality (4) holds; and  $p' < 0$  when inequality (5) holds.

A table of values allows us to identify the critical market-determined exchange rate, given  $s_w$ , at which the net premium becomes negative, that is,  $p' < 0$ . In all the cases above, only when the market-determined rate is equal to the par value of ₡3.90 to the US dollar is the net premium received equivalent in fact to the US price premium received by the sugar industry. At any price which makes the US dollar more expensive, the US price premium accruing to the sugar export sector will be less than the US price premium, but still positive. Thus, when the world price of sugar is 75 per cent of the US price (i.e., when  $s_w = 0.75$ ), which is incidentally a fairly modest premium, given the values of market differentials of the last few years, a market-determined rate of 6 pesos for every dollar begins to hurt beyond the price premium. When  $s_w = 0.6$ , however, only a market-determined rate of 8 pesos to the dollar hurts the sugar industry in the same sense. But at  $s_w = 0.5$ , even an 8 pesos per dollar price will yield a positive price premium, i.e.,  $p' > 0$ .

The above results are important in pointing out that the sugar industry is not heavily penalized by the new exchange rate policy applying to sugar exports because of the high price premium it has continually received from the protected US sugar market.