Table 1. "NET PREMIUM (PENALTY)" OF SUGAR, GIVEN THE SIZE OF THE US PRICE PREMIUM AND THE MARKET-DETERMINED RATE

p	p*/p	Values of p' when s_w takes different values per US dollar		
		s_w = 0.75	s_w = 0.60	s_w = 0.50
3.9	1.0000	0.2500	0.4000	0.5000
4.0	0.9825	0.2325	0.3825	0.4825
4.5	0.8955	0.1455	0.2955	0.3955
5.0	0.8260	0.0760	0.2260	0.3260
5.5	0.7691	0.0190	0.1691	0.2691
6.0	0.7217	-0.0283	0.1217	0.2217
6.5	0.6815	-0.0685	0.0815	0.1815
7.0	0.6471	-0.1029	0.0471	0.1471
7.5	0.6173	-0.1327	0.0173	0.1173
8.0	0.5912	-0.1588	-0.0088	0.0912

NOTE: Columns (1) and (2) are the basic materials used in Figure 2.

The computations do not take into account the well-known fact that domestic sugar prices are well above the sugar prices in other countries. In the absence of a device which allows the US or the Philippines to tax this premium[8] directly, depending on the value of s_w and even the basic rate, $\bar{p}$, which for the moment is given at ₱3.90 to 1, and provided the market-determined rate is not far out of line from the par value of ₱3.90 to one US dollar, the sugar industry can absorb the foreign exchange impact of the new policy without any undue hurt on the industry. Of course, some marginal firms that would otherwise not exist without the premium will be put in a very uncomfortable position. One effect of this is that excess profits from sugar are removed, and, from the national viewpoint, this could mean that other sectors of the economy now become relatively more profitable areas of investments compared to sugar. Another effect is that the government has acquired a sufficient leverage to enable it to impose an export tax on sugar, which it had failed to pass for a long, long time.[9]

Logs.

The result of the exchange-rate differential for logs will naturally make it relatively more profitable to export wood

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[8]Except by removing the sugar import ban, which can be ruled out as impossible in view of the institutional mechanics of the US sugar quota arrangements, so long as the Philippines is a sugar quota supplier to the US.

[9]At this time of writing, and for the first time, the sugar industry has taken the position that an export tax is an acceptable quid pro quo for removing the 80 per cent retention scheme.

products having a greater degree of processing. Thus, exports of plywood, veneer, and other wood products will now attain a relative profitability much greater than they formerly enjoyed with respect to logs. It will also encourage a further expansion of capacity in the wood industries over and above the present plans envisaged under the incentives administered by the BOI. (For a discussion of the benefits derived from processing logs, see {10}.)

Copra.

The country still remains as the world's largest supplier of copra. These exports find their way to Europe and the United States, where copra is transshipped to coconut oil processors. Being in such a dominant position in trade, the country faces a relatively more inelastic demand curve than if it were a minor exporter of the product. Thus, in terms of copra, exchange depreciation subjects the country to terms of trade problems leading to "immiserizing growth", to use J. Bhagwati's phrase. To the extent that the exchange retention scheme taxes the potential cheapening of copra in the world market, then the inimical terms of trade effects are minimized.

Moreover, the setup greatly favors incentives in favor of coconut oil exports, thereby inducing more copra to be processed domestically prior to export and raising the potential value-added content of coconut exports. In any case, the freeing of the exchange rate for exports of coconut oil gives local produ-

cers a more than offsetting incentive, which may counteract the ill effects of the proposed excise tax on coconut oil in the European Economic Community. The danger that looms in the surface, which can harm the coconut oil export industry, is a quota. Setting an upper limit on coconut oil exports will prevent its natural expansion into a given market. A quota is not susceptible to an indirect offsetting policy, but is subject to retaliatory measures of a different sort. But in any case, any taxation within the importing country which affects coconut oil exports -- whether through the tariff, quota, or excise taxation within the importing country -- hurts coconut oil exports.

Copper.

Copper ore and concentrates have steadily become a major source of export earnings since the early '60's. Knowledgeable predictions show that these exports will continue to increase in their share of exports; the copper mines are only beginning to be more fully exploited. Whether or not it is now an appropriate time to place an exchange-rate differential on copper depends in part on what such a scheme can do to encourage the setting up of a copper-processing industry in the country. Only if the exchange-rate penalty continues to be in force will a copper-smelting plant become more feasible as an industrial project within the country. This decision would have to be weighed by many factors, since it is a highly capital-intensive plant, and it would require a very large initial investment which has high opportunity cost, espe-

cially if the savings resources used are domestic. The relative infeasibility of a copper-smelting plant at this time in the Philippines, which several studies have critically assessed, might be differently concluded under a setup involving some exchange-rate penalty for copper concentrates exports and none for finished copper products.

Further remarks on 4 leading exports.

The exchange-rate differential between exports in general and the 4 leading exports singled out was apparently designed to strengthen the relative incentives available to some sectors of the economy which have not yet accounted for a major share of Philippine exports and also to strengthen the Central Bank's dollar position in enabling it to pay the country's foreign exchange indebtedness. The export potentials of the non-leading sectors could be necessarily strong, if properly induced by economic policy. In the short run, any real export gains of the economy depend on the amount of excess capacity that might be induced to produce for exports. The gains can be realized if monetary policy is able to support the credit requirements of an economy which is geared towards production for export. The long-run gains depend on how the incentive of a more attractive exchange rate is able to redirect investments in exports.

The analysis of the retention scheme undertaken above is not an exercise applicable only to an obviously impermanent policy, since we know it will be removed as soon as a substitute

export tax is passed into law. It underlines the importance of any policy which might alternatively be adopted to enable the government to appropriate, say, by export taxation, part of the windfall from exchange rate in some sectors of the economy which might be having some windfall gains (sugar premium), terms of trade losses from devaluation (copra), and redirection of incentives in favor of processing raw materials (copra, logs, copper, and, even, sugar).

As an indication that the retention scheme is only tentative, there is now much interest (at this time of writing) on a substitute export tax on selected commodities, presumably only the leading four exports. This measure has more advantageous features than a retention-scheme penalty.

(3) Tourism and other invisibles.

An obvious effect of the exchange-rate adjustment is the encouragement of tourism expenditures by foreigners in the Philippines. Moreover, the repatriation of earnings by Filipinos working abroad will receive better exchange-rate treatment and may come in at a much larger volume. In any case, the strict foreign exchange regulations of the recent months have discouraged the inflow of exchange receipts through the official exchange-rate mechanism.

On the increase of tourism, a lot more may be said. We may at this point make the observation that a realistic exchange

rate is an important ingredient of policy which has strong potentials in attracting the tourist dollar. With the expected increase of international tourist traffic in the 1970's and with the advent of large-scale air carriers, the jumbo jets, an attractive exchange rate for the tourist dollar is bound to have a far-reaching impact on the volume of tourist receipts. The sparse evidence available among the successful tourist countries shows that the demand for foreign tourism with respect to the exchange rate is relatively elastic.[10]

At the end of this essay, we shall return to the supplementary policies needed to strengthen the tourist industry. This refers to airline and trade policy.

II. FOREIGN EXCHANGE PAYMENTS (DEMAND)

Moving initially from an overvalued exchange rate, the adoption of a flexible exchange rate depreciates the domestic currency by as much as (or anyway close to) the overvaluation. Thus, all foreign exchange costs become more expensive in terms of the domestic currency.

(1) Imports.

Being a fairly small country relative to the volume of world trade in the commodities we import, any changes in our import position do not affect the prices of our imports in dollar

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[10] See Andreas Gerakis' study {3}.

terms; we are, in short, price-takers in world trade. But the real costs to the economy are expressed in terms of increased peso costs in acquiring the imports and in terms of changes in foreign costs of imports due to changed conditions in the international economy. The immediate effect of a currency depreciation is to raise the peso costs per dollar of imports. Based on the rate of exchange for the peso which is beginning to settle to close to six pesos to the dollar (or more than half the original cost of 3.90 pesos to a dollar), the increase in import costs in peso terms are somewhat substantial, more than 50 per cent.

But the country has been paying for the growing overvaluation of the peso in the last three years in terms of the increase in the cost of money to import goods, with the application of various monetary instruments like special time deposits for the opening of letters of credit to import. These increased costs have had their effects on the prices of imported goods, especially in the last six months. Provided that the depreciation of the peso (a) allows the government to lift excessively stringent monetary policies affecting imports, (b) reduces the real administrative burden of the government and private sector alike by doing away with regulatory controls designed to depress import levels, and (c) encourages the substitution of domestic goods and resources for imports, the expected price increases of imports would no longer be at the same extent as the depreciation of the peso. This statement depends, of course, on the following

assumptions: (1) the dollar price of imports does not change (in fact they may, since some economies may be revaluing their currencies and since there is, apparently, an increasing tendency for worldwide prices to increase), and (2) no changes in tariff rates are made.

Crucially, of course, much depends on the nature of the demand for foreign exchange in terms of pesos, i.e., the elasticity of the demand curve, with respect to changes in peso price of dollars. Quite a lot of speculation about the nature of this demand schedule has been made, and it is often advanced that no matter what the price of imports, the country would be forced to import by force of its needs. This is the same way as saying that the demand for imports is very price-inelastic. The evidence that we are aware of would seem to point out that there is a substantially greater price-elasticity of import demand than would often seem to be assumed in standard speculative discussion in this country.

First, the only attempt to estimate import-demand elasticities for the country that we are aware of tends to show that a great variety of import categories are indeed price-responsive. Our detailed study of about 76 import categories for the years 1953 to 1963 records the evidence that some price-elasticities are indeed larger than often supposed anyway. We have, of course, appropriately tagged these findings with some caution, but nonetheless they give sufficient clue that the empirical evidence con-

tradicts the often cited elasticity pessimism concerning imports. (See {13}.)

Second, our experience after decontrol in 1962 also supports our contention. There was a substantial correction of the balance of payments deficit consistently experienced prior to decontrol. The expansion of imports, caused by releasing all the control mechanisms against all uses of foreign exchange, certainly was not as much as the expansion of total export revenues during this period. The fact that there had been sudden spurts in imports, especially after 1966, is not an indication of import inelasticity as it is the fact that official policy had tried to support an exchange rate which was becoming increasingly overvalued due to a failure of supply of foreign exchange to match demand at that maintained rate, given many factors operating within the economy, including the rapid increase of governmental expenditures unmatched by increase in tax resources. As a consequence, excess demand for foreign exchange occurred, and without any price corrections or other controls, imports would have been more substantial than necessary at a cheaper rate of foreign exchange than at a more expensive one.

(2) Invisibles.

(a) External debt repayment.

To stave off the growing overvaluation of the peso in the mid-60's, the government had obtained a series of short-term foreign exchange liabilities. In addition, industrial and public in-

vestment programs had obtained through a variety of devices -- including long-term loans from the World Bank and from private supplier's credits on imports of machinery, which increased the total external debt. Many of these had begun to mature towards the close of the decade almost simultaneously. The inability of the country to generate new and substantial sources of export revenues in view of the basic distortions of economic policy against exports which prevailed in the 1960's,[11] as before, have aggravated the problem of external debt repayments.

The peso cost of paying for maturing dollar obligations will increase by the amount of total depreciation of the peso. This has two major effects.

(1) In the case of maturing public loans for infrastructure facilities which were economically designed to become self-liquidating, as in the case of the World Bank loans to the National Power Corporation, National Irrigation Administration, and the National Waterworks and Sewerage Administration, it will become mere necessity to raise the basic rates charged for their services (electricity, irrigation, and water), if they are to be placed on a viable repayment position. The only way these utility companies can keep their repayment positions would be for the government to pay them a direct subsidy, but the implications of this on the use of other government resources for competing pro-

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[11] See J.H. Power and G.P. Sicat on these points; see {7} and {18}.

jects is very clear. In view of pressures on prices immediately felt during the transitional stage of the flexible exchange rate, the government will probably find it for the moment impolitic to plunge into the action of raising basic rates for these services.

(2) In the case of private enterprises now faced with a higher peso cost of buying their foreign exchange repayment obligations, there is now an increase in the value of their capital costs. This could contribute to a profit squeeze because what would now otherwise have been profits will be channeled into the increased costs of repayments. But the profit squeeze depends only on whether the enterprise remains "import-substituting" or "export-oriented". If "import-substituting" entirely, any profit squeeze felt may make relatively more attractive the necessity of earning foreign exchange directly. But, of course, the relative attractiveness of engaging in exports depends on many other factors, not the least of which is the structure of domestic protection for the good being produced. In any case, a revaluation of the capital account of most firms requires them to raise their operating profits to meet repayment levels at the same profit rates, if the latter could be maintained.[12]

The magnitude of the external debt problem is best given in the following words, which are Sixto Roxas' (see {9}):

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[12]For an interesting analysis of the financing problems faced by firms during this transitional readjustment, see J.C. Laya {5}.

> "From 1959 to 1961, total external debt service was only averaging about $60 million a year, equivalent to only 8.5 per cent of our average annual foreign exchange receipts. From 1966 to 1968, our total debt service was running at $442 million a year or about 28 per cent of average annual foreign exchange receipts. In the fiscal year ending in June this year, our total debt service will come to $664 million if we take no new account of the new credit arrangements reached since the end of last year. This is equivalent to about 58 per cent of our total expected foreign exchange receipts this fiscal year."

These facts show that the country's borrowing capacity has been overextended. What makes the setup more discouraging was that, despite all the efforts designed to proclaim an export expansion policy, the government had not, up to February, 1970, made major corrections in the policy setup which are conducive to export growth. For the moment, it would be necessary to indicate that the government position in influencing the exchange rate is now somewhat weaker compared to the setup in 1962, since it is faced with a heavy external debt repayment burden. Therefore, its degree of freedom with respect to influencing the exchange rate is limited.[13]

One palliative to the problem of external debt repayment is

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[13]This setup could further mean that the exchange rate would now be more subject to the speculative activities within the foreign exchange market, with the government relegated to the position of a passive bystander. Circular 289 states that "the authorities shall not intervene in the market except to the extent necessary to compensate for excessive fluctuations but shall not operate against the trend in the market." Ruling out the remote possibility that any group with large resources is really after influencing the exchange rate of the currency which cannot be matched by government resources, it would seem that no single foreign exchange operator could sizably affect the exchange rate.