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INTRODUCTION

The Republic of the Philippines enters the decade of the 1970's facing serious economic and political challenges. This island nation, larger in area than the United Kingdom with a population of more than 37 millions (in mid-1969), has been independent only since 1946. Following post-war reconstruction, the national income has grown at an annual average rate of more than five and one-half per cent. An explosive population growth, accelerating from three to three and one-half per cent per year over the same period, has substantially negated, however, what would otherwise appear to have been a very respectable pace of growth. Moreover, balance of payments difficulties have been chronic and by the end of the 1960's had reached crisis proportions. At the same time industrial growth, which had a brief spurt in the 1950's, has been lagging in the 1960's. Only remarkable gains in agriculture, forestry and mining have kept the overall growth rate above five per cent in recent years. Finally, these economic difficulties have been accompanied by a growing political disenchantment which has culminated in rather widespread student and labor unrest in late 1969 and early 1970, and an increasing demand for political and social reforms from nearly all segments of the population.

The issues are many: land reform, honesty in government, extreme inequality in the distribution of wealth and income, double standards in the administration of justice, the absence of a true opposition to the political hierarchy, and the continuing American economic and miliary presence seen as a leading obstacle to reform, to mention only a few. In addition there is some evidence of political alienation from the national government in Central Luzon and Mindanao. Despite the seriousness

of these challenges and the evidence of growing discontent, there are many elements of strength in Philippine institutions that give cause for some degree of optimism in assessing the ability of the nation to carry through the reforms necessary for continuing success in economic and social development. The democratic framework within which politics operates and the widespread commitment to democratic processes and the rule of law come first to mind. The strength of educational institutions and the general level of educational attainment are advanced in relation to the state of economic development. And there is apparent even in the Roman Catholic Church, which includes the great majority of Filipinos in its fold, an awakening to the need for reform.

The role of economic development is central in meeting these challenges. While success in this area will not prove a cure-all, it is difficult to imagine that a stable independent nation could develop without significant economic progress. And success in economic development for a country like the Philippines, with a large and rapidly growing population in relation to its natural resources, means success in industrialization. This, of course, is the focus of the present study. And its principal thesis is that here, too, reform is needed. A resurgence of industrial growth requires a re-direction of economic policies. It is our belief that if this is accomplished resources and entrepreneurship will not be found wanting.

To develop this thesis we have first traced in Chapters One and Two the history of economic growth and industrialization in the Philippines since the American occupation, with a particular focus on the most recent

two decades. In Chapter Three we have described briefly the institutional setting within which economic policies and processes operate; and have followed with an analysis and critique of past industrialization policies in Chapters Four and Five. In Chapter Six we present our conclusion about the need for new directions in industrial growth, as well as some suggestions about the policy reforms that this need implies.

CHAPTER ONE

PHILIPPINE ECONOMIC GROWTH SINCE 1902: AN OVER-VIEW

1. Growth Trends, 1902-1968

Data pertaining to economic growth in the Philippines prior to this century are such as to make quantitative estimates largely guesswork. Between 1902 and 1961, however, five nation-wide censuses were undertaken and the economic data contained in these census reports have provided a basis for studies of long-term economic growth in the Philippines since 1902.[1/] While there are no doubt many weaknesses in the data, these, together with various studies of the international trade of the Philippines over the same period, give what is probably a reasonably accurate picture of some major trends and patterns in Philippine economic growth.

Table I shows overall and sectoral rates of growth between census years, based on estimates of ouput in 1939 prices made by R.W. Hooley. Omitted from his estimates are services and construction. The latter together accounted for a relatively stable 30 per cent of Net Domestic Product during the past nearly two decades. It is possible, however, that from 1902 to the outbreak of World War II their combined share rose somewhat, so that this omission might give a downward bias to Hooley's growth estimate.

On the other hand, the ouput estimates for Mining and Forestry and Transportation and Communication in the earlier censuses seem improbably small, leading one to suspect that their growth rates may be overstated. Any

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1/ We have relied especially on the studies of Hooley and Umaña. See R.W. Hooley, "Long-Term Economic Growth of the Philippine Economy, 1902-1961," The Philippine Economic Journal, First Semester 1968; and S.C. Umaña, "Growth of Output of Philippine Manufacturing," Proceedings of the Conference on Growth of Output in the Philippines, Los Baños, December 1966.

net bias from these two sources is probably not very great, however, and the estimated growth rates for the major sectors, as well as for "All Sectors," in Table I are, we think, as good indicators as are available of Philippine economic growth in this century.[2/]

The data of Table I indicate that the national product grew at an annual average rate of about 3.2 per cent between 1902 and 1961. This implies an annual per capital income growth rate of just under one per cent, since the rate of population growth averaged a little more than 2.2 per cent. The minor sectors in the lower half of the table had the highest growth rates, but these may be suspect for the reason stated above; and, in any case, their weight is relatively small in the total. Of the major sectors Manufacturing led with 4.6 per cent growth rate, while Agriculture and Commerce grew at rates that approximated closely the rate of population growth.

Growth rates for 1952-1968, based on national accounts data are also included in Table I. While the coverage is broader than that of Hooley's study, we think that the data are comparable enough to indicate the faster pace of growth of recent years. 1952 was selected as the initial year for this most recent period in order to minimize the possibility that what is being measured is postwar reconstruction rather than long-term growth. It is for the same reason that Hooley's data for the census year 1948 are not included.[3/]

2/ Sicat has constructed a time series of estimates of national product, excluding subsistence ouput, for the period 1900-1940 based on exports and tax revenues. His results show a somewhat higher growth rate (3.5 per cent in contrast to Hooley's 3.0 per cent for 1902-1938), but the difference may be accounted for by the slower growth of subsistence output. See G.P. Sicat, "On the Measurement of Long-Term Output," The Philippine Economic Journal, First Semester 1968.

3/ Hooley's "All Sectors" growth rate for 1938-1948 is minus 0.5 per cent, and for 1948-1961 is 6.9 per cent.

TABLE I

GROWTH RATES BY SECTORS
PHILIPPINES 1902-1968
(Per Cent Per Annum)

SECTOR / YEAR	1902-1918	1918-1938	1938-1961	1902-1961	1952-1968
Agriculture	5.1	0.5	2.2	2.4	5.0 a/
Manufacturing	4.1	4.7	4.9	4.6	7.1
Commerce	2.9	-0.1	3.4	2.0	5.7
Electric Power	9.3	6.4	10.0	8.6	b/
Mining and Forestry	23.7	15.8	1.5	12.0	6.6 c/
Transportation and Communication	15.1	9.6	6.6	9.9	5.6 d/
All Sectors	4.4	1.8	3.6	3.2	5.7 e/
All Sectors per Capita	2.5	-0.3	1.0	1.0	2.4
Exports	5.1	2.2	1.7	2.8	4.2

Sources: For 1902-1961 and sub-periods, R.W. Hooley, "Long-Term Growth of the Philippine Economy, 1902-1961," The Philippine Economic Journal, First Semester 1968. For 1952-1968, OSCAS, National Economic Council.

a/ Includes Forestry and Fishing.

b/ Included with Transportation and Communication.

c/ Mining only.

d/ Includes Electricity and other utilities.

e/ Includes Construction (5.2) and Services (4.8).

There appear to have been two periods of relatively rapid growth -- one at the beginning of the century (1902-1918) and the other, the period from the end of postwar reconstruction to the present (1952-1968). Between these two periods output lagged behind population growth, so that per capita income declined. Of course the long period of relative stagnation between 1918 and 1952 includes both the great depression of the 1930's and World War II, each of which severely set back the Philippine economy. Moreover, there were also shorter periods of rapid growth within these years that are not evident from the census data. Sicat has estimated that growth between 1926 and 1934 was even more rapid than from 1902 to 1918, 4/ and Umaña confirms this with his estimate of an annual average rate of 10.4 per cent for manufacturing growth between 1923 and 1934. 5/ In addition, recovery after World War II was very rapid. This serves to remind us that judging growth trends on the basis merely of census benchmarks can be misleading.

Nevertheless, the periods, 1902-1918 and 1952-1968, do stand out in Table I as years in which the pace of growth was very respectable by any standard. Growth of per capita output sustained at the rate of about two and one-half per cent per annum (common to both periods) over the entire span of years, 1902-1961, would have meant an output per person more than two and a quarter times the actual level in 1961. It might be instructive, therefore, to take a closer look at these two periods to see what, if anything, can be learned about the possibilities for sustained rapid growth in the Philippines. The two periods moreover present a fascinating contrast in patterns of growth.

4/ Op. Cit., Chart, p. 38.

5/ Op. Cit., p. 3-7.

2. Export-Led Growth, 1902-1918.

The first period begins early in the era of American rule and closes at the end of World War I. This was a period of rapid growth in world output and trade, and it may not seem surprising that the Philippines shared in it. Moreover, terminating the period in 1918 might appear to bias upward the result to the extent that the Philippines participated in the war boom. There are some reasons to believe, however, that these influences were not decisive and that the explanation for rapid growth in this period lies elsewhere. First, beginning the period in 1902 lends a downward bias to the growth estimate because of a depresssion following that year, which resulted from a number of causes including destruction and dislocation from the Philippine-American War.[6/] Moreover, Sicat's study [7/] shows a roughly constant and rapid rate of growth from 1908 to 1918, rather than a bulge during the war. In fact, the entry of the United States into the war seems to have had an adverse effect on Philippine trade and ouput. Finally Umaña's manufacturing growth rate for the period 1904-1915 is far above Hooley's 1902-1918 average.[8/]

What seems to have been the most important influence during this period was not the war, but the opening of the American market on a preferential basis to Philippine exports, mainly agricultural and agriculture-based products. This proceeded gradually with a 25 per cent preference until 1909,

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6/ A. Castro, "Philippine-American Tariff and Trade Relations, 1898-1954," Philippine Economic Journal, First Semester, 1965.

7/ Op. Cit., p. 38.

8/ Op. Cit., p. 3-7.

free trade with quotas until 1913, and fully free trade thereafter until the 1930's. This explanation of rapid growth in this early period finds corroboration in the data of Table I. Exports and agriculture both led overall growth with growth rates in excess of five per cent per annum. Manufacturing growth was at a more modest pace of slightly over four per cent, but while manufacturing doubled over the period, two manufacturing sectors -- food manufacturing and chemical products -- increased, respectively, to four times and eleven times their 1902 levels. These sectors were dominated by sugar and coconut oil both of which were exported to the American market in rapidly increasing volume.

Land inputs increased in the same proportion as agricultural output, while labor inputs rose at a slower rate. Accordingly agricultural output per employed agricultural worker rose almost 40 per cent. Nevertheless, agricultural labor as a proportion of the entire labor force rose from about 60 per cent to almost 70 per cent. 9/ The picture is, then one of rapidly increasing agricultural production, induced by export demand for raw and processed agricultural products. The boom in agriculture drew labor away (relatively) from the other sectors, but the abundance of fertile land in relation to population made possible an increase in land per worker and in labor productivity.

The case may seem to fit Myint's "vent for surplus" theory of export-led growth. 10/ The land that was pulled into the production of abaca, coco-

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9/ These are estimated percentages of the total labor force, not of the labor force in the sectors covered by Hooley, which exclude Construction and Services.

10/ Hla Myint, "The Classical Theory of International Trade and the Underdeveloped Countries," Economic Journal, June 1958.

nuts, sugar, etc., and the labor too, may have been relatively "surplus" in the sense that alternative opportunities for their employment were not promising. This implies some assumptions about what might have occurred if the Philippine economy had not been tied to the American market by preferential free trade. What if, for example, the Philippines had been permitted to retain the independence won from Spain? Would independent economic policies have produced equally rapid growth in a different pattern? The question is not easily answered.

It is important to note also, however, that it was the element of discrimination in the trading relationship that provided the principal inducement to exports. And it was with respect to tropical agricultural products that discrimination was most effective, since the principal competitors of the Philippines were countries other than the United States.[11/] On the other hand, discrimination in favor of the Philippines with respect to products produced cheaply in the United States (e.g., manufactures) had little incentive effect. Therefore, there was an element of trade diversion in the relationship; and Philippine production was biased toward complementarity with America. How far different this pattern was from one that would have been based on comparative advantage vis a vis the world is difficult to judge. Perhaps in the early years the difference would not have been very great. As Philippine factor proportions changed, however, and the factors of production specific to agriculture were less in surplus supply, diseconomies [redacted]m trade diversion may have become more important.. That there were such diseconomies is strongly suggested, at least, by the rapid country-wide

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11/ It is true, of course, that Americans produced sugar and substitutes for coconut oil, but at a significant cost disadvantage as evidenced by the persistent demand from these interests for quotas (or Philippine independence).

diversification of Philippine trade over the past decade as preferences with the United have gradually been reduced.

In any case, in this early period land was still relatively abundant and export-induced growth with agriculture the leading production sector was no doubt beneficial (if not ideal) for the Philippine economy at that stage. Moreover, there were important repercussions of this growth on the other sectors of the economy. The rapid growth of Electric Power, Mining and Forestry, and Transportation and Communication have already been noted. No doubt the extremely high growth rates shown in Table I reflect mainly the emergence of modern production, particularly in the latter two sectors. Hooley's figures for production in 1902 are so very small that one cannot avoid wondering whether a substantial amount of traditional and perhaps primitive, mining, forestry, transportation and communication activities were simply not counted.

3. Import Substitution via Market Growth

In the case of manufacturing, we have already noted the rapid increases in production of sugar and coconut oil. The latter, though begun only in 1913, had within five years surpassed copra in export value. But in addition to these manufactures for export, there occurred a significant amount of import substitution in manufacturing -- a process which Hirschman has called "import-swallowing." 12/ This is the kind of natural import substitution which occurs in an export-led growth process when incomes and markets expand to the point where domestic production becomes economical.

12/ A. Hirschman, The Strategy of Economic Development (New Haven: Yale University Press, 1958, p.)

Table II gives the percentage distribution of manufacturing output among industries at the two-digit ISIC level of disaggregation for the census years. Recall from Table I that manufacturing growth was at an annual average rate of 4.1 per cent between 1902 and 1918, and at a rate of 4.7 per cent during 1918-1938. There is a striking difference between the patterns of growth in the two periods, however. The first period was dominated by Food Manufacturing (read sugar) and Chemical Products (read coconut oil). Together they account for the entire growth in the manufacturing sector. The period 1918-1938 saw a much more balanced growth of manufacturing industries, however. Industries other than food and chemicals, ~~which, taken together, had no growth at all in the first period~~, increased their outputs at an average rate of 5.1 per cent, surpassing the hitherto leaders.

What this suggests is that, following the surge of export-led growth induced by the once-over opening of the U.S. market on a preferential basis, the next stage of manufacturing growth was characterized by a broad-gauged response to growth in incomes and widening of domestic markets. One naturally wonders what course this process might have taken had there been no great depression nor World War II. In a more favorable world climate a reasonably balanced, moderately paced growth might have proceeded without special stimulation -- i.e., on a self-sustaining basis. What happened instead was that the 1930's brought not only reduced demand, but also quota restrictions and tax penalties on Philippine exports to the American market. This perhaps, ~~more than anything else~~ explains the slow growth in the agricultural sector between 1918 and 1938.

4. Import Substitution via Protection:

We turn now to the recent period of rapid growth since 1952. The discussion here will be very brief since the succeeding chapter focusses on

TABLE II

DISTRIBUTION OF VALUE ADDED IN PHILIPPINE MANUFACTURING
1902-1961
(per cent)

$= \frac{\text{Ind. V.A.}}{\text{Mfg VA}} \cdot 100$

	1902	1918	1938	1961
Food Manufacturing	25.7	50.9	52.1	27.2
Beverages	12.7	5.3	4.7	7.2
Tobacco Products	24.2	9.6	7.2	5.7
Textile Products	0.5	0.5	0.8	5.1
Footwear and Other Wearing Apparel	5.9	3.5	7.8	4.0
Wood and Cork Products	8.0	5.4	5.3	6.2
Furniture and Fixtures	2.3	1.3	1.9	0.8
Paper and Paper Products	0.0	0.0	0.0	2.0
Printed and Printed Products	4.9	1.7	3.6	3.2
Leather Products	0.7	0.3	0.1	0.4
Rubber Products	0.0	0.0	0.0	1.6
Chemical and Chemical Products	1.9	10.9	6.9	9.9
Products of Coal and Petroleum	a	a	b	7.8
Non-Metallic Mineral Products	3.9	0.7	3.3	3.9
Basic Metal and Metallic Products	0.9	0.8	0.7	5.2
Machinery	3.6	0.8	0.2	5.3
Transportation Equipment	a	1.3	0.4	2.9
Miscellaneous Manufactures	4.2	5.9	3.9	1.4

Notes: a = negligible

b = included in miscellaneous manufactures

Source: Salvador Umaña, "Growth of Output in Philippine Manufacturing: 1902-1960," Proceedings of the Conference on Growth of Output in the Philippines, Op. Cit.; Bureau of the Census and Statistics, 1961 Census of Manufacturing.

the period in greater detail.

The contrast with the earlier period is very sharp. Growth was led this time by manufacturing output, which rose rapidly across a broad front of import substitution industries. The stimulus was import and exchange controls initiated at the end of 1949 in response to a balance of payments crisis. Scarce foreign exchange was, in effect, rationed on criteria of "essentiality." As the protective effect of import restrictions spawned new consumption goods industries, "essential" imports became the capital goods and intermediate goods required for maintaining and expanding employment. As a result, the new industrialization of the 1950's favored the finishing and assembling of imported semi-manufactures for sale in the home market, in contrast to the earlier period which was dominated by the processing of domestic raw materials for export. We might say that in the earlier period manufacturing looked inward to supply and outward to demand, while in the later period this was reversed. In each case, however, an artificial element of protection was present. In the earlier period it was protection in the American market for tropical agricultural products against rival tropical suppliers. In the later period it was protection in the Philippine market for the manufacture of consumption goods against all foreign suppliers.

Unfortunately the apparent success in growth performance since 1952, as evidenced in the growth rates of Table I, becomes open to some doubts when we look at trends within the period. In particular, the sharp deceleration of manufacturing growth is disturbing. Between 1952 and 1956 the growth rate averaged 12.9 per cent. In the next four years it was half that rate, and in the 1960's it has remained below five per cent. Manufacturing has ~~recently~~ been a lagging sector in Philippine growth in the 1960's. An explanation of

this phenomenon is one of our principal tasks in the pages that follow. Suffice it to say here that, as in the cases of many other developing countries following a policy of protection-induced import substitution, the early gains from taking over an existing market for consumption goods from excluded foreign suppliers are not easily repeated when the tasks become integrating backward to the production of intermediate and capital goods and breaking into the export market.

5. Structural Change and Productivity Trends.

We should include in this overview of long-term Philippine growth a look at some aspects of the changing structure of output and employment and the related questions of productivity change and sources of growth. Table III presents in summary form long-term changes in the distribution of output and employment, as well as in average labor productivity by sectors. Outputs for all sectors and employment changes in agriculture and manufacturing are taken from Hooley. The total labor force for his coverage of industries (recall that he does not include construction and services) is estimated by applying the proportions of 1961 to total employment for both years. Total employment in 1902 and 1918 was estimated by assuming that it represented the same proportion of population of labor force age (ten years and over) as in 1961. Admittedly this is crude, but we think that the major long-term structural and productivity changes would not be altered very much if we had more accurate labor force data.

The structural changes that occurred over the entire six decades are generally in the direction one would expect. Agriculture's share of output

TABLE III

DISTRIBUTION OF OUTPUT AND EMPLOYMENT
AND LABOR PRODUCTIVITY
PHILIPPINES, 1902 AND 1961

	1902	1918	1961
Agriculture			
Output (per cent of total)[a/]	55	60	34
Employment (per cent of total) [a/]	78	82	71
Output per Employed Worker (Pesos at 1939 prices)	84	116	98
Manufacturing			
Output (per cent of total) [a/]	13	12	28
Employment (per cent of total) [a/]	5	6	14
Output per Employed Worker (Pesos at 1939 prices)	302	324	403
Other Sectors			
Output (per cent of total) [a/]	32	28	38
Employment (per cent of total) [a/]	17	12	15
Output per Employed Worker (₱ at 1939 prices?)	139	358	483

Source: Hooley, Op. Cit., and Bureau of Census and Statistics, Journal of Philippine Statistcis, January-March, 1967.

[a/] Total output and employment exclude Construction and Services.

and labor force declined while that of manufacturing rose.[13] What is disturbing, however, ~~is that~~ the proportion of labor in agriculture declined so little -- from 78 to 71 per cent. The latter percentage (for 1961) corresponds to about 60 per cent of the labor force including the construction and services sectors. Coupling the high proportion of the labor force in agriculture (even in 1961) with the very low productivity of labor in agriculture (also in 1961) gives us a substantial reason for low per capita income in the Philippines today. And coupling the slow decline of agriculture's share of the labor force with the relatively low productivity in agriculture when compared to the other sectors (less than one-fourth) gives us one of the important reasons for the slow growth of per capita income over the six decades. Another important part of the explanation of the latter is, however, the almost negligible growth of labor productivity in agriculture -- a rate of about one-fifth of one per cent per annum over the 59 years.[14]

We can contrast this performance with that of the various countries that were successful in raising per capita income in the 19th and 20th Centuries to levels which put them in the category of developed economies. In each case a rapid reduction in agriculture's share of the labor force was an important element in the ~~process~~. And success in this structural transformation was accompanied by (or permitted?) rising productivity in

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13/ The reader is reminded again that Construction and Services are not included in either the output or employment totals. The shares of agriculture and manufacturing in the total labor force (including construction and services) were 60 per cent and 12 per cent, respectively, in 1961; and the corresponding shares in total output were 24 per cent and 20 per cent.

14/ In the middle 1960's agricultural productivity began to rise sharply, however, in what may prove to be the beginnings of a real agricultural revolution. See Chapter Two.

agriculture at a pace that narrowed the gap between average output per worker there and in the rest of the economy. 15/ Denison has found that even among the advanced countries today, an ability to reduce the proportion of labor in agriculture is an important determinant of differences in growth rates -- this despite the fact that their agricultural sectors by now are quite small and the productivity gap between the two sectors is much narrower than in the less developed countries. 16/

Turning to manufacturing, the picture is not very much brighter. It is true that its share of the labor force rose from about five to fourteen per cent, largely at the expense of agriculture, but partly at the expense of other sectors whose labor productivity may not have been less. Productivity growth within the sector was slow, however, averaging only one-half of one per cent per year.

Moreover, to see the extent of manufacturing employment in 1961 in its proper perspective we should note that the total indicated here includes a considerable number of persons engaged in traditional handcraft activities in the home. According to the 1961 Census of Manufacturing, employment in large manufacturing enterprises (defined as those with 20 or more workers) was less than three per cent of the total labor force. Adding small enterprises might raise this proportion to eight per cent.

The other sectors look better in the aggregate. Output per employed worker appears to have risen at an annual rate of better than two per cent.

15/ S. Kuznets, Modern Economic Growth (New Haven: Yale University Press, 1966), chapters 2 and 3.

16/ E.F. Denison, Why Growth Rates Differ (Washington: The Brookings Institution, 1967), chapter 16.

This may be partly illusory, however, since these sectors were allocated the residual of the labor force after the growth of employment in Agriculture and manufacturing was calculated. Any error in the growth of the entire employed labor force would have a disproportionate effect on the growth of employment in "Other Sectors." Nevertheless we feel that the data warrant a conclusion that productivity growth was more rapid there than in agriculture and manufacturing. This, together with the modest shift of labor from agriculture to manufacturing, is what largely explains the one per cent growth in per capita income over the first six decades of this century.

The emphasis above was on labor productivity, but we would like, if possible, to estimate the change in productivity of all inputs. Unfortunately we can do this only for agriculture and manufacturing separately, since we have no information on inputs other than labor into the other sectors. Lampman has used Hooley's input estimates for the two sectors to estimate overall input productivity by means of a simple Solow-Denison disembodied growth model. 17/ He used a weight of 70 per cent for labor's contribution which Williamson suggested scaling down to 55 per cent. 18/ We have made estimates for contributions to growth in agriculture and manufacturing for the periods 1902-1918 and 1902-1961, by using alternatively weights of 50, 60, and 70 per cent for labor.

17/ R. Lampman, "The Sources of Post-War Economic Growth in the Philippines, The Philippine Economic Journal, Second Semester, 1967. R. Solow, "Technical Change and the Aggregate Production Function, "Review of Economic and Statistics (August 1967), pp. 312-320; and E.F. Denison, The Sources of Economic Growth in the United States (New York: Committee for Economic Development, 1962).

18/ J.G. Williamson, "Dimensions of Postwar Philippine Economic Progress, "Quarterly Journal of Economics, February 1969, pp. 93-109.

The procedure is well-known, but perhaps it should be described briefly. If we can assume an aggregate production function of the Cobb-Douglas type,

$$Q = AK^{a} L^{1-a}$$

and, assuming that A, K and L are functions of time, we can differentiate totally with respect to time to get

$$\frac{dQ/dt}{Q} = \frac{dA/dt}{A} + \frac{a\, dK/dt}{K} + \frac{(1-a)\, dL/dt}{L}$$

That is, the proportional time rate of growth of output depends on the rates of growth of the inputs multiplied by their respective weights, which in turn are their growth elasticities; and on some residual influences (e.g., technical progress) that are neutral with respect to capital and labor. Moreover, if the factors of production are paid their respective marginal products (as is assumed under perfect competition), the growth elasticities will equal the proportionate shares of capital and labor in the total product. Thus the alternative weights for labor mentioned above of 50, 60, and 70 per cent could represent alternative assumptions about labor's share and they imply values for a , respectively, of 50, 40 and 30 per cent.

The results for agriculture are shown in Table IV. Since land and capital grew at approximately the same rate in each period, they could be lumped together as shown. The contribution of the residual influences appears in the last line, indicated as "Output per Total Inputs." It is evident that the value of the residual contribution is not very sensitive to changes in the assumption about labor's share.

The breakdown of contributions for 1902-1961 indicate that all of the growth in output can be accounted for by the growth of inputs. No contribution is indicated from the residual influences, which might include improvements

TABLE IV

CONTRIBUTIONS TO GROWTH PHILIPPINE AGRICULTURE

1902 TO 1961

(Annual Average Percentage Rates)

	1902 - 1918				1902 - 1961			
	Rate of Increase	Contribution (Labor's Share)			Rate of Increase	Contribution (Labor's Share)		
		(.70)	(.60)	(.50)		(.70)	(.60)	(.50)
Output	5.1				2.4			
Inputs								
Land and Capital a/	5.2	1.5	2.1	2.6	3.1	.9	1.2	1.5
Labor	3.0	2.1	1.8	1.5	2.1	1.5	1.3	1.1
Total Inputs		3.7	3.9	4.1		2.4	2.5	2.6
Output per Total Inputs		1.4	1.2	1.0		0.0	-0.1	-0.2

Source: Hooley, Op. Cit.

a/ Capital comprises machinery and animals.

TABLE V

CONTRIBUTIONS TO GROWTH
PHILIPPINE MANUFACTURING
1902 to 1961

(Annual Average Percentage Rates)

	1902 - 1918				1902 - 1961			
	Rates of Increase	Contribution (Labor's Share) (.70)	(.60)	(.50)	Rates of Increase	Contribution (Labor's Share) (.70)	(.60)	(.50)
Output	4.1				4.6			
Inputs								
Capital	7.1	2.1	2.8	3.5	5.5	1.6	2.2	2.8
Labor	3.6	2.5	2.2	1.8	4.1	2.9	2.5	2.0
Total Inputs		4.6	5.0	5.3		4.5	4.7	4.8
Output per Total Inputs		-0.5	-0.9	-1.2		0.1	-0.1	-0.2

Source: Hooley, Op. Cit.

in skills of workers and in techniques of production. This is particularly surprising when we note that in the early period of rapid growth the productivity of all inputs did increase significantly, contributing about one-quarter of the growth rate in agriculture. The implication is that the residual influences were negative following 1918.

For manufacturing the results are similar, as is shown in Table V. Again the growth of output is entirely explained by the growth of inputs, leaving no gain in total productivity. In the case of manufacturing, however, the experience of 1902-1918 indicates a negative residual contribution, so that following 1918 there was a very slight improvement in the productivity of capital and labor combined. The reader can verify that, even if one assumed the share of labor to be 100 per cent in Manufacturing, and similarly in agriculture, the contribution of the residual influences would, in neither case, be very significant.

This may seem surprising in view of the importance of the "residual" in calculations of this sort made for other countries. It seems to conflict also with the widely held view that improvements in education, health, and social organization in the Philippines were substantial since the advent of American rule at the beginning of the Century.

We have no general explanation for this phenomenon. There is, however, a plausible explanation for the results in Agriculture, which is consistent both with the overall productivity gain from 1902 to 1918 and the lack of any for the longer period. Suppose that over the whole period there was a positive residual, despite its apparent absence as deduced from the simple Solow-Denison model. Suppose also that in the early period land of uniform quality was available in abundance. This seems reasonable when we recall that, despite a rising share of the labor force in agriculture, both land

and capital inputs per agricultural worker increased almost 40 per cent. Moreover, average labor productivity increased in about the same proportion. This, of course, cannot be explained by a production function characterized by constant returns to scale unless there is a significant residual.

Over the longer period land and capital inputs continued to increase faster than employment of labor, so that by 1961 the ratio of land and capital to labor in agriculture was about 75 per cent higher than in 1902. This was accompanied, however, by only a very slight rise in average labor productivity; hence a residual of zero in the results shown in Table IV. And from 1918 to 1961 the residual, as calculated, would be significantly negative. This calculation assumes, however, that the inputs are of uniform quality over time. Suppose that after 1918 the land pulled into cultivation as the agricultural population grew rapidly was of diminishing quality. This conceivably could swamp other factors which were contributing to productivity increase.

Consistent with this hypothesis are studies cited by Hooley which indicate declining yields per hectare for rice and corn from some point after 1918. 19/ Hooley also suggests, however, that the rise in agricultural prices and incomes in the early period, followed by sharp declines, especially in the 1930's, may have had an effect on productivity. The nature of the connection is not clear, but investment in machinery was at a slower pace after 1918 (as was investment in animals), and there is a widely held belief that irrigation facilities did not keep pace with agricultural output.

19/ Hooley, Op. Cit., pp. 16-17.

The latter, of course, is also consistent with the hypothesis that new land inputs were of diminishing quality, since ease of irrigation is an aspect of land quality and it is reasonable to suppose that the land most accessible to water was cultivated earlier. In any case, however, it is likely that investments affecting agricultural productivity are partially a function of farm incomes.

Still the contribution of capital inputs is already accounted for in the calculation, and unless capital growth has been overstated it would seem that this could not serve as an explanation of the negative trend of total productivity after 1918. Capital inputs here are machinery and animals, however, and the extent to which irrigation (and other investments) might have increased at a slower pace could imply such an overstatement.

There is still another possibility, however. If, instead of a disembodied growth model, we assumed one in which important elements of technical progress are embodied in capital inputs,[20] the size of the residual will be positively related to the pace of investment. The slower rate of capital formation after 1918 and the chance that even this slower rate represents an overstatement of capital growth may, then, supplement the likelihood that land inputs were of diminishing quality in explaining the failure of total productivity in agriculture to increase over the six decades.[21]

20/ R.M. Solow, "Technical Progress, Capital Formation, and Economic Growth," American Economic Review, May 1962, pp. 76-86. This is the "embodied" growth model of Solow. When we attributed, above, the disembodied model to him and Denison we had in mind his earlier contribution cited in footnote 17.

21/ It was noted earlier that the depression of the 1930's and World War II might be sufficient explanations of the slow productivity growth. Lampman, however, found that even in period 1948-1961 the residual part of the explanation of agricultural growth was very small -- this, despite the fact that the early years of the period "reconstruction gains" were important. Op. Cit., 179.

It would seem that in manufacturing the argument for an embodied growth model could be put more strongly. But, surprisingly, a higher rate of capital formation in 1902-1918 (compared to that of the entire period) was accompanied by a lower residual. This is not perhaps, a good test, however, since in the earlier period manufacturing growth was dominated by only two industries -- sugar and coconut oil. Moreover, Lampman found a significant residual associated with a very high rate of capital formation in the period 1948-1961. To the rate of growth of manufacturing output of 11.3 per cent, he estimated the contribution of labor to be 4.2 per cent, that of capital to be 3.9 per cent and that of the residual to be 3.2 per cent. 22/ Of course there was an element of reconstruction in this growth and that no doubt raised the residual. In any case the pattern of post-war manufacturing growth requires more detailed analysis and we return to this question in Chapter Two.

6. Alternative Strategies.

Instead of trying simply to summarize this chapter, it might be more useful to return to the question, raised earlier, whether the rapid growth of 1902-1918, led by agro-exports and induced by trade preference in the U.S. market, might have continued and developed a self-sustaining character had there been no Great Depression or World War II. 23/ We have seen that, following World War I and the postwar depression, growth continued to be rapid until the early 1930's; and this growth extended more broadly across the manufacturing sector than in the period before 1918 when sugar and coco-

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22/ Ibid., p. 180.

23/ The same question should be raised about the rapid growth, of a quite different pattern, that occurred in the 1950's and 1960's. This will be treated in the succeeding chapter, however.

nut oil dominated manufacturing growth. Moreover, exports continued to grow rapidly, as apparently did agricultural output, at least until the late 1920's. 24/ Why couldn't a process of this sort continue indefinitely? First, we must remember that it was based on external preferential demand. If the growth of this demand retarded or if the preference disappeared growth might falter. In addition on the supply side the process depended on a rapid increase of land inputs of a given (or not very rapidly declining) quality. This seemed to be realized until sometime in the late 1920's. But thereafter there appears to have been a strong tendency for average yields from land in agriculture to decline though the data are far from adequate and it is somewhat difficult to locate the turning point because of the generally erratic character to yield variations. 25/ The implication is that increasingly growth in output and employment would need to depend more on manufacturing and the other non-agricultural sectors. The structural changes that are shown in Table III for the period 1902-1918 (and which may have continued past the middle 1920's), would have to be reversed. From growth based on the rapid expansion of agricultural land, the Philippines would have to turn to industrialization.

This might have occurred, of course, had not the depression and World War II intervened. With the widening of the domestic market from rising incomes and the natural import substitution that would result, it seems likely that eventually an internal-saving investment mechanism in the industrial

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24/ This is suggested by several studies. See especially E.C. Venegas and V.W. Ruttan, "An Analysis of Rice Production in the Philippines," Economic Research Journal, December 1964, p. 159; A.E. Recto, Price and Market Relationships for Corn in the Philippines, unpublished M.A. Thesis, University of the Philippines, 1965, p. 55; and A.J. Nyberg, "Growth in the Philippine Coconut Industry, 1901-1966." The Philippine Economic Journal, First Semester 1968, p.44.

25/ See the references cited in the preceding footnote.

sector would replace external demand for agriculture-based products as the prime motivating force for growth. We are concerned, however to point to two inhibiting factors that probably would have retarded, if not thwarted, this development.

The first is the classic factor price disequilibrium problem of Manoilescu.[26] Put very simply it is that manufacturing (and other "modern" sectors) must pay labor a wage above its marginal social opportunity cost, the latter depending on labor's marginal product in agriculture (and other traditional sectors) plus some extra costs of employing labor in industry. While this may be a nearly universal phenomenon in less-developed countries, it appears to be especially serious in the Philippines. For the ratio of average labor productivity in non-agriculture to that in agriculture (more than four to one) is far above the average even for less-developed countries.[27] This is the ratio of average products, not marginal products, and it fails to take into account differences in the qualities of labor required in the two sectors. On the other hand, non-agriculture includes some low productivity activities like domestic handicraft and small-scale retail trade that give a downward bias to the ratio. Accordingly, we feel that there is strong evidence of factor price disequilibrium in the Philippines.[28]

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[26] M. Manoilescu, The Theory of Protection (London: King, 1931).

[27] Kuznets, Op. Cit., p. 402.

[28] See also the corollary evidence on the labor surplus character of the Philippine economy in T. K. Ruprecht, "Labor Absorption Problems and Economic Development in the Philippines," The Philippine Economic Journal, Second Semester 1966, pp. 290-293.

Its effect on growth, of course, is to inhibit the structural change that was indicated above as essential to continued success -- i.e., industrialization. Put another way, it biases resources allocation away from what should be an evolving comparative advantage in labor-intensive manufactures. The bias is two-pronged. A wage above the marginal social opportunity cost of labor not only is an impediment to investment in industry generally, but it specifically disfavors labor intensive techniques. And traditional agricultural exports can maintain balance of payments equilibrium at an exchange rate which does not permit (socially) comparatively advantageous manufactures from competing effectively with foreign products in either the domestic or world markets.

The second inhibiting factor, which tends to reinforce the first, is the system of preferential free trade. Preference in the American market meant preferences over third-country competitors; not, of course, over Americans. This was effective preference, then, only in products for which the close competitors were countries other than the U.S. The same was true in the Philippine market where tariffs applied to other countries, but not to the U.S. Thus the system was biased toward exchange of tropical agricultural products for manufactures, which meant an additional artificial obstacle to industrialization.

Our conclusion is that in the absence of measures to offset this bias -- i.e., without special inducements to industrialization -- Philippine growth [illegible] fall considerably short of its potential. And while it is easy to attribute the relative stagnation of the Philippine economy over the entire 60 years to the depression and its impact on American agricultural protection policies, as well as to World War II, we cannot be sure that if these had not occurred the Philippines would have succeeded in achieving the transformation required to maintain the pace of growth it had enjoyed

in the first quarter of the century.

In the 1950's the Philippines embarked on a new surge of growth behind protection of manufactruing. This is, of course, the remedy that Manoilescu had urged. As we have indicated above, however, the rapid early gains in industrial growth were followed (from the late 1950's) by a deceleration to the point where manufacturing became a lagging sector, as it had been in 1902-1918. Again, as in the case of the colonial trade pattern, doubt arises whether protection-induced import substitution is an effective vehicle for achieving self-sustaining growth.

In sum, we have shown that the Philippines had two extended periods of relatively rapid growth in this century, one at the beginning and the other at the end of the almost seven decades that have transpired. In each case there was an element of protection, serving both as a stimulus and as a factor biasing the growth pattern in a particular way. We have noted also the important underlying change in factor proportions as the country evolved from a Myint "vent for surplus" situation to Manoilescu's "factor price disequilibrium." 29/ We have suggested that the earlier colonial trade pattern, biased toward the export of agriculture - based products and the import of manufactures, was inadequate as a vehicle for successful development because of its bias against industrialization. The recent period seems to have been characterized by the opposite bias -- in favor of industrialization. And yet industrialization has faltered. Why? We turn in the succeeding chapters to a closer look at this apparent puzzle.

29/ In both situations there is, of course, a surplus of factor supply -- land in the Myint case and labor in the Manoilescu case. The use of this surplus to produce for export in latter case is inhibited not only by the failure of the market price of labor to reflect the surplus but also by the systems of protection around the world that are biased against trade of manufactures. Note also that the domestic aspect of the inhibition against manufacturing depends on the condition that agricultural products are exported. For if they could not be exported at any price, the exchange rate would have to adjust to make manufactures exportable despite the high wage rate.

CHAPTER TWO

INDUSTRIALIZATION AND TRADE SINCE 1950

1. Postwar Reconstruction

The period since the end of World War II has witnessed a more rapid rate of industrial growth than any period of comparable length in modern Philippine history. This is somewhat misleading, of course, since in the early postwar years the economy was recovering from very low production levels owing to wartime destruction and dislocation. A U.S. Congressional Report in 1945 stated that among war-ravaged countries the Philippines was the "most utterly devastated" from the standpoint of the effect on the economy and on the nation's capacity to rebuild.[1/] It is not surprising, therefore, that manufacturing output tripled between 1946 and 1948, and continued to increase at an annual rate of about 20 per cent in the succeeding three years. Nevertheless, we have seen from Table I (Chapter One) that dating postwar manufacturing growth from 1952 yields an annual average rate of increase of over seven per cent, despite the slowdown in recent years; and this is considerably more rapid than in any other sub-period of this century.

Since the import controls which gave impetus to the surge of manufacturing growth in the 1950's were initiated in 1949, there was some overlap between reconstruction and the new import-substituting industrialization. This was the reason given earlier for selecting 1952 as the initial year of the postwar growth period. Nevertheless, for some purposes it will be better to date the period from 1950, since this was the first full year in which the protectionist policies were effective.

[1/] Quoted in S. Jenkins, American Economic Policy Toward the Philippines (Stanford: Stanford University Press, 1954), p. 42.

In any case we will give only scant attention to the years, 1945-1949, limiting our discussion to those developments which help to explain the foreign exchange crisis of 1949, which was the prelude to the imposition of effective import controls. Basically the crisis resulted from a combination of a continuing huge trade deficit and a decline toward the end of the 1940's of the flow of dollars for war damage and rehabilitation that had made the deficit viable. Except for copra, exports were slow to recover and during 1947-1949 were far below pre-war volume. Imports, on the other hand, were more than double pre-war volume and were concentrated on food and other consumption goods.

Political independence, which came in July of 1946, followed passage in the United States Congress of a Philippine Trade Act, which provided for ~~gradual~~ eventual elimination of the preferential trade system over eight more years of free trade (except for some quotas on Philippine exports), followed by twenty years of gradually diminishing tariff preferences. Also included were several additional limitations on Philippine sovereignty as the price for war damage payments from the United States, since the Rehabilitation Act was made conditional on acceptance by the Philippines of the Trade Act. In particular, Americans were given preferential status over other foreign nationals with respect to investment in natural resource exploitation and public utilities; and the right of the Philippine Government to change the dollar value of the peso, to suspend convertibility or to restrict capital movements was contingent on approval by the President of the United States. Moreover, the Philippines was denied the power to impose export taxes, while the United States retained the right to limit the entry of Philippine goods that are "likely to come into substantial competition with like articles which are the product of the United

States ..."[2]

The prohibition against export taxes is symmetrical with a provision of the American constitution; it was imposed presumably to prevent their use as a retaliatory measure in trade. However, it ran counter to the long-run economic interests of the newly independent republic. It prevented, until the Revised Trade Act became effective in 1956, the use of a weapon which could have been effective both for protection against uneconomic terms of trade losses and for transferring income from traditional exports to other sectors. The latter was especially important in the case of sugar, which enjoyed a very high price premium in the protected US market. While the rehabilitation of the badly damaged sugar industry was a major preoccupation early after independence, the initial prohibition against export taxes almost certainly strengthened the protective shield of the sugar industry when rehabilitation was near completion. Thus, the benefits from the sugar premium were not dispersed to other sectors of the economy. The alternative means of squeezing export income were much inferior because, as we shall show in Chapter 5, they cut across-the-board among all sectors, including potential manufactured exports.

More serious was the limitation on exchange rate policy, though it seems to have received less attention in professional discussions. The sentimental value attached to retaining the prewar parity between the peso and the dollar, strengthened by the infringement on exchange rate sovereignty,[3] had

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[2] Ibid., p. 66.

[3] It should be noted that the Philippines could have devalued with the approval of the U.S. President. Such approval was forthcoming in 1949 for exchange controls.

Econ - [illegible]

probably the most serious consequences on the direction of Philippine industrial and economic growth. With much of industrial productive capacity at the beginning of independence incapacitated owing to war destruction, the Philippines lived rather extravagantly on foreign exchange windfalls provided by American military spending, war damage dollar receipts, and on foreign exchange assets accumulated by the Philippine government during the war. Rapid reconstruction after the war could have been achieved with better effects under a more realistic exchange rate, which would have redirected consumption to investment and set Philippine industrial growth on a more promising path.

Yet, by maintaining the prewar parity of the peso, the country used these enormous external resources for consumption goods imports in the promotion of a policy to reduce prices. The Philippines was the only economy in the world which experienced a downward price trend for over a decade after the end of the Second World War. All other countries, and especially those which suffered a similar degree of destruction, realistically adjusted their exchange rates.

However, the Trade Act was designed primarily to reestablish the pre-war pattern of colonial trade and to protect the interests of American investors in the Philippines. It was hoped that post-war rehabilitation would be speeded by the encouragement thus given to traditional exports and to American private investment. In fact exports lagged while imports of all kinds, essential and non-essential, soared under free trade. This was, of course, mainly due to the effects of the war on production, but it was due in part also to the war inflation, which left the peso greatly overvalued at a rate of two to the dollar. Even the substantial price declines which accompanied

the resurgence of domestic production left exports and import substitutes at a disadvantage in relation to goods which were not internationally traded. Therefore, even as production recovered, the trade deficit remained large; and when the invisible dollar receipts declined sharply, so did the foreign exchange reserve. From the end of 1948 to the end of 1949 reserves dropped from $420 million to $260 million.[4/]

2. Import Controls.

While import controls were adopted early in 1949, they became really effective only in 1950, after a full-blown foreign exchange crisis in December of 1949 led also to the adoption of exchange controls. The immdediate cause of the crisis was capital flight, possibly triggered by the devaluation of the British pound; but, as we have noted, there was an underlying weakness that would have required corrective measures sooner or later. It is significant, however, that the controls were effected during a crisis when there was little time to think about, let alone implement, more fundamental solutions. And direct controls, even if adopted as a short-run measure, have a tendency to produce an environment in which their continuation can easily be rationalized. For as they remove the immediate pressure on the balance of payments, the Government can always find other more urgent problems than long-run balance of payments equilibrium. And the protective effect of the controls soon creates private vested interests in new industries dependent on their continuance.

[4/] F.H. Golay, The Philippines: Public Policy and National Economic Development (Ithaca: Cornell University Press), p. 76.

It appears, in any case, that the adoption of a strategy of encouraging manufacturing behind protection was more or less inadvertent. For it is difficult to find any evidence that this was a planned ~~strategy~~ decision whose long-run consequences were foreseen. Rather, the imposition of import controls was a response to an immediate crisis with weapons which, if crude, were nonetheless quickly effective in defending the balance of payments. But the controls were equally effective in providing a high degree of protection for the manufacture of consumption goods. The resulting profit incentive evoked a strong entrepreneurial response; and what began as an emergency tactic in balance of payments policy became the principal policy instrument for promoting industrialization over the decade of the 1950's.

Some idea of the extent of the protection offered by the controls is suggested by the rise in domestic wholesale prices of imported goods in relation to their c.i.f. import prices. The ratio of indexes of these prices is shown in column (3) of Table VI.[5/] Unfortunately the import unit value index of column (2) has current year weights while the index of wholesale prices of imported goods is based on the 1955 composition of imports. This means that the rise in the ratio -- the "scarcity premium" on imports -- is probably understated during the first half of the 1950's. For this is when the composition of imports changed most rapidly, and those imports whose quantities had been most sharply reduced by 1955 are likely to have had the greatest price increases. After 1955 the composition of imports changed only slowly, so that, with a mental adjustment upward of the trend from 1949 to

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5/ The present series for import unit values extends back only to 1950. Figures from the Central Bank Statistical Bulletins in 1951 and 1952, based on an older series, give inconsistent indexes for 1950 in terms of 1949=100, ranging from 76 to 90. The former seems improbably low to us, so we have selected the latter.

TABLE VI

CHANGES IN RELATIVE PRICES OF IMPORTED GOODS, 1949-1968
1949=100

	(1) Wholesale Prices of Imported Goods	(2) Import Unit Values	(3) Column (1) / Column (2)
1949	100.0	100.0	100.0
1950	121.4	90.0	134.8
1951	152.7	101.4	150.5
1952	135.5	99.9	135.6
1953	128.6	95.3	134.9
1954	124.6	91.3	136.4
1955	118.5	91.3	129.7
1956	128.9	92.5	139.3
1957	135.8	95.5	142.1
1958	141.2	97.6	144.6
1959	153.9	99.7	154.3
1960	162.8	101.8	159.9
1961	171.2	103.3	165.7
1962	187.4	105.3	177.9
1963	198.8	112.2	177.1
1964	200.7	113.3	177.1
1965	201.7	115.2	175.0
1966	204.1	117.0	174.4
1967	205.6	119.7	171.7
1968	206.9	119.1	173.7

Source: Central Bank Statistical Bulletin, December 1968.

1955, we think that the ratio is a good indicator of trends in the implicit degree of protection provided by the control system.

Decontrol of imports was accomplished between 1960 and 1962, but this permitted a highly protective tariff law, enacted by Congress in 1957, finally to become effective. Moreover devaluation accompanied decontrol, the peso price of the U.S. dollar rising from 2.00 to 3.90. Accordingly, after 1962 the ratio has a different meaning. It measures the combined protective effect of the tariff system and the higher price of foreign exchange, since the index of import unit values is based on dollar prices. Thus we can compare, if only roughly because of the imperfections of our measure, this combined protective effect with that prevailing under import controls.

While the scarcity premium may be a good measure of average protection under controls, it probably seriously understates the degree of protection given to favored manufacturing industries. For import restriction was related to "essentiality," and this meant that finished consumption goods tended to be most severely restricted, while capital goods, intermediate goods and raw materials were more liberally imported. Thus protection for the manufacture of the former came both from the higher prices in the domestic market of the rival foreign products and the relatively low prices of their imported inputs that the undervaluation of foreign exchange and liberal imports permitted.

Moreover, we can observe from Table VI the very sharp rise in the average scarcity premium from 1949 to 1951, as shown in column (3). During the next four years the premium was lower, suggesting some easing of import controls. Data on the volume of imports from Table VII confirms this. While

TABLE VII

PHILIPPINE TRADE AND TERMS OF TRADE, 1950-1968
1955=100

Period	Quantum Index		Price Index		Value Index		Barter Terms of Trade	Capacity to Import
	Imports (1)	Exports (2)	Imports (3)	Exports (4)	Imports (5)	Exports (6)	(4)÷(3)	(6)÷(3)
1950	63.8	70.6	94.6	119.7	62.8	84.7	121.4	.859
1951	79.7	79.2	111.2	127.9	88.6	102.5	114.8	.921
1952	72.3	88.3	109.5	100.6	79.2	88.4	91.9	.807
1953	79.9	82.6	104.5	122.8	83.5	101.4	117.5	.970
1954	88.3	91.7	100.0	109.0	88.1	100.1	109.0	1.001
1955	100.0	100.0	100.0	100.0	100.0	100.0	100.0	1.000
1956	92.1	111.6	101.4	101.4	93.4	113.2	100.0	1.116
1957	109.1	104.7	104.6	102.8	114.1	107.6	98.3	1.028
1958	96.4	115.6	107.0	106.9	103.2	123.8	99.9	1.157
1959	87.2	114.7	109.2	115.9	95.2	132.9	106.1	1.217
1960	96.5	123.2	111.5	114.1	107.6	140.6	102.3	1.260
1961	99.0	119.2	113.2	105.0	112.1	125.2	92.6	1.106
1962	93.7	130.6	115.4	106.2	108.1	138.7	92.0	1.201
1963	92.1	162.3	123.0	111.8	113.4	181.4	91.0	1.474
1964	113.9	166.3	124.1	110.9	141.3	184.4	89.4	1.485
1965	117.1	170.7	126.2	112.8	147.8	192.5	89.4	1.525
1966	124.6	180.9	128.2	113.8	159.7	206.4	88.8	1.609
1967	148.4	174.6	131.1	115.9	194.6	202.4	88.4	1.543
1968	162.0	171.5	130.4	121.7	211.2	208.7	93.3	1.600

Source: Central Bank Statistical Bulletin, December 1968.

we do not have an index of the quantity of imports for 1949 in this series, Golay states that there was a more than 40 per cent drop from 1949 to 1950.[6/] Imports then rose rapidly in volume to 1955, leaving the level still about of 1949, however. After 1955 the quantity of imports dropped and, with the exception of 1957, remained below the 1955 level until after decontrol. Correspondingly the premium rose steadily to a high in 1962. Thereafter, however, imports were no longer controlled and the ratio of world to domestic prices of imports depended on the tariff system and the new exchange rate. This explains the stability in our measure after 1962.

From Table VII we can see also that the quantity of exports rose at a moderately rapid pace (between five and six per cent per annum) during the 1950's. The rate of increase was greater in the first half of the decade, but this may include an element of postwar recovery. Moreover under-reporting of exports is believed to have increased toward the end of the decade, thereby understating the growth in those years. Prices of exports, however, fell in the first half and rose in the second half of the 1950's, more than offsetting the difference in the recorded quantity increases. Thus at a time when import controls were becoming increasingly tight, export earnings were rising at an average annual rate of more than seven per cent.

This coincidence of rapidly expanding export earnings and tightening of import controls (as evidenced in the decline in the volume of imports after 1955) requires some explanation. In part it can be attributed to the fact that import prices were rising almost as fast as export prices. Nevertheless, the so-called "capacity to import" -- export total value index

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6/ Ibid., p. 76.

divided by import unit value index (shown in the last column of Table VII) -- rose at an annual average rate of 4.7 per cent, as opposed to a rate of 3.1 per cent in the first half of the decade.

Moreover, a look at the other elements in the balance of payments, shown in Table VIII, suggests that their total effect was not less favorable in the second half of the decade. Adding United States Government expenditures and transfers payments together (there seems to have been a change in classification at mid-decade), they total more in 1956-60 than in 1951-55. The same is true of long-term capital inflow. These are more than offset, however, by the deterioration of the short-term capital account (including errors and omissions), though the margin is slight. This leaves the substantial improvement in the trade balance in the second half of the decade as the major influence on the trend of the balance of payments. And this is reflected in a smaller cumulative deficit -- only $35 millions, as opposed to $141 millions between 1951 and 1955.

The important point, however, is that there were deficits in both halves of the decade. The tightening of controls in the second half was related to the level of reserves, not to the trend in the size of the annual deficit. The foreign exchange reserve of the Central Bank, which had totalled $587 millions in 1945, and $296 millions in 1950, was down to $90 millions by 1959.[7/] This represented about two months of the tightly controlled level of imports. Deficits were no longer tolerable and a re-evaluation of policies was clearly in order.

7/ This is the "gross" reserve of the Central Bank. If we considered also the rise in public and private short-term net indebtedness abroad, the picture would be even more bleak.

TABLE VIII

BALANCE OF PAYMENTS 1949-1968
(Millions of U.S. Dollars)

	Balance of Trade	U.S. Government Expenditures	Other Services	Current Account Surplus	Transfer Payments	Long-Term Capital	Short-Term Capital, Errors and Omissions	Change in Reserves
49	-316	164	-135	-287	218	6	-106	-169
50	6	107	-90	24	166	34	-159	64
51	-80	98	-110	-92	23	2	16	-51
52	-80	126	-100	-54	41	14	-9	-8
53	-81	140	-111	-52	22	42	-7	4
54	-82	123	-124	-83	26	21	1	-33
55	-146	128	-142	-160	32	100	-25	-53
56	-39	51	-122	-110	102	59	-45	6
57	-169	46	-146	-269	126	50	3	-90
58	-51	31	-128	-148	111	23	35	21
59	19	25	-119	-75	131	76	-134	-2
60	-30	21	-136	-145	140	76	-41	30
61	-97	31	-99	-165	94	-8	3	-76
62	-16	32	-77	-61	92	3	-3	31
63	122	33	-56	99	79	-19	-125	34
64	-23	41	-42	-24	108	40	-110	14
65	-24	67	-5	38	99	23	-95	65
66	-9	79	-5	65	96	-43	-140	-22
67	-224	103	-90	-211	187	0	38	14
68	-284	124	-234	-394	126	191	59	-18

Source: Central Bank.

The situation was actually more serious than this suggests. For the growth of export volume was retarding in the second half of the decade as was indicated above. The sharp improvement in export prices (about 16 per cent) between 1955 and 1959 masked an apparent real export lag. We say "apparent" because this may have reflected partly a growing under-reporting of exports because of the unfavorable exchange rate that import restriction defended. In either case -- real lag or under-reporting -- the Government could no longer ignore the question of a realistic exchange rate.

3. Decontrol and Devaluation

Armand Fabella, former Director-General of the Program Implementation Agency, has stated very succinctly the principal reasons for the decontrol and devaluation that took place between 1960 and 1962.

> In the early part of the past decade, the weapon of foreign exchange controls proved to be extremely effective in guiding the direction of economic growth ... Towards the end of the 1950's, more and more of this foreign exchange had become committed in advance .... Therefore, the use of foreign exchange controls in guiding economic development became less effective as foreign exchange supply crises developed ..... Of course, decontrol took place ... not only because of the above factors but also because of the artificiality of the foreign exchange rate.[8]

The diminishing degree of discretion in foreign exchange allocation is reflected in the changing composition of imports, as seen in Table IX. Consumer goods, which accounted for 37 per cent of imports in 1949, represented only 14 per cent by the end of the 1950's. The proportionate share of machinery and

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[8] A.V. Fabella, "Some aspects of the Strategy of Development Planning," in G.P. Sicat, ed. The Philippine Economy in the 1960's (Quezon City: Institute of Economic Development and Research, University of the Philippines, 1964), p. 57.

TABLE IX

PERCENTAGE DISTRIBUTION OF IMPORTS: 1949-1968

	1949	1951-53	1955-57	1959-61	1963-65	1967-69[a]
Producer Goods	**62.7**	**76.8**	**81.7**	**86.1**	**83.9**	**87.9**
Machinery and Equipment	9.9	9.1	11.0	19.7	17.4	19.9
Unprocessed Raw Materials	1.0	1.6	4.2	10.4	15.4	13.1
Semi-processed Raw Materials	41.6	48.0	51.3	45.8	45.9	50.2
Supplies	10.1	18.0	15.2	10.2	5.1	4.5
Consumer Goods	**37.3**	**23.2**	**18.3**	**13.9**	**16.4**	**12.1**
Durable Goods	2.5	1.6	1.3	.8	1.0	1.1
Non-durable Goods	34.8	21.6	17.0	13.1	15.4	11.1

Source: Central Bank

a/ First half 1969 only.

equipment, in contrast, doubled over the decade -- from 10 to 20 per cent. Unprocessed and semi-processed raw materials also increased as a proportion of imports, their combined share rising from 43 to 56 per cent.

Thus the evidence strongly supports Fabella's contention. After a decade of exchange controls there was little discretion left to controllers. 86 per cent of imports were "producers goods" most of which were essential to the maintenance and expansion of employment and output in already existing industries. While deficits continued and the foreign exchange reserve dwindled, the remedy of further restricting "non-essential" imports was rapidly becoming obsolete. For virtually all imports were by now essential in some sense. Any further tightening of import controls would be likely to depress output and employment because of the dependence of the new manufacturing industries on imported inputs.

There is some evidence to suggest that this was, in fact, already happening during the second half of the 1950's. From Table X we can see that there was a sharp drop in the rates of growth of national product, and especially in the contribution of manufacturing, after 1956. This might also be attributed to declining opportunities for easy import substitution in final processing of consumption goods. What Albert Hirschman has called the "exuberant" stage in import-substituting industrialization[9/] lasts only as long as the emphasis is on taking over an existing market for consumption goods from the restricted foreign suppliers. There are no immediate market constraints

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9/ A. Hirschman, "The Political Economy of Import-Substituting Industrialization in Latin America," The Quarterly Journal of Economics, February 1968.

TABLE X

RATES OF GROWTH OF NATIONAL PRODUCT,
MANUFACTURING AND AGRICULTURE
1948 to 1968

(Average annual percentage changes in 1955 prices)

	Gross National Product	National Income	Value Added in Manufacturing	Value Added in Agriculture[a/]
1948-52	9.2	9.1	10.5	6.6
1950-56	7.9	7.8	12.3	6.2
1952-56	7.7	7.6	12.9	6.3
1956-60	4.4	4.6	6.3	3.3
1960-64	5.6	5.1	4.8	3.5
1964-68	6.1	5.3	4.7	6.9

Source: National Economic Council.

a/ Includes fishing and forestry.

and with high protection even comparatively disadvantageous industries can "earn" high profits and enjoy a burst of rapid growth during the period of market absorption. Manufacturing can temporarily play the leading role in economic growth.

There are two constraints that may soon operate to bring the exuberant stage to an end, however. The first is the shortage of foreign exchange which evidently was becoming acute in the late 1950's, as evidenced above. The second is the limited size of the domestic market for consumption goods. As this limit is approached, sustaining the earlier pace of industrial growth is impossible unless industry is able to break out of the confines of the domestic market for finished consumption goods. This could be done in either or both of two directions. First, investment could move back to the earlier stages of the production process -- i.e., backward linkage import substitution. Second, manufactures could break into the export market. In the absence of either or both of these the manufacturing sector must inevitably become a "lagging" sector -- i.e., one that merely follows the growth of domestic demand which, in turn, must get its impetus from some other sector.

Moreover, it is these same two new directions that could resolve the balance of payments problem. Backward integration of industrial production would tap a vast new source of foreign exchange saving when the potential at the finishing stages of production is becoming exhausted. And manufactured exports can expand along highly elastic world demand curves to supplement foreign earnings from primary exports. So looked at either from the standpoint of market constraints or the foreign exchange constraint the required redirection of industrial growth is evident. Backward integration and new exports are the avenues for the next stage of industrial growth.

Both constraints were beginning to operate in the Philippines in the late 1950's, though the balance of payments problem was both more evident and more immediate. An additional constraint on policy remedies was the character of the industrial growth that had been spawned by the controls system -- particularly the heavy dependence on imported materials and equipment. For, while increasing restrictions on these imports would create a profitable new market for industrial investment and also save foreign exchange, it would simultaneously create difficulties for the existing manufacturing industries. One could argue that this was precisely what was needed to separate the relatively efficient from the inefficient, as well as to force greater attention to cost-saving all around. But the short-run ~~cost~~ sacrifice in output and employment plus the power of the manufacturing interests entrenched behind protection meant that the political disadvantages of such a policy would loom overwhelmingly large even if its long-run economic merits could have been appreciated. This is the dilemma that Philippine policy-makers faced at the end of the decade.

Aside from backward integration in industry there were, of course, other possible remedies for the slowdown in industrial growth and the balance of payments problem. A revolution in agricultural production could have raised incomes and demand for industrial products at a more rapid pace. And it could have been foreign exchange saving (e.g., rice, corn) or earning (coconuts, sugar, etc.). This too was not likely, however, under the policies of the 1950's which were biased against both agriculture and exports. The bias against exports from the undervaluation of foreign exchange also precluded the emergence of new manufactured exports as a remedy.

Finally, an increase in foreign capital inflow -- public or private -- could have financed the necessary imports and permitted a higher rate of in-

vestment and growth. This again was not likely to occur under the existing policies, however. For the bias in profit incentives against the future growth areas -- backward linkage import substitution and manufactured exports -- plus the relative exhaustion of opportunities for further import substitution in the favored consumption goods sector meant a poor investment climate for private capital, domestic or foreign. And the international lending agencies were not likely to come forth with assistance on the scale required unless policies were reformed so as to promise long-run balance of payments viability.

In the light of all this it is not surprising that the Government, early in 1960, decided to abandon controls and at the same time to seek a more favorable exchange rate for exports. The details of decontrol and devaluation, a gradual process which was completed by January 1962,[10/] are set out in Chapter Four. It will suffice here to note the economic implications of this remedy.

Were it not for the Tariff Law of 1957, which decontrol made finally effective, the combination of elimination of import controls and a devaluation of sufficient measure to attain balance of payments equilibrium would have largely corrected the biases of the previous system and would have given great encouragement to both exports and backward integration in manufacturing. But the system of tariffs was there, lurking beneath the surface, and with decontrol it became the principal instrument of protection. Again the reader must await Chapter Four for the details of tariff structure, but it is important to note here that it was (and is) highly protective and biased in the same manner as

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10/ There is one important exception to the completeness of the devaluation. Exporters were required until November 1965 to convert 20 per cent of their proceeds at the old rate. This was, in effect, an export tax of about 10 per cent.

the import controls system against backward integration. Moreover, its protective effect, substituting in part for that of import controls, meant that the required exchange rate adjustment was considerably less, implying a substantial remaining bias against exports. And, because of the factor price disequilibrium discussed in Chapter One, this meant particularly a bias against manufactured exports.

Nevertheless, decontrol and devaluation altered the economic climate somewhat in favor of exports and against industries most heavily dependent on imports. As a result there occurred some important shifts in resource allocation and income distribution. These, in turn, had a surprising effect on the division of income between saving and consumption. Finally, related to this was the occurrence of a mild inflation, especially in food prices, following devaluation.[11/]

The industry groups that were most favored by import controls, in terms both of protection from foreign competition and liberal imports of material inputs, were generally also favored by tax exemptions. Sicat has found that for these groups profits were higher than the average for manufacturing before decontrol and lower after.[12/] This reflects the fact that the higher exchange rate applied uniformly to imports of finished goods and

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11/ The immediately following paragraphs owe much to the work of Treadgold and Hooley, and also Ross. See M. Treadgold and R. Hooley, "Decontrol and the Redirection of Income Flows: A Second Look," Philippine Economic Journal, Second Semester 1967, pp. 109-128; and A.C. Ross, "Understanding the Philippine Inflation," Philippine Economic Journal, Second Semester 1966, pp. 228-259. The pioneer article on this subject, which contains valuable insights and interesting predictions from the vantage point of early 1962, is that of B. Legarda y Fernandez, "Foreign Exchange Decontrol and the Redistribution of Income Flows," Philippine Economic Journal, First Semester 1962, pp. 18-27.

12/ G.P. Sicat, "Rates of Return in the Philippine Manufacturing," IEDR Discussion Paper, 65-4, July 13, 1965.

intermediate inputs alike, while the controls system had created, in effect, a multiple exchange rate system via differential scarcity premiums corresponding to the varying degrees of restriction of imports. This effect was mitigated, however, by a multitude of tariff adjustments, mainly upward, to ease the problem of "distressed industries." In addition, the outstanding debts of these industries were re-financed on favorable terms by longterm lending institutions of the Government. Still, manufacturing profits in general declined rather sharply after 1961.

The decline in the rate of growth of manufacturing output, which we noted had already begun as early as 1957, apparently continued, although there is some belief in official circles that the recorded rate of decline is exaggerated by a failure to include adequately the growth performance of some of the newer industries. The official estimates are based partly on the Central Bank industrial production index which uses 1955 weights. Using 1966 weights, based on the Survey of Manufacturing, raises the industrial growth rate only very slightly, however. So while there may be some remaining bias from general under-reporting, it appears that industrial growth has remained at a level much below that of the 1950's. The official data put manufacturing as a lagging sector from 1962-68, with a growth rate of about 4.8 per cent compared to 5.3 per cent for net domestic product.[13/]

Despite this, gross investment rose sharply in the early 1960's, reaching 22 per cent of gross national product by 1964, in contrast to ratios ranging from 11 to 15 per cent in the 1950's. The rise was mainly in durable

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13/ Between 1962 and 1963 manufacturing output increased by more than eight per cent, but this seems to have been associated with the sudden jump in exports of sugar, coconut oil, plywood and veneer. See the discussion of export response below.

equipment, rather than construction, and the manufacturing sector apparently shared in this rise. Heavy expenditures in establishing petroleum refineries can account for much of this rise in 1961 and 1962, but thereafter the increases in investment were spread more broadly across the economy. After 1964 the growth of investment just kept pace with the growth of the national product. It should be noted that the much higher ratio of investment to national product in the 1960's was accompanied by a slower rate of growth of the latter, implying either a higher incremental capital-output ratio, or growing excess capacity, or both.

The traditional export sector gained most from the devaluation, their peso proceeds per dollar earned rising about 75 per cent, even with the temporary implicit ten per cent tax. The apparent supply response of these exports was immediate, substantial, and short-lived. The export quantity index rose 24 per cent between 1962 and 1963 while, surprisingly, prices also rose, so that the value index rose by 31 per cent. Of the value gain, 95 per cent is accounted for by the ten principal traditional exports, dominated by coconut products, logs and wood products, sugar[14/] and several metal ores and concentrates. There was another modest rise of six per cent in 1966 after the removal of the implicit tax on exports in November of 1965. By 1968, however, export quantity had declined five per cent from the 1966 level, though prices continued to rise enough to prevent a decline in value. Overall between 1962 and 1968 export quantity increased 31 per cent and value, 50 per cent.

[14/] The rise in sugar exports was due more to the strained relations between Cuba and the United States, as the Philippines gained a significant portion of the quota that Cuba lost.

The striking aspects of this export response to a devaluation are, perhaps, three in particular. First, most of the gain occurred in one year, from 1962 to 1963. This is not only striking, but suspicious. George Hicks discovered that data of the Philippines' trading partners shows ~~fer~~ far less of a rise, owing to an apparent substantial under-reporting of exports by Filipinos before devaluation was completed.[15/] Second, export prices rose substantially between 1962 and 1968, accounting for about 40 per cent of the gain in export value. Copper prices rose 80 per cent, coconut oil 41 per cent, copra 16 per cent, and sugar 17 per cent. Of the major exports only logs and lumber suffered a price decline, and that was a modest three per cent. This, incidentally, is more understandable when coupled with the downward adjustment of the export quantity increase based on Hicks' findings. Nevertheless, it appears that the Philippines was fortunate in experiencing a rapidly growing world demand for its exports following devaluation.

Finally, with one important exception, there was no great surge of new exports resulting from the substantial improvement of the exchange rate. The exception is iron ore, the export volume of which has increased about twelve-fold since 1962. It represents only about one and one-half per cent of total export value, however, in contrast to logs and lumber which account for more than 25 per cent. The ten most important exports contributed the same 86 per cent of export earnings in 1968, as in 1962.

Still, the fact that their share has been constant means that minor exports have also been growing moderately rapidly and, perhaps, at a

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15/ George L. Hicks, "Philippine Foreign Trade, 1950-1965: Basic Data and Major Characteristics," mimeographed (Washington: National Planning Association, Center for Development Planning, 1967).

faster pace than traditional exports if under-reporting was less prevalent for them. Moreover, Sicat has identified a number whose growth rates have been very high.[16] Included are fish and shrimps, cocoa butter, beer, food sauces, refined petroleum products, various chemicals, rattan furniture, and shoes. As yet these rapidly growing minor exports do not account for very much of the Philippines' foreign exchange earnings, but perhaps they indicate the potential that could be tapped with a more fundamental correction of the bias against exporting.

Domestic wholesale prices of export products rose greatly as a result of the devaluation, of course, reaching a level in 1963 double that of 1955.[17] The wholesale price index of domestic products, in contrast, rose only 38 per cent over the same period. It is interesting that the rise in domestic prices of export goods relative to their world prices began as early as 1958, about 40 per cent of the total rise to 1963 occurring by 1961. As Amado Castro has suggested, it was increasingly possible from the late 1950's to "get around the regulations" of the controls system.[18]

The relative rise in export prices had its counterpart in profits of exporters. Some indication of this can be gleaned from Table XI, which shows

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[16] G.P. Sicat, "An Inventory of Philippine Exports, 1961-1967," IEDR Discussion Paper, 69-5, February 14, 1969.

[17] The export unit value index rose only 12 per cent between 1955 and 1963.

[18] A. Castro, "Philippine Export Development, 1950-65," in T. Morgan and N. Spoelstra, eds., Economic Interdependence in Southeast Asia (Madison: University of Wisconsin Press, 1969), p. 192.

TABLE XI

PROFIT RATES IN MINING, AGRICULTURE AND MANUFACTURING CORPORATIONS
1955-1962

(Net profit, after tax, as a percentage of net worth)

	1955	1956	1957	1958	1959	1960	1961	1962
Mining	15.1	20.4	14.9	11.0	15.4	21.3	23.0	20.8
Agriculture	7.0	5.7	15.7	8.8	8.9	13.9	8.5	13.9
Manufacturing	n.a.	15.5	18.3	20.9	19.3	14.8	15.8	11.7

n.a.: not available

Source: A. Castro, "Philippine Export Development, 1950-65," in T. Morgan and N. Spoelstra, eds., Economic Interdependence in Southeast Asia (Madison: University of Wisconsin Press, 1969), p. 190.

profit rates of mining, agricultural, and manufacturing corporations between 1955 and 1962. (Unfortunately, the study on which this is based does not extend beyond 1962.) It is evident that the export-oriented sectors, mining and agriculture, had improved profits in the early 1960's, as compared to the 1950's.

While exporters gained substantially, and this means overwhelmingly the traditional exporters, it was consumers who bore the main burden of the income transfer, according to Treadgold and Hooley.[19/] This burden was in the form of higher prices, mainly for food. The consumer price index which had risen at an annual rate of only 1.3 per cent between 1949 and 1962, increased at a rate of 6.1 per cent between 1962 and 1967, while the food component of the index rose at a rate of 9.2 per cent. The latter, with a weight of about one-half, accounted for 75 per cent of the rise in the index, while cereals alone accounted for 36 per cent, with an annual average price increase of 10.9 per cent. Finally, the price of rice led the cereals index with an 11.6 per cent rate of rise.

Treadgold and Hooely attributes this inflation, dominated by cereals, to the effect of devaluation in inducing a shift of land away from food production to export crops. They present evidence of a strong (lagged) correlation between land use and relative prices, and a substantial shift from food crops to commercial crops between 1959 and 1965.[20/] It is again interesting that the shift began before devaluation, further corroborating Castro's

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[19/] Op. Cit., p. 116.

[20/] Ibid., pp. 118-119.

thesis that exporters had already begun to gain, several years before devaluation, by successfully evading the exchange control system. After 1965, however, the incentives from higher food prices were sufficient to stabilize the pattern of land use. The price of rice rose sharply in 1966, but thereafter declined slightly, owing to substantial imports in 1967 and to the first harvest from the new "miracle rice" seeds in 1968.

The index of real wage rates declined about ten per cent between 1962 and 1964 as a consequence of the inflation. An increase in the minimum wage prescribed by law brought a rise of about eight per cent over the following two years. After 1966, the index remained roughly constant until the latter half of 1969 when it declined, as inflation resumed, owing to massive spending during the presidential election campaign plus tighter restraints on imports.

It is remarkable that real wage rates have not risen (and may have declined) over the two decades since 1949. We mean here, however, real wage rates in a welfare sense. For the index is derived by deflating an index of money wage rates by the index of consumer prices. The latter, as we have noted above, is heavily influenced by food prices, which is no doubt consistent with the wage-earners' budget allocation. But the decline in real wage rates in this sense, since 1962, has not meant a correction of factor price disequilibrium-- i.e., it has not lowered the real cost of labor to manufacturing. On the contrary, while money wage rates rose 31 per cent between 1962-1968, the manufactured goods price index rose only 14 per cent. This perhaps, helps to explain the decline in manufacturing profits. Labor, moreover, is doubly disadvantaged by this inflation since real earnings in a welfare sense have declined while the penalty on employment has risen.

The inflation had its monetary side, of course. Table XII shows increases in money supply, real GNP and consumer prices in the 1960's in comparison with the period 1955-60. (Between 1950 and 1955 prices generally declined.) The reader will note, first, the absence of any significant inflation prior to devaluation. This tends to confirm our explanation given above, of the reason for abandoning controls and devaluing the peso. The problem was not monetary, but structural.[21/]

Between 1960 and 1963 however, the monetary authorities permitted a very rapid increase of the money supply, averaging more than 14 per cent per year for the three years. The economy, therefore, was very liquid during the readjustment period. And the substantial price increases that occurred in 1963 and 1964 would no doubt have been considerably less had the money supply not increased that much. Nevertheless the monetary factor cannot explain why the price rise was dominated by rice and other foodstuffs. A monetary policy designed to prevent any inflation during this period of adjustment and resource re-allocation would probably have had a very depressing effect on output and employment. We do not mean to suggest, however, that the money supply should have increased as much as it did between 1960 and 1963. On the other hand, except for these three years, the rate of increase of money supply has been only moderately in excess of the rate of growth of real GNP. Furthemore, let us suppose that the breakthrough in rice production had occurred in

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21/ This can be seen in the following way. A general deflation (or devaluation) would leave untouched the relative biases in the protection system against exports and backward linkage import substitution and in favor of import-dependent, overcrowded consumption goods industries.

TABLE XII

AVERAGE ANNUAL RATES OF INCREASE OF GNP, MONEY, AND CONSUMER PRICES, 1955-1968
(Per Cent)

	GNP (1955 prices)	Money Supply	Consumer Prices
1955-1960	6.3	7.8	2.0
1960-1961	6.5	11.4	4.5
1961-1962	6.1	10.2	3.0
1962-1963	7.4	21.3	7.9
1963-1964	2.5	0.3	8.9
1964-1965	5.5	6.5	3.1
1965-1966	6.0	7.8	5.0
1966-1967	6.2	10.5	5.9
1967-1968	6.4	7.2	0.7

Source: National Economic Council for GNP; Central Bank for money supply and consumer prices.

1962 instead of in 1968. Given the extensive excess capacity in manufacturing[22/] it is likely that the economy could have absorbed the additional liquidity with far less of a rise in the consumer price index.[23/]

The income shifts, described above, were accompanied by a sharp rise in the share of saving in national income at the expense of personal consumption. (Government consumption, in contrast, increased.) Table XIII gives the evidence on expenditure shares of gross domestic product. Saving, investment, exports and imports all had substantially greater shares in the 1960's than in the 1950's.[24/] While a full analysis of the relationship between these income and expenditure shifts on the one hand and saving on the other is beyond the scope of this study, we call attention here to several interesting implications of these data. First, contrary to expectations, the shift from manufacturing profits to profits of the "rural elite" in the traditional export sector did not result in increased consumption. Second, the period of import controls did not impose as much "austerity" -- if we

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[22/] This is based on surveys by Bautista for 1961 and the Program Implementation Agency for 1964. See R.M. Bautista, "Capital Coefficients in Philippine Manufacturing Industries: An Analysis," Philippine Economic Journal, Second Semester, 1966, pp. 210-211.

[23/] Movements of the general wholesale price index were similar to those of the consumer price index. The former is more influenced by world prices for exports, however, and is accordingly a less sensitive indicator of domestic price movements.

[24/] Regressions of consumption functions, reported by Williamson, dramatize the substantial effects of decontrol on consumption. See J.G. Williamson, "Determinants of Personal Saving in Asia: Long-Run and Short-Run Effects," Appendix on the Philippines, IEDR Discussion Paper 67-11, September 15, 1967.

TABLE XIII

GROSS DOMESTIC PRODUCT[a/] BY EXPENDITURE SHARES
Five-Year Averages, 1948-1968

	1948-1952	1953-1957	1958-1962	1963-1967	1968
Personal Consumption	81.1	81.3	78.3	72.0	73.4
Government Consumption	7.5	7.4	7.9	8.6	9.0
Gross Investment	13.8	12.4	15.6	20.3	21.7
Exports	15.4	12.3	11.4	16.0	15.2
Imports	17.8	13.3	13.1	17.0	19.4
Expenditures on GDP	100.0	100.0	100.0	100.0	100.0
Gross Saving	10.6	10.0	13.0	18.8	16.3
Net Factor Payments Abroad	.7	1.3	.9	.6	1.3

Source: National Economic Council.

[a/] In current prices.

measure this by the share of personal consumption -- as did the period after decontrol. Third, inflation, concentrated in food prices, evidently forced a lower level of consumption on low income groups. The very recent increases in rice and corn yields fron new seeds and techniques may reverse this last result, however. Finally, it appears that it may be possible in the Philippines to force saving through an increase in investment or exports, or both.[25/] Some idle resources no doubt are available to mitigate the inflationary pressures from increased expenditure. In addition, labor seems to be relatively passive in the face of cost of living increases, so that a wage-price spiral may not materialize. What really limits the ability to raise the rate of growth, however, seems not to be saving, but the scarcity of foreign exchange to which we now return once more.

4. Foreign Exchange Crisis Once More

In the second half of 1969, two decades after the foreign exchange crisis that led to the protection system, the Philippines again faced an acute shortage of foreign exchange. The immediate cause of the crisis was massive spending in the Presidential election campaign. The spending, in turn, was made possibly by an increase in the money supply of almost 17 per cent from July to October -- just prior to the November election. This was simply the spark that ignited the crisis, however. For more than a year prior to this, monetary stringency and informal import controls had been employed to defend the foreign exchange reserve. Even with these restraints, however, the trade deficit had grown to unmanageable proportions by 1968, as is evidenced in Table

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25/ We shall argue below, in Chapter Four, that it is also possible to raise voluntary saving with a more realistic interest rate policy.

VIII. Table VII shows more explicitly the sharp rise in import volume and the decline in export volume after 1966. A five per cent improvement in the terms of trade was swamped by the effect of these quantity changes.

On the import side the increases were across the board, though in 1967 rice and machinery predominated and in 1968 machinery again stood out. On the export side coconut products and sugar registered the most substantial quantity declines, though the value of sugar and coconut oil exports rose, owing to substantial price increases. The machinery imports reflect the continuing rise in gross investment in the private sector plus the Government's infrastructure program -- roads, schools and irrigation -- to bolster agriculture and the rural economy. Insofar as they have a long-run payoff in greater output their adverse effect on the current balance of payments may be discounted. This assumes, however, that the additional capacity is potentially foreign exchange saving or earning. Again, with respect to exports, there is some evidence to suggest that the reported decline for copra, especially, is either temporary, owing to unfortunate weather, or the result of understating shipments to avoid the penalty of the official exchange rate (as occurred in the later 1950's and early 1960's). Taking these together with the effects of the quadrennial spending binge of the Government suggests that the situation is probably not nearly so bad for the long-run as it seems at the moment of crisis (January 1970).

Nevertheless, there is evidence suggesting that the balance of payments problem of the Philippines is deeper and more persistent than a focus on these short-run influences would suggest. We can, perhaps, trace the beginnings of the problem to the decision to defend in the 1950's the pre-war

parity of the Peso in the face a price level far out of line as a result of the wartime inflation. A deflationary policy plus import controls were the weapons. In the second half of the 1950's the scarcity premium had to be raised steadily by ever tightening controls. Despite a favorable trend in prices the rise in export volume slackened. When there was no leeway remaining for further tightening, controls were abandoned and the peso was devalued. Surprisingly the ratio of wholesale prices of imported good to import unit values (column 3, Table VI) reached an even higher level when the new exchange rate permitted a rebuilding of the foreign exchange reserve for a few years. Since 1962, however, the above-mentioned ratio (which we labelled the "scarcity premium" under controls) has stabilized and exports received their final boost from the removal of the ten per cent penalty at the end of 1965. With no further measures to discourage imports or encourage exports, the balance of trade has deteriorated sharply. All of this is consistent, at least, with the hypothesis of a continuing underlying tendency toward deterioration of the trade balance that required increasingly stronger measures to offset it.

It could be argued, of course, that the reason for the deterioration of the trade balance since 1966 is the erosion via inflation of the prior devaluation. We can test this by looking at what has happened to the "real" exchange rate since 1962. A devaluation is supposed to raise the prices of internationally traded goods relatively to those not internationally traded. To the extent that this gap subsequently narrows proportionately, the devaluation is eroded. This could happen, of course, either because non-traded goods prices rise or traded goods prices fall. The real exchange rate is, then, the nominal rate multiplied by the ratio of an index of traded goods

prices to one of non-traded goods prices. For the former we use the index of unit values of exports for the real export exchange rate, and the index of unit values of imports for the corresponding real import exchange rate. For non-traded goods prices, we use the index of wholesale prices of locally produced goods for domestic consumption (published by the Central Bank).

The extent of erosion was very similar for the two real rates. Setting the real rate equal to the nominal rate of ₱3.90 per dollar for each in 1962, the real export rate in 1968 was ₱3.32, while the import rate was ₱3.27. Thus about two-thirds of the devaluation remained for imports and almost 70 per cent for exports. Nevertheless, the extent of the erosion is significant and must serve as a partial explanation of the balance of payments problem.

With the promise of a breakthrough in agricultural productivity, however, the danger of continuing inflation in the Philippine economy appears considerably lessened. The twin failures to move ahead rapidly in the directions of new exports and backward linkage import substitution remain, in our opinion, as the fundamental weakness underlying both the balance of trade deterioration and relative stagnation in manufacturing growth.

Before leaving the balance of payments problem, we should comment briefly on the capital account. A country with a per capita income of less than $200 at an early stage of industrial development might be expected to have a continuing substantial trade deficit offset by a long-term capital inflow. This has not been true of the Philippines, however. Even in the 1950's long-term capital inflow was only about nine per cent of imports and one per cent of GNP. Moreover, the short-term capital account was generally negative, as

Table VIII indicates. In the 1960's the capital account has deteriorated sharply and the Philippines has been a net capital exporter during most of the decade. Favorable offsetting influences, however, have been U.S. Government military expenditures and various transfer payments (including a significant volume of remittances from Filipinos working abroad), though both of these have fallen steadily as a proportion of imports or GNP.

A recent study by Bantegui[26/] of a large sample of American investments in the Philippines throws some light on the deterioration of the capital account from the 1950's to the 1960's. He argues that American capital was attracted by the controls system to invest in the 1950's in the production of goods they could no longer export to the Philippine market. So investments in import substitute consumption goods industries tended to predominate. But after an initial burst of investment to by-pass the import controls, the pace of investment slowed. And, correspondingly, the portion of profits remitted as dividends rose.

The reason for this, we suggest, is that after substituting production in the Philippines for what was formerly exported from America, there were no further avenues for rapid expansion. Investment was then required only for the pedestrian growth of local market demand. The natural routes of backward integration and breaking into the export market were unprofitable because the pattern of incentives under the protection system was set against them. This helps to explain also why profits from Philippine enterprises, as well as foreign, tend sometimes to look abroad for investment.

26/ B.G. Bantegui, "Aspects of U.S. Investments in the Philippines, 1956-1965," National Economic Council (unpublished).

5. Structural Change and Productivity

The kinds of structural change that accompany industrialization were very evident in the 1950's. Equally evident is the lack of a continuation of structural change in the 1960's. We have seen above, in Table IX, the sharp changes in the composition of imports, with the shares of capital goods and material inputs rising at the expense of consumer goods. By the end of the 1950's the pattern had become relatively frozen, however, as the 1960's saw little further change. The same is true with respect to the industrial distribution of the national product, as Table XIV illustrates. The sharp rise in the share of manufacturing at the expense of agriculture that characterized the 1950's has been absent in the 1960's. This appears to be further evidence of the failure to sustain the pace of industrialization beyond the first stage of import substitution.

The shares of the employed labor force in manufacturing and agriculture have remained virtually unchanged since the first Philippine Statistical Survey of Households was undertaken in 1956, with manufacturing accounting for eleven or twelve per cent and agriculture for between 57 and 60 per cent. The employment index of the Bureau of Census and Statistics shows a more rapid rise of manufacturing employment before 1956, however, so that the proportion of employment in manufacturing undoubtedly rose in the first half of the decade. Nevertheless, for the entire period, 1952-68, this index shows a disappointing annual average rate of growth of only 2.7 per cent, about the same as for total employment and far under the rate of growth of value added in manufacturing, which was more than seven per cent. While it is believed that this index tends to understate manufacturing employment gains in recent years, only a slight upward adjustment would be required for it to confirm the constancy of manufacturing's share since

TABLE XIV

INDUSTRIAL DISTRIBUTION OF NET DOMESTIC PRODUCT
At 1955 Prices
(in per cent)

	1950	1960	1968
Agriculture	36.4	31.4	31.3
Manufacturing	13.2	17.9	17.3
Services	23.8	25.8	26.5

Sources: OSCAS, National Economic Council.

1956 that is shown by the data from the household surveys.

The data from the annual manufacturing surveys show a much faster rise in manufacturing employment, ~~since 1957~~, averaging about six per cent per annum since 1957. This is the "organized" manufacturing sector, however, comprised of establishments with five or more workers. It represented in 1961 less than four per cent of total employment. So, while the growth of overall manufacturing employment was not great enough to contribute to growth by reducing the proportion of employment in agriculture, there was a shift within manufacturing itself, from unorganized to organized, which no doubt had a favorable effect on growth.

Still, the growth of manufacturing employment has been disappointing. A part of the explanation is a rapid rate of substitution of capital for labor. Williamson and Sicat have found evidence of this for the period 1957-1965,[27] but it appears to have been just as true of the earlier post-war period. This tendency toward increasing capital intensity, together with the decline of the growth rate of manufacturing output, explains why the sector's share in employment has not risen for more than a decade.

The failure to shift labor relatively from agriculture to manufacturing was accompanied by a tendency toward mal-allocation of resources within manufacturing itself, which further contributed to slow growth. Williamson and Sicat found that between 1957 and 1962 the average improvement in total factor productivity in manufacturing sectors considered separately was about 2.8 per

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[27] J.G. Williamson and G.P. Sicat, "Technical Change and Resource Allocation in Philippine Manufacturing: 1957-1965," IEDR Discussion Paper No. 68-21, p. 52.

cent, while for the manufacturing sector considered as a whole was less than 1.8 per cent.[28/] The difference results from re-allocations of resources within manufacturing, which apparently reduced overall growth by more than one percentage point.

A very important corollary finding was that, considered independently, shifts of capital within manufacturing tended to reduce productivity while shifts of labor tended to improve it. In general, of course, capital and labor move together in relative resource allocations. But where the more rapidly advancing industries are relatively labor-intensive it will appear that labor is on balance moving toward them, while capital will be moving toward those rapidly advancing sectors that are relatively capital-intensive. Thus it follows from their findings that shifts of resources toward industries of higher capital intensity were adverse, while shifts toward industries of higher labor intensity were favorable to overall productivity increase. And the former type of shift predominated over the latter. This is a very important conclusion in the light of the many biases present in Philippine economic policies toward the use of capital in substitution for labor.

Williamson and Sicat tested this relationship also for the period 1960-1965, in order to see if decontrol and devaluation had any effect on this tendency to mal-allocate resources. They found that the tendency still was present, but in less degree, though all of the improvement seemed to have occurred between 1960 and 1962. The deterioration after 1962, they suggested,

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[28/] *Ibid.*, p. 43.

might have been due in part to the higher minimum wage law which went into effect in 1964. In any case, we have noted already that the highly protective tariff law, which replaced controls, had the same sorts of biases including the bias in favor of capital intensity, stemming from much lower duties on capital goods.

Williamson has also followed up the pioneer study (mentioned in Chapter One) by Lampman of sources of growth.[29] He applied a Cobb-Douglas production function to aggregate growth data for the Philippine economy over the period 1947-65. He added, however, an element for quality of the labor force, measured by educational attainment (in years) and earnings differentials associated with alternative levels of attainment. His production function is written.

$$Q = A^{*} K^{a} (Lq)^{b} N^{(1-a-b)}$$

$Q = AK^{a} L^{1-a}$ ← Cobb Douglas prdn fn.

where Q is total output, K is capital, L is labor, q is quality of labor and N is land. The results are shown in Table XV.[30] First, we note that education, as measured in the manner described above, made a significant contribution to growth, explaining about 11 per cent of the total output increase over the entire period. The unexplained residual, $\Delta A^{*}/A^{*}$, remains high, however, especially in the early post-war years. It seems difficult to avoid the judgment that the very high residual in 1947-1950 can be attributed to the reconstruction and rehabilitation which characterized these years. Some

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[29] J.G. Williamson, "Dimensions of Postwar Philippine Economic Progress," Quarterly Journal of Economics, February 1969, pp. 93-109.

[30] He made calculations with alternative sets of growth elasticities, a and b, but the results were not significantly different. The results reproduced here correspond to a=.30 and b=.55.

TABLE XV

CONTRIBUTIONS TO GROWTH OF NATIONAL PRODUCT, 1947-1965
(In Per Cent)

Years	$a\frac{\Delta K}{K}$	$b\frac{\Delta L}{L}$	$(1-a-b)\frac{\Delta N}{N}$	$b\frac{\Delta q}{q}$	$\frac{\Delta Q}{Q}$	$\frac{\Delta A^*}{A^*}$
1947-50	.88	1.93	.30	.55	8.63	4.97
1950-53	.72	1.93	.30	.55	6.50	3.00
1953-56	1.52	1.93	.30	.55	7.20	2.90
1956-59	1.05	1.87	.95	.77	4.33	-.31
1959-62	1.95	2.22	.01	.70	3.33	-1.54
1962-65	2.07	1.65	.11	.66	4.40	-.09

$a = .30$; $b = .55$

Source: J.G. Williamson, "Dimensions of Postwar Philippine Economic Progress," Quarterly Journal of Economics, February 1969, p. 104.

of that may have remained also in the next two three-year sub-periods, but an alternative plausible explanation exists for the moderately high residual during 1950-1956. This was the period of easy gains in import substitution when there were no immediate limits on expansion, either from market demand or from the supply of imported materials and equipment. The reader will recall that this was a period of a general easing of import controls following the severe restrictions of 1950 (see Table VII). The rapid growth of national product, led by manufacturing, may have been accompanied by a fuller use of resources generally. After 1956 growth in the economy slowed as import restrictions tightened and market demand limitations were approached in some areas. In fact, this combination led to the emergence of excess capacity in many manufacturing industries, if we can judge the late 1950's by what Bautista found in his 1961 survey.[31/] This, in turn, may help to explain the negative value for the residual after 1956. Another part of the explanation, however, is the failure after 1956 of the manufacturing sector to grow rapidly enough to increase its share of output and especially employment vis a vis agriculture, together with the perverse shifts of resources within manufacturing. The lesson is that the allocation of resources matters a great deal in a growth context where investment can be mis-directed year after year.

The residual rose significantly, but remained slightly negative, after 1962. Williamson attributes the improvement to the favorable effects of decontrol on resource allocation. It is also possible that decontrol per-

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31/R.M. Bautista, Op. Cit.

mitted a fuller utilization of resources -- i.e., that excess capacity diminished. Finally, he notes that the residual has remained negative and speculates that the tariff structure might be at fault, since it seems to be designed to create distortions similar to those of the controls system.[32]

The conclusion we reach after this survey of structural change and factor productivity over the past nearly two decades is that there appears to be a very strong link between these two aspects of economic development. In particular, it seems that over the most recent decade, the failure of manufacturing employment to grow relatively to that in agriculture, plus the related perverse structural change within manufacturing toward relatively capital-intensive industries, helps to explain the poor growth performance. And the poor growth performance can be attributed largely to a reduction in efficiency in the use of inputs. For the reader will recall that investment as a proportion of national product was much higher in the second half than in the first half of the postwar period. We have, in other words, at le a part of the explanation for the sharp rise in the incremental capi put ratio.

Finally, it is our hypothesis that this decline in e the related failure of industrialization to sustain its e is not a natural, or in any sense inevitable, phenome stems from mistaken policies. These policies are analyzed in Chapters Four and Five. In order t chapters, however, we turn in Chapter Three social framework within which policies ar

roup cial trans- were es, were inter- had become

[32] J.G. Williamson, op. cit., p. 108.

CHAPTER THREE

POLITICAL, SOCIAL AND INSTITUTIONAL FRAMEWORK

An understanding of some aspects of the broader framework of Philippine society should be helpful in providing insights into the functioning of the economy. In this chapter, therefore, we outline a few salient facets of the political, social and institutional framework.

Distribution of Wealth and Power: Historical Capsule

To understand the distribution of wealth and power in the Philippines, a bit of economic history is useful. During the Spanish occupation of the Philippines, which lasted for over four centuries -- from 1565 to 1898, there emerged well-defined economic and social classes who owned and directed a sizable portion of economic wealth and social power.

A landlord class evolved as a result of land settlement policy at the beginning of Spanish rule. The process of land consolidation came from several sources. The Catholic Church succeeded in consolidating lands from bequests of Spanish settlers whose original property rights came from royal decrees, as well as from lands granted to the religious orders by the Spanish crown. A class of government servants, many of whom intermarried with Filipinos, were awarded land for services rendered to the civil government of Spain. A group of Filipinos, largely from the royal houses upon which early forms of social and political organization had been based, have through the centuries transformed themselves into major landowners. A final class of landowners were the Chinese, who through their money-lending and commercial activities, were able to amass wealth and acquire land. This group eventually also intermarried with Filipinos. These form the elite group whose members had become

wielders of economic power at the end of the Spanish rule, when the economy was based largely on agriculture and to a lesser extent on commerce. The last three classes of persons formed the core of the Philippine intelligentsia who were responsible for the growth of Philippine nationalism in the last century of Spanish rule and from whom many Filipino heroes originated.

With the growth of foreign trade, especially after the opening of the Suez Canal in the late 1850's, the merchant and landowning classes became more powerful. 1/ Also during these years, the sugar industry in Negros and Panay Islands had its beginnings. Following the transfer of political control from Spain to the United States and the subsequent more rapid expansion of exports, especially after 1909 when free trade between the U.S. and the Philippines ensued, sugar and coconut products began to dominate the economic picture. This provided the background for the rise of a powerful and cohesive sugar interest group, a development that was facilitated by the fact that sugar was based on large-scale plantation agriculture. Because coconut agriculture was largely dominated by small-sized owner-operated farms, coconut interests were never as effectively organized as sugar, but they have received substantial support from the sugar bloc because of their larger community of interest which was access to the huge American market. The preeminence of the sugar and other primary exporting interests

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1/ The galleon trade of the 17th and 18th century was also a contributing factor towards the growth of the merchant class. For some account of the galleon trade and other social and historical forces which led to the emergence of social classes, see O.D. Corpuz, "Notes on Philippine Economic History," in G.P. Sicat and others, Economics and Development (University of the Philippines Press, 1965), chapter 2.

in Philippine politics was to be counterbalanced by the growth of industrial interests in the postwar period, but the former still represent a very strong force in guiding economic policy, particularly in the determination of trade relations with the U.S.

Another effect of American rule was the reduction of church land holdings through the purchase by the government of friar lands. While the power of the church was not reduced, because of its ability to accumulate wealth in banking, finance and industry, in addition to its investments in education, it removed (or reduced) the obvious symbol of temporal wealth, which was one of the most sensitive issues that led to the rise of Philippine nationalism.

A new industrial class heavily dependent on a protectionist policy emerged as a result of government promotion of industrialization in the 1950's. During this decade, the clash between the "new" protectionist interests, shielded under a system of controls, and the traditional export class led by the powerful sugar bloc became vitriolic. This did not mean that there was complete opposition between these interests. The more enterprising members of the moneyed class, including sugar-associated interests, had moved into industry as a result of the more attractive policies favoring that sector. The flexibility of this class enabled its members to reap rewards on both sides of the stream, and this helped to provide finance and entrepreneurship for the development of the 1950's.

Although evidently representing traditional economic interests, the primary export sector has proved to be a liberalizing influence in the controversy over exchange rate policy. As it turned out, however, probably because they represented older vested interests in contrast with those of the new industries that were being promoted, their influence was not adequate to push the government toward more realistic exchange rates in the 1950's. The export interests were able, however, to gain a concession in the form of a "barter scheme", essentially a form of export bonus which enabled them to get a minor increase in the effective exchange rate they received for their exports. As we shall show in the next chapter, this did not create a substantial incentive to change the structure of domestic industries.

Hindsight suggests that the basic weakness of the "liberalizing" influence of the export bloc stemmed from the inability to appeal to the new industries for a common interest in the promotion of exports, both primary and industrial. By the end of the 1950's the dependence of the manufacturing sector on the foreign exchange earnings of primary exports was clear, as was the need to begin to export manufactures. But an appreciation of this at the beginning of the 1950's required an uncommon degree of economic sophistication and foresight. Moreover, once protection with its concommitant of an overvalued currency was adopted, the appeal for a common interest in exporting had little chance. For among the new industries that emerged were some that were obviously comparatively disadvantageous. Finally, even among

those in which a comparative advantage exists there is little interest today in the export market because of the apparent inability to compete at world prices. That this inability is due simply to the wrong exchange rate is rarely appreciated. Currency overvaluation by making foreign prices artificially low, seems to create an insidious psychological complex of economic inferiority. Consequently, even among knowledgeable Filipinos, "exports" can only mean sugar, coconut products and logs, not manufactures. The latter can qualify only as import substitutes, heavily dependent on protection. This attitude, fostered by overvaluation of the Peso, underlies the persistence of the split between the "export bloc" and the industrial sector on questions of economic policy.

At the apex of traditional social and economic classes are the great landlords. As a result of their social awakening in reaction to peasant unrest, there has developed through the years a gradualistic approach to land tenancy reform. ~~This culminated in the passage of land tenancy reform.~~ This culminated in the passage of the Land Reform Code of 1964. This code should signal the weakening of the position of the landed class, especially as more land comes under the jurisdiction of the land reform program. However, the slow pace of implementation of land reform is an index of the unwieldy structure of constitutional provisions on "just compensation" as much as it is the result of landowner pressures against the implementation of land reform. The recent declaration of large rural areas as "land reform areas" (as provided for in the land reform law) are, however, signals for the future. If

continued this will lead to greater diversity among economic power groups that determine national economic and social policies.

Income Distribution

Given the pattern of distribution of power and wealth, one would expect income also to be very unequally distributed. This appears to be the case, although one is never sure what standard to use in judging this. There is generally greater inequality in income distribution in less developed countries than in the more advanced, but data of a character to enable broad comparisons among poorer countries are lacking. For what it is worth, however, the data in Table XVI permits comparison of Philippine distribution by ordinal groups of income units with that of a number of underdeveloped, as well as developed countries. Inequality in income distribution appears to be greater in the Philippines than in any of the others except Mexico (though Ceylon seems to be very close to the Philippines). The sample of less developed countries is very small, however, and questions of comparability remain. 1a/

In any case it appears that the top five per cent of income earners among Philippine families receive more than the bottom 60 per cent. However this might compare with other countries, a growing awareness in the Philippines of this degree of income inequality has evoked a great amount of concern

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1a/ The apparently more egalitarian distribution in India has been sharply challenged. See the discussion by various writers in the American Economic Review, December 1965, pp. 1173-88.

on the part of journalists and social critics; and it has also produced considerable political agitation for various "welfare state" measures like minimum wage legislation, profit-sharing schemes and social security systems. The opposition Liberal Party has broadly endorsed the welfare state as an immediate political goal.

What is considered an extreme degree of inequality in income distribution is usually attributed to the pattern of land ownership, the dominant economic position of a few families, and the regressive character of the indirect tax system. No doubt these, especially the first two, are important. On the other hand, so long as labor is very abundant in relation to capital and land, labor services are bound to be cheap in comparison with what the owners of property can command. Land reform can help, but probably only in the very long run -- and then only when the proportion of labor in agriculture is much smaller. Legally raising the minimum wage in industry may help a small minority of the labor force, but will widen the disparity between the few fortunate enough to have well-paying jobs and the many who do not. Forthermore, by imposing a penalty on employment, it retards the rate at which the really poor -- the unemployed and underemployed -- can be enabled to participate in the benefits of economic growth.

The real cause of income inequality is, of course, underdevelopment. There is considerable evidence to support the view that one of the fruits of economic progress is a wider and more equitable sharing in the national

TABLE XVI

PERCENTAGE SHARES OF ORDINAL GROUPS OF INCOME UNITS

Countries and Year	Shares of Ordinal Groups				
	Bottom 20%	Bottom 60%	Top 20%	Top 10%	Top 5%
Underdeveloped Countries bottom 60% ≈ top 5%					
India, 1953-54 to 1956-57	8.0	36.0	42.0	28.0	20.0
Ceylon, 1952-53	5.1	27.7	53.9	40.6	31.0
Mexico, 1957	4.4	21.2	61.4	46.7	37.0
Barbados, 1951-52	3.6	27.1	51.6	34.2	22.3
Puerto Rico, 1953	5.6	30.3	50.8	32.9	23.4
Developed Countries bottom 60% < top 10%					
United Kingdom, 1951-52	5.4	33.3	44.5	30.2	20.9
West Germany	4.0	29.0	48.0	34.0	23.6
The Netherlands, 1950	4.2	29.5	49.0	35.0	24.6
Denmark, 1952	3.4	29.5	47.0	30.7	20.1
Sweden, 1948	3.2	29.1	46.6	30.3	20.1
United States, 1950	4.8	32.0	45.7	30.3	20.4
Italy, 1948	6.1	31.2	48.5	34.1	24.1
Japan, 1959	8.0	34.0	47.0	33.5	
Philippines bottom 60% < top 5%					
1956-7	4.5	25.0	55.0	39.4	27.7
1961	4.2	24.2	56.4	41.0	29.0
1965	3.5	24.3	55.4	40.0	28.7
1960 (JLETC)					
Before Taxes	4.2	24.2[a]	56.0[a]	42.2	
After Taxes	4.6	24.6[a]	55.3[a]	40.3	

Sources: P.D. Ohja and V.V. Bhatt, op. cit. The sources are cited in this paper. For Japan, T. Ishizaki, "The Income Distribution in Japan, The Developing Economies, June 1967.

For the Philippines, Bureau of the Census and Statistics, "Family Income Distribution and Expenditure Patterns in the Philippines, 1965, "Journal of Philippine Statistics, vol. 19 no. 2 (April-June 1968).

Joint Legislative-Executive Tax Commission, A Study of Tax Burden by Income Class in the Philippines (Manila, Philippines, 1964), pp. 65-6.

[a]Read off a Lorenz curve.

income.[1b] Kuznets has suggested, however, that in the course of economic development income inequality may at first increase before it later diminishes.[1c] One reason is the shift of the population from rural to urban life, the latter being characterized by greater inequality. As the weight of the urban population grows relatively, inequality in the total income distribution would tend to rise for that reason. On the other hand, if average income is much higher among urban families, the movement of average rural families to average urban living ("average" here referring to average income) would tend to reduce inequality. This apparent paradox is resolved if we assume that in the early stages of development labor is redundant everywhere, so that many of those migrating to urban areas remain unemployed or poorly employed; and that much later labor becomes relatively scarce, so that those attracted to the cities find well-paying jobs. Morever, as Kuznets suggests, the relative labor scarcity tends to reduce inequality in the urban sector itself.

The pattern of income distribution in rural and urban Philippines is shown in Table XVII. The data conform to Kuznets' hypothesis. Inequality appears to be significantly greater among urban families. Morever, inequality seems to be greater also in Metropolitan Manila than in other urban

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1b/ S. Kuznets, Modern Economic Growth, Op. Cit., Ch. 4. ✓

1c/ S. Kuznets, "Economic Growth and Income Inequality, "American Economic Review, March 1955, pp. 1-28.

areas, though the difference is not great. On the other hand average income in urban areas is two and one-half times that of rural areas; and in Metropolitan Manila it is almost four times the rural average. This suggests that the trend in income inequality will depend significantly on the ability of urban industries to provide rapidly expanding employment for surplus rural labor. As we have seen in Chapter Two, postwar experience has been disappointing in this respect. The failure of industrialization to maintain its rapid early pace plus the excessive capital intensity of urban investment are jointly responsible for this. The host of ill-advised policies which contributed to this lack of success are set forth and critically evaluated in the next two chapters. Here it is sufficient to point out that income inequality did increase between 1956 and 1965, and to suggest that one reason is that given above.

There are two other influences on income distribution in the postwar period that are worth mentioning. One is the emphasis on industrialization in the 1950's to the neglect of policies to increase productivity in agriculture. This, taken together with the deterioration of agriculture's domestic terms of trade which resulted from protection of manufacturing, doubtless increased income inequality. Decontrol and devaluation in the early 1960's partly reversed this, however, and the substantial improvements in agricultural yields since 1967, especially in rice, have further benefitted income in agriculture.

TABLE XVII

PERCENTAGE SHARE OF ORDINAL GROUPS OF INCOME UNITS

PHILIPPINES, URBAN AND RURAL

	Rural	Urban	Metropolitan Manila	Other Urban
Highest 10 percent	30	41	42	38
" 20 "	47	57	59	55
" 30 "	60	68	69	65
" 40 "	70	76	76	74
" 50 "	79	83	83	81
" 60 "	86	88	88	88
" 70 "	91	93	92	93
" 80 "	95	96	96	96
" 90 "	98	99	99	99

Source: Bureau of the Census and Statistics, "Family Income Distribution and Expenditure Patterns in the Philippines, 1965, "Journal of Philippine Statistics, April-June 1968.

Finally, however, the dependence of the new industries on imported inputs meant that the rural economy did not participate as fully in the growth of income as it might have if industrialization were linked to a domestic raw materials base. Moreover, import-dependence has led to the concentration of manufacturing around Manila, the principal port, again accentuating urban-rural income differences.

Politcal System: The Constitutional Framework

The Constitution of the Philippines provides for a republican form of government, with separation of powers among the three major branches of government -- the Presidency, Congress, and the Courts. It is patterned, with some modifications, on the constitutional framework of the United States.

The Presidency, however, is vested with more highly centralized powers than the American President or the corresponding state governors in the United States. Local governments have only minor tax powers, largely in the form of real estate, sales, and amusement taxes. The tax (and consequently the expenditure) powers of the national government are, therefore, overwhelmingly predominant.

This to a large extent explains the highly centralized organization of decision-making machinery. New organs of government which are created by law and whose direct functions are not defined to fall under any of the government ministries (and there have been a proliferation of these) automatically fall under the office of the President. This is one reason why

the Executive Secretary, who is really a cabinet member in charge of matters pertaining to the President's office, is probably second in power only to the President. It is by no means a demeaning term, therefore, when he is referred to in the popular news media as the "Little President."

This pattern of distribution of political power has made the Presidency a most important source of political patronage. Local as well as Congressional leaders look to the President for political and budgetary patronage. Public works projects depend heavily on his allocation decisions transmitted through the Budget Commission. Despite recent efforts toward decentralization, which took the form of granting income tax rebates to provinces based on collections in 1959, decisions about the release of public works funds have fallen largely on presidential shoulders, sometimes to the disadvantage of local political leaders. The present Mayor of Manila (a member of the opposition party), for example, is almost continually in conflict with the National Government over the release of funds "owed" to the city government.

Moreover the powers of the President have been growing largely due to congressional default.. Congress has tended to enact bills appropriating public money without defining specific funds sources. Laws appropriating money "subject to the availability of funds," when appropriations are often about double availability, have given wide discretion to the President in his management of the budget.

Beyond the fiscal operations of the government, the President has additional broad powers over economic policies. He is able to adjust tariff

rates within a wide range under authorization of Congress. He is able to influence through his personal leadership the decisions of the Central Bank and of the large government financial institutions. In fact, because the Monetary Board, which decides Central Bank policy, is filled with representatives of governmental institutions (the Secretary of Finance and the heads of the Development Bank of the Philippines and the Philippine National Bank), presidential influence on monetary policy is probably decisive. Given the highly personalized structure of Philippine policies, it has been argued by some observers that the Presidency has been inclined to reward its business supporters significantly more than those who have supported the opposition. The main instrument in differentiating favor is access to the credit facilities of large government financial institutions. 3/

Congress is bicameral with a House of Representatives elected by regional representation for a fixed term of four years, simultaneously with the President's term, and a Senate elected nationally with a staggered change of one-third of its membership every two years. The law-making chambers are, in principle, independent of the President. And Congress

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3/ Armand Fabella, Introduction to Economic Policy (Manila, Philippine Executive Academy, 1969).

has shown its independence by being hard on recommendations of the President, especially on tax matters and recently on foreign investments incentives legislation. On many occasions tax recommendations have been shelved or vitiated in the maze of congressional give and take. A foreign investment incentives law was finally passed by Congress in 1967 after many years of discussion since independence. The President had urged the encouragement of foreign investment to meet the financial requirements of his Four Year Economic Program. Yet the resulting law, the Investment Incentives Act, has been much more restrictive to foreign investments than was orginally proposed. 4/

On the other hand, as already mentioned, Congress has let slip one of its major functions as the originator of all laws requiring the use of public funds. By legislating more appropriations than could be met by the financial resources of the Government, it gave the Presidency wide discretion to choose its own priorities in fund releases. It also made particular members of Congress subject to the patronage of the President in pushing through their favorite projects.

The courts have been asserting their power and independence in the interpretation of laws and constitutional provisions of special economic significance. A few very important examples concern nationalistic legislation on retail trade and constitutional provisions concerning limitations

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4/ See discussion below, Chapter 4.