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by

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by Gerardo P. Sicat*

Since 1967, the Philippines has become subjected to heavy balance of payments deficits, which show no signs of abating despite the monetary restrictions undertaken by the Central Bank. The clues to the true exchange rate at the moment may be found in the foreign exchange markets of Hongkong and other foreign exchange trading centers and in the cross-rates of exchange between stock market prices of Philippine securities jointly traded in the Philippines and the American stock exchanges (Atlas Consolidated, Marinduque Mining, Benguet Consolidated, etc.). In recent periods, this has reached levels above 5 pesos per US dollar.

It is desirable to outline the various alternatives which are available to the nation now that the 1969 presidential elections are over. This will guide our leaders on the various possibilities from which they will opt the most appropriate foreign exchange rate policy of the immediate future. It is not claimed that the ones listed below are the only possible alternatives. The major variants which deserve close attention are however listed.

I. STATUS QUO: FIXED EXCHANGE RATE AT OFFICIAL ₱3.90 TO 1 US DOLLAR.

This policy cannot succeed unless accompanied by import restrictions, quotas, and exchange controls, now that the "equilibrium" market rate for the peso is well below this rate.

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*Professor of Economics, University of the Philippines; November 12, 1969. This paper was written largely while the author was visiting Australia and Indonesia in October, 1969.

The best hope of maintaining this policy successfully is through a vigorous export incentives policy either through differential tax incentives policies or interest rate incentives in favor of export industries. The last solution requires (1) the raising of the general level of interest rates than is now currently available and (2) lowering or retaining low interest rates to export industries through the use of monetary and long-term finance policy instruments.

It is however difficult to maintain a "disequilibrium" exchange rate without creating for greater distortions in the price of foreign exchange. Export incentives cannot hope to yield substantial export gains in traditional and, especially, in new exports, instantaneously. At best, their effects can be felt only substantially at least one year after the policy is opted for. Thus, "stabilization" or short-run loans, in addition to exchange controls will be needed to shore up the balance of payments position.

This solution is essentially the "Taiwan-model". There is an important exception though. When Taiwan relaxed foreign exchange controls, it adopted "an equilibrium" exchange rate (through exchange depreciation policies during the late 50's and early 60's). Moreover, such a policy was accompanied by other complementary policies -- high interest rates and low wage policies, as well as vigorous promotion of industrial development. At the moment, many of these ingredients are missing in current Philippine economic policy.

II. DUAL EXCHANGE RATES -- ONE AT 3.90 PESOS TO 1 DOLLAR; A HIGHER EXPORT RATE.

This solution requires, again, exchange controls.

Variants

(1) Exchange rate bonus to "all" exporters.

The rate can be in the range of 10 to 20 per cent bonus to exporters. This policy is the symmetric reverse of the 20 per cent export retention scheme of 1961-5.

(2) Exchange rate bonus to "new" exporters.

The need to discriminate as between different types of export commodities, even when the definition of "new exports" is confined to a historically obtained export volume, is bound to make this measure relatively unpalatable to exporters of traditional products. (See my paper, reference {2} for more detailed discussion.)

(3) Export bonus scheme à la Pakistan.

Bonus certificates are given to a percentage of the proceeds of all "new" export earners. (The Pakistan scheme applies only to certain types of exports, most of which are industrial.) These bonus certificates can be auctioned at the "free market" rate for foreign exchange, or exporters can use them to purchase imports. The other portion of export earnings are exchanged by the Central Bank at the official rate of foreign exchange. The bonus scheme can have a variation by allowing only "new exporters". (This solution incidentally is akin to the unfortunately short lived "barter" or export incentives scheme in the 1950's in the Philippines.)

The "bonus" auction scheme of Pakistan has the advantage of being self-financed, in contrast to the exchange rate bonus schemes suggested above. There is no need to "create" new money or look for a financing scheme which will divert tax money to exporters, as it is done in Israel.

The "auction" method can be helpful only if the "bonus" market rate is substantially greater than the official exchange rate, as found in Pakistan. Thus, exporters get a substantially better exchange rate on their earnings so long as the auction principle is followed under a fixed exchanged rate system, the "bonus" rate will be made to float, and the "bonus" rate exceeds the fixed exchange rate.

One undesirable variant of this policy is exemplified by the example of Indonesia, which fails to meet the above conditions. They have a fixed bonus exchange rate for exporters (no "auction" principle in trading bonus certificates), but the market exchange rate is allowed to float. At present (November 1969), the exchange rate [redacted] is 377-383 rupiahs per US dollar, the export "bonus" rate is 325, and there is a fixed exchange rate for exporters which is much less. Here, the market rate for foreign exchange, which also happens to be the "official" exchange rate adopted by the central bank exceeds the export bonus rate.

(4) Foreign exchange tax.

The foreign exchange tax suggested recently in many quarters (including Congress) is intended to correct the large outflows of all forms of foreign exchange payments (visibles and invisibles). The proposal, which is reminiscent of the exchange tax of the 1950's, will en-

able the government to earn new tax revenues at the same time that it makes the price of imports and of foreign exchange more expensive.

I believe that this policy (and the inferior substitutes that replaced it after the Laurel-Langley Agreement mandatorily required its abolition) is one of the principal errors of Philippine industrial policy in the past. Because of its attractive features which temporarily staved off import demand and earned revenues for the government, it influenced the adoption of a consistently pursued balance of payments policy which concentrated largely on controlling foreign exchange (and import) payments. Thus, leaders as well as their advisers failed to appreciate the enormous advantages of having a correct exchange rate policy and of having market prices for Philippine economic resources (labor, capital, domestic natural resources) guide entrepreneurs in choosing industries which had enormous export earnings potentials. The principal offshoot of this policy was the attraction of new industries which were not only import replacing but import dependent as well -- i.e., the industrialization policy encouraged "import dependent import substitution".

(5) Foreign exchange tax, with export bonus.

This variant may appear as an attractive substitute. The export bonus may be in the form of (a) the exchange rate bonus suggested above or (b) the bonus certificate auction system of the Pakistan model. If the first variant (exchange rate bonus) is opted for, the question of financing the bonus arises. The financing choices are: (1) create new money by Central Bank fiat or (2) use the foreign exchange tax proceeds

to pay exporters. The first is certainly more inflationary than the second. And the second financing scheme is certainly more costly (unnecessary administrative organization to police the controls) than devaluation, while it has many of the features of an actual devaluation.

III. DEVALUATION TO EQUILIBRIUM RATE

This is a major exchange rate correction, which applies across-the-board, without need for explicitly stringent controls. Its attractiveness, among other things, is that it is handled without the need for diverting scarce managerial and administrative resources on the part of the government to administer exchange controls and its effects are automatic, unlike bonus schemes. Therefore, it is also least influenced by the evils of graft, corruption, political patronage, and pressure group manipulations.

The variants of the devaluation depend on its extent. To be at all effective, it must be however close to the market rate of foreign exchange for the peso.

Devaluation will be able to correct fundamental problems related to resource and product price distortions currently afflicting the economy. (See reference {4 }). A price correction leads to better resource allocation. Rapid economic development requires efficient, not wasteful, use of resources. The evidence about the effects of decontrol in Philippine manufacturing shows that after decontrol, there was immense improvement of resource allocation compared to the period of stringent controls of the 1950's. (Reference {6 }). Devaluation raises import prices and

cheapens exports across-the-board in the foreign markets and therefore increases the peso income per dollar of export revenue of exporters.

Devaluation must be accompanied by a vigorous support from fiscal and monetary incentives to export-oriented industries. This ought to be pushed hard enough so that the required export-response follows.

The much-argued inelasticity of exports (which still afflicts current thinking even by economic technicians in the Philippines) might be true for traditional exports of copra, sugar, and coconut oil, even perhaps logs, especially considering now the expected depletion of tappable forest reserves. The evidence for other countries however shows that with a correct foreign exchange rate, many industrial activities, in which countries like the Philippines have "potential" comparative advantage, become new and substantial export possibilities. The evidence is best supported by the examples of South Korea, Taiwan, and Hongkong, to mention only the most dramatic cases. At the new equilibrium rate, it is possible to expand new exports given the support of export policy, especially in the industrial sector [redacted] (See reference {5}).

IV. FLEXIBLE EXCHANGE RATES (Floating Rate)

Initially, this involves allowing the currency to depreciate (devalue) and then allowing the rate to depreciate or appreciate, depending on supply and demand conditions.

(1) Hongkong Tourist "Emporium" Solution.

All foreign exchange rates may be convertible at a "floating" exchange rate market in which all foreign currencies can be traded. The

tourist emporium solution will require a more liberal policy towards foreign airline flights into Manila coupled with the removal of all tariffs on principal tourist "buys", like cameras, watches, electronic equipment, textiles and leather (to encourage the use of our immense supply of tailors and shoemakers). The Philippines could easily become a more attractive tourist emporium alternative to Hongkong, because of the advantages it could offer to "sun lust" travelers as well as its beautiful scenic and historic spots, many of which Hongkong lacks.

This variant can also be subsumed under a devaluation policy.

Argument pro: Employment potentials of this measure are great for the tourist and related service industries and can be expected to spill over into manufacturing industries.

Common arguments against (plus counterarguments):

(a) Textiles, electronics, etc. industries will be killed.

Counterargument: This does not follow. Let these textiles, electronics, etc. industries get importations of raw materials imports under liberal terms and give to them, like to all other sectors, attractive export incentives. Or give production subsidies, perhaps related to cheapening labor costs of labor-intensive enterprise. The example of Hongkong is the best counterargument against this argument, for Hongkong has progressed industrially under these conditions.

(b) This policy will encourage wasteful consumption.

Counterargument: Not necessarily. The increase of consumption is only at best temporary. In any case, it makes citizens well-off.

Moreover, this policy simply requires a more rational domestic taxation of consumption goods. For instance, the sale of films may be taxed heavily. Citizens who are made better off by cheaper consumer durables are eventually taxed through their consumption of films. Or all the tourist items (whose tariffs are removed) may be subjected to domestic excise taxation, provided that tourists are able to get exemptions on these [redacted] (This is Japan's trick.) Moreover, with the expansion of purchases of these goods, it will be possible to attract the establishment of high quality precision instruments like cameras, more sophisticated electronic products, etc., because flexible exchange rates (like devaluation) makes wage costs relatively much cheaper.

(c) There will be an unhealthy redirection of investment and savings resources into service industries, and this is undesirable because these industries are not productive.

Counterargument: (1) Large capital investments in some manufacturing industries, which are currently operating at low-capacity use, represent already committed economic resources. These industries will gain from these policies. They will, in order to survive, have to make their industries more flexible. (2) Moreover, the expansion of employment and income in the service industries enlarges the potential base for industrial products which are domestically produced. The removal of tariffs on "tourist" products, therefore, need not mean a reduction of the tax base because new consumption taxes are imposed to substitute for tariffs and the rapid expansion of income helps to enlarge the tax base automatically.

(2) No Emporium: The Canadian Solution

The Canadian experience of the 1950's is one alternative that may be studied. This solution simply requires that a floating exchange rate be adopted. Studies, such as Sohmen's (1969), may be consulted.

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A COMMENT ON INDUSTRIAL POLICY AND EXPORT GROWTH

It would be important to stress below a viewpoint which deviates entirely from currently accepted notions in the Philippines about the direction that industrial growth should take. This widely circulated viewpoint claims that there is a "basic" difference between the Philippine economy and other countries which have shown, in recent years, tremendous economic growth because of their "outward-looking" industrial policies. Therefore, development strategies should be essentially different.

The said viewpoint is summarized as follows. The Philippines is a large country compared to many of the recently successful export-growth-oriented countries because it has a large population base. Thus, the population of the Philippines is about 1½ as much as South Korea, 3 times as Taiwan, and more than 9 times Israel or Hongkong.[1] Therefore, Philippine stress on import-substitution industries, based on generating internal demand and on expertise generated by firstly capturing a domestic market base, is a natural course to follow. This argument is an offshoot of the

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[1]The 1966 estimated populations (million people) of each country are: Israel, 2,629; South Korea, 29,086; Hongkong, 3,732; Taiwan, 12,791; Philippines, 33,477. See United Nations, Statistical Yearbook 1967.

well-known (Burenstam-Linder) empirical hypothesis that exports develop out of an internal market base. This has been argued as the experience of the development of export specialization of many developed economies in the past.

Unfortunately, one misleading fiscal policy implication from this hypothesis is that to gain an industrial market base, policies should first stress the promotion of import-substituting industries. In due time, it is hoped, that these will finally become export-oriented. It could become like waiting for manna from heaven. If the instruments of economic policy used further distorts internal and external prices and therefore create incentives which are contrary to long run comparative advantage, inefficient import substituting industries result. Note here that the argument is not against "import substitution," since the industrialization process is inevitably, partly, and even substantially, import substitution in character. It is against inefficient, and therefore costly, import substitution policies, which waste resources, by misleading entrepreneurs into wrong types of industrial efforts to undertake. The experience of the Philippines in terms of industrial export expansion is the clearest argument of its weakness as a basis for economic policy. (See reference {3}).

When there are clear distortions generated by economic policies (fiscal) which support import substituting industrialization and which stifle the incentives to export (as clearly demonstrated by the net structure of economic policies in the Philippines [Reference (4)]), it will take a long time (eternity?) waiting for industrial exports to expand significantly. To appreciate the economic experience of Hongkong, South Korea, Taiwan, and Israel, as examples, we have to study the attempts of these countries to counteract the distortions created by misguided economic policy which have allowed their entrepreneurs to engage profitably in industries which have economically long run viable footing. (See Johnson (1965) for a

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