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Industrial Development And Exchange Restrictions

Reed J. Irvine

Most of the independent countries of Asia have joined the International Monetary Fund, and in doing so they have signified acceptance of the principle that the elimination of exchange controls will promote greater economic efficiency and productivity. Most of these countries profess keen interest in accelerating the rate of economic development and raising living standards, but surprisingly few have demonstrated any great faith in the efficacy of the above principle as a means of attaining these ends. While notable progress has been made in other parts of the world toward relaxation of exchange restrictions and freer convertibility of currencies, most of the underdeveloped countries of Asia are as firmly wedded to their restrictive systems as they were prior to the Korean war.

In some cases, far from regarding the relaxation of restrictions as a way of improving the functioning of the economy, some countries have seemingly come to look upon these restrictions as indispensable tools for promoting economic development. The Philippines appears to be close to this position. Exchange controls there are unquestionably used to protect certain domestic industries which the authorities wish to encourage. One example is the cotton spinning and textile industry now being developed in the Philippines under the protection of the curbs imposed on imports of cotton yarn and textiles. The volume of imports allowed depends to a large extent on the production capacity of domestic producers, and in the Philippines it is an accepted principle that imports may be banned completely if local requirements can be filled by domestic producers.

The use of these techniques to develop a cotton textile industry in the Philippines gives rise to questions which are pertinent to a number of economic development projects now under way in various other parts of the world. An examination of Philippine approach may cast some light on the major question of whether or not the underdeveloped countries are wise in attempting to insulate their economies in order to promote industrial development.

The Philippine cotton textile industry

The only cotton textile mills operating in the Philippines in the post-war period, prior to the imposition of exchange controls in 1949, were two mills owned by the Government which have had a consistent record as money losers. By 1955, after 6 years of exchange control, 18 knitting mills had been established and these had sufficient capacity to supply a substantial portion of the country's requirements for cotton knit goods.

Difficulties in importing sufficient yarn to supply the knitting mills stimulated interest in the expansion of domestic spinning capacity. Since the latter part of 1954, three privately owned mills producing cotton knitting yarn have been established. These mills have the capacity to produce about half the country's total requirements for knitting yarn at

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the present time. Over the next three years a very rapid growth of spindleage is foreseen. Spindles in operation are expected to rise from 70,000 in the last half of 1956, to 103,000 at the end of 1957 and 240,000 at the end of 1959.[1] It is estimated that the number of spindles that will be operating by the end of 1959 will be able to produce as much as 51 million pounds of cotton yarn a year. Unless per capita consumption of textiles rises, this amount of yarn should be adequate to produce 90 per cent of the Philippines' total cotton textile requirements.[2]

The private spinning development was slow in getting started because of the investors' insistence that they be assured long run protection from imports as well as adequate supplies of raw cotton.[3] Protection is needed since Philippine yarn appears to be far from competitive. Recent figures are not presently available, but in 1955, yarn produced by the government-owned National Development Corporation sold for P1.80 per pound, less than the actual cost of production. Japanese yarn at that time was priced at the equivalent of P1.30 per pound in Japan.[4] Imported yarns were reported to cost as little as P1.54 per pound landed in Manila. The newer Philippine spinning mills are probably more efficient than the National Development Corporation mills, but it seems unlikely that they will be able to operate without some form of protection. Since it is possible under Philippine law to ban imports completely whenever the Government decides that domestic production is adequate to satisfy domestic demand, it is likely that pressure for this move with respect to cotton knitting yarn will be felt in the not-too-distant future if production capacity expands as is now projected.[5] By the end of 1957, the country will probably be able to produce more knitting yarn than it is now consuming.

1/ Manila Embassy communication, 2/8/57 enclosing memo from S.L.Buffington, Industrial Development Corporation Cotton Textile Adviser.

2/ This is based on utilization of raw cotton at the rate of 1/2 bale per spindle per year, the U. S. average. The Philippine rate is said by Industrial Development Corporation Cotton Textile Adviser to be higher. Per capita textile consumption was 2.4 pounds in 1954 and somewhat lower than this in 1955.

3/ Philippine Council for United States Aid, Industrial Philippines, 1953, p. 26

4/ This price is computed at the exchange rate of P2.34 per dollar, which included the 17 per cent exchange tax. This tax has since been replaced by a special import duty which was recently reduced from 17 per cent to 15.3 per cent.

5/ The Government has been willing to accord a high degree of protection to the domestic producers of weaving yarn and gray cloth. Imports of these items were completely banned in 1952. More recently the weaving yarn ban was reinforced by subjecting this commodity to the no-dumping law as a result of a complaint that some yarn had been imported to the detriment of the domestic industry.

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The immediate result of achieving self-sufficiency will be higher production costs for cotton wearing apparel and higher prices for the consumers. However, this may be offset to some extent by the economies effected by smoothing-out the flow of yarn to the knitting mills. This has been irregular in the past and the mills have at times had to operate inefficiently because of short supplies resulting from the vagaries of exchange control administration. The improvement will, of course, depend on the constancy of the inflow of raw cotton. For the time being uncertainty on this score has been eliminated by International Cooperation Administration financing of raw cotton imports, and it is expected that both I.C.A. and P.L. 480 cotton will be available over the next few years.[1]

The development predicted for the Philippine textile industry in 1958 and the years thereafter apparently envisions a large scale expansion of the cotton weaving industry since spinning capacity will be far in excess of that required for knitting yarn. Realization of these plans is more doubtful than in the case of the knitting yarn industry, but one private mill with integrated spinning and weaving operations has already been established.

Domestically woven textiles in the past have been less competitive with imports than have knitted goods. Substitution of domestic production for imports of fabrics would have a greater impact on the consumer than would the banning of knitting yarn imports because fabrics account for a larger portion of total consumption and because the domestic production of fabric will probably be relatively less competitive with imports.

The problem of competitiveness

The apparent lack of competitive strength on the part of Philippine cotton textile products would normally tend to discourage any expansion of the industry. It appears that the Government has nevertheless decided that expansion is desirable and has undertaken to create conditions under which the industry might flourish. Exchange controls are the means by which this is to be accomplished. The question for the Philippines and other countries in a similar stage of development is whether or not this approach is a desirable one.

A government may adopt this approach because it believes that the industry requires only temporary protection. Labor and management may need time to gain experience or to overcome consumer prejudices in favor of established imported lines. There may be some merit in a government affording protection to domestic entrepreneurs under these conditions, but this does not justify the use of exchange controls. Unlike subsidies or tariffs, exchange controls place no definite ceiling on the amount of the premium that the public is required to pay for developing domestic production. They

[1] It is noteworthy that the U. S. surplus commodity disposal program, while not displacing normal raw cotton marketings, may be an important factor in reducing the volume of U. S. textile exports to the Philippines.

also tend to insulate more completely against the healthy prod of outside competition. Perhaps their most serious disadvantage is that they make it too easy to conceal the protective aim behind talk of balance of payments difficulties and the "non-essentiality" of competing imports. This makes it easy to give more protection than is needed and may make it more difficult to get rid of the protection long after the need for it has passed. In the Philippines, the policy appears to be to afford more complete protection as the domestic industry grows in size. This is just the reverse of what might be expected if the object of the protection were merely to tide the industry over an initial period of difficulty. Apparently, the Government does not believe that the gap between domestic and imported goods can be eliminated only by increasing the efficiency of the domestic producers.

There is one other reason why a basically economic industry might require protection in order to survive. If the exchange rate is overvalued, imports may have a price advantage over domestically produced goods that will make if difficult or impossible for even very efficient producers to compete. In this case, the use of exchange controls might be advocated as a means of compensating for the unfair advantage enjoyed by imports. In some cases this may be defensible, but it is an extremely dangerous approach when the country's objective is the development of new and unproven industries. Not only are the new enterprises insulated from the incentives to increased efficiency provided by outside competition, but it often becomes impossible to tell whether particular industries enjoying this type of protection are in fact economic. Given complete protection, large amounts of capital may be channelled into industries that may never be economic under any conditions. By the time this fact is discovered the damage will have been done. This danger exists in the case of agricultural as well as industrial development.[1] Agricultural mistakes may be rather less costly than errors in industrialization since it is usually easier to switch crops than to convert industrial plants to new uses, but where extensive land reclamation is involved the loss may be extremely high if profitable production proves impossible. It would be serious for any country to find itself burdened with a collection of economic

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1/ The Philippine experience with tobacco production illustrates this point. The Government has employed subsidies and import restrictions to develop the domestic production of Virginia-type tobacco and production has rapidly expanded to a point far exceeding the requirements of the protected domestic market. Because of its poor quality the tobacco has limited export possibilities and the surplus has become an embarrassing problem for the Philippine Government.

white elephants, but it might be disastrous for the poorer countries of Asia. The tendency to regard exchange controls as a necessary protection device leads one to suspect that this danger is not as generally understood as it should be.

There is some temptation for underdeveloped countries to regard an investment which promises to save foreign exchange and to employ local labor as economically desirable even though it may be more costly to manufacture the product domestically than to import it. It is too often forgotten that such investment is not economically desirable unless there is good reason to believe that production can in the forseeable future be brought to a level of efficiency comparable to that in the exporting countries, or unless there is simply no way in which the factors of production can be more efficiently employed. Where the domestically produced goods are manufactured and sold at a higher cost than imports, the increase in the supply of goods available for consumption will necessarily be smaller than the additional money incomes generated by the more costly production.1/ This obviously means inflation. Since the factors of production engaged in the new industry are rewarded in excess of the value of their contribution at the existing price level, the general price level will tend to rise as the workers and investors in other industries, including the export industries, endeavor to increase their money incomes to prevent their real incomes from being reduced. If, as is likely, it is impossible to raise the prices of the exports in the world market, the profitability of the export industries will fall and production and foreign exchange earnings will decline. Depending on the size of the decline, the total increase in employment and real income in the country will be reduced and perhaps even wiped out. Even if it is not completely eliminated, the result may be a slight increase in total goods available for consumption but a net decline in the real return per unit of the factors of production employed.

This can be avoided by concentrating investment in those fields in which the productive process does not generate larger money incomes than can be absorbed at a constant price level by the new output or by the imports which can be purchased with the new output. If no such field can be found sound economic policy lies in selecting those fields for investment which most nearly approach this goal, minimizing the ill effects of having to move into relatively less economic production. In any case, what must be guarded against is the fallacious assumption that it is only necessary to demonstrate

1/ Assume that a country decides to replace x imports by the same amount of domestic production at a cost equivalent to 11/10x. Assuming that there is a 50 per cent saving in foreign exchange it will be possible to increase available supplies for consumption to 1 1/2x (1x from new domestic production and 1/2x from imports; the other 1/2x of imports must be used to supply raw materials for the new domestic production). If previously the money incomes were just equal to x, the new production will raise them to 21/10x while the supply of goods will rise to only 1 1/2x.

that a particular project can save foreign exchange and employ idle resources. The first danger sign is the inability of the proposed industry to stand on its own feet without heavy protection, tax subsidies, etc.

As Maurice Zinkin points out in his excellent book, Development for Free Asia, this is not a problem confined to Asia but it is one that the poorer Asian countries must guard against even more than the advanced nations.

> "In Asia, which can so much less afford waste, Governments must consider with the greatest care the real costs of the schemes they foster. It may be that an automobile plant will considerably increase self-sufficiency, but if the number of automobiles required in any particular country is so small that they can only be produced locally at three or five or ten times the cost at which they could be imported, then probably the country would be stronger for putting these resources into something which would be economically more beneficial, a fertilser plant perhaps, so that there would be more food, or new roads so that communications would improve. No general rule can be laid down; each case must be considered on its merits. But it can at least be said that in every instance where some industry asks for protection or for subsidy, the onus of proving that the benefits gained will more than offset the economic loss must be placed squarely upon that industry. At present in every country of the world, and Asian countries are no exception, a large number of industries are allowed to batten on the community without any commensurate return either in extra national safety or anything else."1/

Industrialization without controls: The example of Hong Kong

The idea that it might be possible to develop economically and even to industrialize at a rapid rate without the use of the protection provided by extensive controls over foreign exchange and imports has little apparent support in most parts of Asia. However, the Asian countries have in their midst a very interesting example of what can be done in this direction under a free economy. The little colony of Hong Kong, with a population only a little more than one tenth that of the Philippines, has made remarkable strides in the building of light industries in the postwar period. There have been no subsidies, no controls and no protection. The industries that have been developed have shown the ability to compete in world markets and their products have become an important source of foreign exchange earnings for the Crown Colony.

1/ Zinkin, Maurice, Development for Free Asia, Essential Books 1956, p. 36

The cotton textile industry is an outstanding example of this. Before 1947, there was no modern spinning mill in Hong Kong, but by the end of 1955, seventeen factories with a total of 300,000 spindles were in operation. This development was entirely financed by private capital, much of it capital that was brought into Hong Kong by refugees from Communist China. In 1955, about a third of the yarn produced by the local mills was exported and the rest was sold in open competition with imported yarn on the local market.

The weaving industry in Hong Kong has a history that dates back to the prewar period, but from 1947 to 1955, there was a 150 per cent increase in the number of power looms installed. During the latter part of this period, stiff Japanese competition forced a number of inefficient producers, including the operators of nearly 7,000 hand looms, out of business, but the industry as a whole expanded and increased in efficiency. Over 90 per cent of the cloth produced in 1954 was exported. The story is similar with respect to the knitting industry--rapid expansion and increased efficiency developed under the pressure of competition from other countries. As a result of the development of these and other light industries, about one-third of Hong Kong's exports in 1954 consisted of the products of local manufacturers.

Hong Kong has had some special factors in its favor--namely the inflow of refugee labor and capital from China. Some of the capital, however, has come from other Asian countries which have created an unfavorable investment climate for their resident Chinese. The capital that aided Hong Kong might well have been used to good advantage in several Southeast Asian countries, but it was repelled rather than attracted. Hong Kong suffers from important disadvantages, including the shortage of factory sites and the proximity of Communist China, but it has not been compelled to seek foreign aid. Heavily dependent on trade, Hong Kong had no choice but to adhere to the policy of free and open markets and in doing so the colony has shown that spectacular development is possible without controls. There could be a lesson in this for the neighboring countries of Asia.

Industrialization not a panacea

The problem of economic development in Asia is muddied by the conviction in the minds of many people that industrialization is the only way for the underdeveloped countries to raise their living standards. This stems partly from the belief that industrial investment is inherently always more productive than agricultural investment and partly from the conviction that a country which depends heavily upon agricultural exports and industrial imports must diversify in order to protect itself from market fluctuations. Generalization on both of these points can be misleading. In many instances, agricultural investments may be far more profitable than investment in industry. Industrial growth and agricultural stagnation do not necessarily add up to progress. The argument that diversification is inherently

desirable, even though industrial investment may offer a lower return, is of doubtful validity. Diversification may be of great value if it means the development of new exports or products that can compete domestically with imports. It is of dubious value if it only means the substitution of high cost domestic products for imports. In such a case, it may be a matter of jumping from the frying pan into the fire. The country remains dependent on raw materials exports for its foreign exchange earnings, and a decline in those earnings will probably have an adverse affect on the supply of imported goods needed by the domestic industries, as well as on the buying power of the consumers on whom those industries depend. A slump in the export industries could bring industrial unemployment, and this might constitute a more serious threat to political stability than chronic agricultural unemployment.

In the brief history of the Philippine cotton textile development, it has already been shown that diversification does not necessarily protect an economy from the vicissitudes of the world market. As was mentioned above, the shortage of foreign exchange resulted in a shortage of yarn for the knitting mills. The development of domestic production of yarn is an answer only as long as the supply of imported raw cotton is not curtailed. The ability of the Philippines to buy raw cotton depends on the earnings from the old mainstays of the economy, sugar, copra, abaca, logs, minerals, etc.

It would be a serious mistake to forget this fact and adopt policies which deliberately seek to weaken these important exporting industries and divert capital from them into projects which cannot really prosper unless the primary export industries are healthy. There is serious danger of such errors where the judgment of government officials rather than free market forces are the dominant factors influencing investment decisions. Since the Philippines is in this situation at the present time, a particularly heavy responsibility rests upon those who are in a position to make or influence the making of decisions vital to the course of economic development.

Politics vs. economics: Implications for the U. S.

The question of whether or not the development of the Philippine textile industry along the projected lines will raise textile costs permanently or temporarily has not been answered, but it is an important one for the country. In such instances as this it is not enough to say that nationalism demands industrial expansion or that developing an industry will increase employment, if the result of the action is the growth of an uneconomic industry that will operate to lower living standards. Of course, many uneconomic things are done in the name of nationalism, and it has even been maintained that it is in the best interests of the advanced nations to help the people of the underdeveloped countries to get what they want even though it may appear to the economist that what they want does not

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represent the best possible employment of limited resources. This can become a very dangerous game. Even if the object of foreign economic policy is simply to promote good will, it may be questioned whether that object is served by financing projects which in the long run may lower living standards. Such a course may win the gratitude of today's leaders, though it often appears that those who have the greatest cause for gratitude are the least inclined to show it. Grateful or not, these leaders will eventually pass from the scene, but the consequences of their economic policies will not be easily eradicated once the die is cast and large amounts of irreplaceable capital are gambled. It is even possible that investments made with foreign assistance at the insistence of today's leaders will be cited as examples of foreign ineptitude by their rivals or successors if it develops that they have injured rather than benefited the economy.

The danger of economic assistance of this type backfiring holds true for the Soviet Union no less than the U. S. This is almost always overlooked by those who assert that America must cater to the less rational wishes of the aid-receiving countries lest the Russians move in with their more "flexible" policy and steal the show with grandstand plays of no economic value but great psychological impact. Perhaps the best commentary on this is the attitude of the citizens of Warsaw toward the magnificent skyscraper, the Palace of Science and Culture, which was built as a gift of the Soviet Union. The Poles say that it is the only building in Warsaw from which one can get a good view of the city, since it is the only spot from which one cannot see the Palace of Science and Culture. It is not surprising that the Poles, whose economy is in a perilous state, should regard this expensive monument of Soviet "generosity" with some bitterness.

The long run interests of the underdeveloped countries lie not in the building of expensive monuments, but in seeking the most efficient use of resources that is possible without radically altering the traditional patterns of life by the use of force. The difficulties which a protective screen of exchange and import controls places in the way of this must be more generally appreciated if this goal is to be reached.