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The Successful Philippine Decontrol and Devaluation 10 pages

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On January 22, 1962, after over 12 years of exchange controls, the Philippine people suddenly found themselves free to import any commodity they desired or to engage in any type of foreign capital transaction that interested them. They could exchange pesos freely for foreign exchange and deposit it in the U. S., or buy U. S. stocks, or deposit it in Swiss banks, or use it to buy French perfume, or, in short, use it in anyway they desired. Before this, the bulk of import and capital transactions were subject to governmental controls, even down to the purchase of a 10 cent postage stamp from the U. S.

What was the effect of this sudden dropping of exchange controls by the Government? Did the volume of imports mushroom as predicted, since the public was left free to purchase foreign luxuries at the slightest whim? Was there a sharp drain in international reserves as controls were dropped overnight? Did prices rise sharply as the peso was devalued?

Contrary to these dire predictions, the sudden dropping of exchange controls in the Philippines has not produced the disastrous results predicted by some defenders of controls. Instead the country has a new economic lease on life. Equilibrium has been restored in the balance of payments, exports are rising more rapidly than earlier, and there has been a resurgence of interest by foreign investors in the Philippines.

The experience of the Philippines with exchange controls and an overvalued exchange rate is one that is common to many underdeveloped countries. What makes the Philippine story interesting, however, is that decontrol was accomplished overnight without disastrous consequences. Many economists would probably have favored a quick devaluation of the peso and a gradual removal of controls. While the Philippines reversed this process, and erred in devaluing in stages, well advertised in advance, they had the courage to grasp the nettle and wipe out exchange controls overnight. On the whole, they have been better off for so doing.

The period of controls

A combination of developments lead the Philippines in the late 1940's to establish stringent exchange controls. Not the least of these was the overvalued exchange rate, which operated, in the well-known fashion to stimulate a high volume of imports, to reduce export incentives, and consequently, to help bring on a drain in international reserves.

It was during the 1940's that the Philippine peso became overvalued. Inflation during the Second World War was more severe in the Philippines than in the United States. Between 1940 and 1949, wholesale prices in the United States approximately doubled, but in the Philippines the increase was four-fold. Since the bulk of Philippine trade was with the United States, a more realistic exchange rate in the late 1940's or early 1950's would have been about 4 pesos to the dollar. The rate for the peso in Hong Kong and other free markets in the early 1950's also indicated that a new rate of 3 to 4 pesos to the dollar would have been more realistic. However, the Philippine authorities elected to retain the prewar rate of 2 pesos to the dollar, a rate that had prevailed since 1903.1/

During the first part of the 1950's, the Philippines attempted to compensate somewhat for the overvalued rate by introducing a special tax on exchange payments of 17 per cent. This tax was in effect from March 29, 1951, to December 31, 1955, and applied to all sales of foreign exchange except "essential" import items. The tax proved an irritant in U.S.-Philippine relations and provision for its abolition was made in the Romulo-Langley Agreement of 1955. The Agreement specified that the previous 17 per cent exchange tax would be replaced by a temporary special tax on import commodities which would be reduced from 17 per cent to zero over a period of ten years, i.e., by January 1, 1965. During 1962 the tax has been at a level of 6.8 per cent.

The Philippine authorities were able to maintain the unrealistic prewar exchange rate during the late 1940's because of two main factors. One was the relatively large volume of United States' economic aid in the form of grants, credits, direct investments and settlement of war claims. The average yearly trade deficit in 1946-1949 was $273 million, but these special receipts from the U. S. financed a large portion of this deficit. The other factor involved the international reserves. At the end of 1945, total reserves including the net holdings of commercial banks were $669 million. By the end of 1949, these holdings were down to $260 million, the difference of $409 million having been used to help finance the large trade deficits.

By 1949, however, continued heavy imports, sagging exports, an outflow of private funds, and a decline in U. S. government disbursements contributed to a balance of payments crisis in that year and stringent exchange and import controls were imposed late in the year. By means of these controls, reserves were boosted from $260 million at the end of 1949 to $365 million at the end of 1950 and the official rate of 2 pesos to the dollar was maintained, but the volume of imports was cut sharply over earlier levels.

In the period from 1951 through 1957, reserves gradually declined as the trade gap widened again in response to an easing of controls. By 1957, the Philippines faced another serious balance of payments crisis as internal monetary expansion raised the level of imports sharply. Reserves fell to a postwar low of $140 million at the end of 1957, and the central bank again tightened monetary conditions, mainly by increasing sharply the amount of advance import deposit requirements, raising commercial bank reserve requirements, and increasing the central bank's discount rate. Exchange controls were also tightened, particularly for consumer imports. These measures were successful in halting the drain in reserves, but at the same time they spurred a renewed debate on the pros and cons of foreign exchange decontrol and devaluation.

1/ All exchange rates in this paper exclude exchange commissions and charges.

The problems created by the controls

Although the establishment of exchange controls in the early 1950's was considered at the time to be only a temporary measure, the "temporariness" of the controls began to dwindle as the years passed. Many Filipinos came to regard them as a necessary tool of economic planning, others as a device needed to restrain the Filipino's fondness for foreign luxuries.

The controls became a part of official Philippine economic philosophy. President Romualdez of the Philippine National Bank, for example, suggested that such classical remedies as decontrol, devaluation and monetary stability were not fully applicable to underdeveloped countries like the Philippines. In a speech at the 1958 annual meeting of the International Monetary Fund he said:

> "It must be stressed that current equilibrium in a country's balance of payments is seldom possible when that country is pursuing a faster rate of reconstruction, investment and economic growth than can be achieved on the basis of its domestic savings alone. And this circumstance is an almost universal one among the underdeveloped countries of the world. In seeking development with stability, underdeveloped countries have to work on an over-all framework of policies entirely different from those in developed countries making classical remedies not altogether appropriate to underdeveloped areas."2/

As vested interests grew under the controls, it began to appear that they would remain a permanent fixture of the economy. They provided attractive financial returns to certain interests and they increased the economic and political power of certain Government officials. But while the controls had helped reduce the drain on the nation's international reserves, there was a growing revulsion at all the graft and favoritism the controls encouraged.

It became evident that the system of controls was a device for stifling some political criticism of the Government. Businessmen, dependent on import licenses to successfully operate their businesses, were reluctant to expose publicly the shortcomings of the administration, including criticism of the system of controls, lest they find themselves without the licenses they needed in order to run their businesses at a profit.

Many people, revolted by the corruption and inefficiency bred by the controls, began to recall with some nostalgia the period when the Philippines operated as a free enterprise economy. Sentiment in favor of abolishing the controls gradually strengthened, bolstered, perhaps, by the example of Western Europe's move to full convertibility in 1958.

Producers of export commodities, especially sugar, had of course long advocated devaluation and decontrol, but their arguments had been dismissed as being motivated only by greed. Decontrol could work only if the peso were devalued to a realistic level, and the advocates of devaluation tended to concentrate their fire on the evils of controls rather than on the advantages of moving to a realistic exchange rate. On the other hand, the defenders of controls were more inclined to stress the dangers of devaluation in making their case.

2/ International Monetary Fund: Summary Proceedings of the Thirteenth Annual Meeting of the Board of Governors, October 1958, p. 102.

The problems involved in dropping controls and devaluing

One of the major arguments against decontrol and devaluation was that such action would be strongly inflationary. There was a fear that prices for essential imports, such as canned milk, would rise drastically. It was argued that even if general inflation was avoided through tight monetary and fiscal policies, the prices of these goods would still go up sharply because of the large change in the import exchange rate. Politicians were concerned that if it was true that the prices of many essentials would rise, that this would have bad political effects.

It was also argued that a devaluation would be inflationary since exporters' incomes would be increased as a result of higher peso proceeds for export products. With a rise in incomes, there would be just as strong a demand for imports as before in spite of the higher prices for imports that would result from the devaluation. Hence devaluation in itself would contribute little to the aim of reducing imports.

In addition, it was argued that higher prices would discourage saving and encourage dissaving, that bank credit would have to be increased because of higher costs, and that wages would accordingly have to be adjusted upward. Thus devaluation would touch off in a short period an inflationary spiral of major proportions.

A second group of arguments related to exports. It was said that: (1) exports were already at relatively high levels; (2) there was no need for further expansion; and (3) devaluation would not increase the volume of exports because of relatively inelastic foreign demand and domestic supply conditions. These arguments were based on analyses of existing Philippine exports and existing market conditions. They overlooked the need to develop new export industries and the possibility that market conditions might alter. The striking developments since complete decontrol and devaluation in January 1962 have revealed a rise in export volume over earlier levels rather than no change.

A third major argument was that if the Philippines were to drop controls, the economy would be left to the vagaries of the market and this would be disastrous. It was argued that the Filipinos had a high propensity to consume luxuries. It was said that if controls were dropped, the people would run wild. Imports of luxury goods would soar beyond all reason, and the country would rapidly lose reserves. Those who used this argument failed to realize that the overvaluation of the peso contributed substantially to this evident high propensity to consume and that if the exchange rate were established at a realistic level, this strong propensity would disappear.

It was also alleged that without controls there would be substantial capital flight which would outweigh any capital inflow This argument also overlooks the point that once an economy has dropped controls, established a realistic exchange rate, and achieved relative monetary and fiscal stability, the main factors prompting capital flight have been removed.

Although the opponents of devaluation believed that no change needed to be made with regard to the exchange rate for exports, they conceded that something needed to be done to reduce the demand for imports stimulated by the overvalued rate. Various proposals were made, including the adoption of measures of monetary and fiscal restraint. Late in 1958 and early in 1959, strong sentiment developed for imposing a special government fee on imports which would accomplish two purposes. By increasing the cost of imports, the trade deficit would be narrowed, and by providing the Government with a new source of revenue, the budget deficits would be reduced, thus reducing inflationary pressures. It was argued, somewhat inconsistently, that by this device there would be no devaluation of the peso, but this overlooks the point that the net effect of increasing the effective import rate would be a de facto devaluation of the peso.

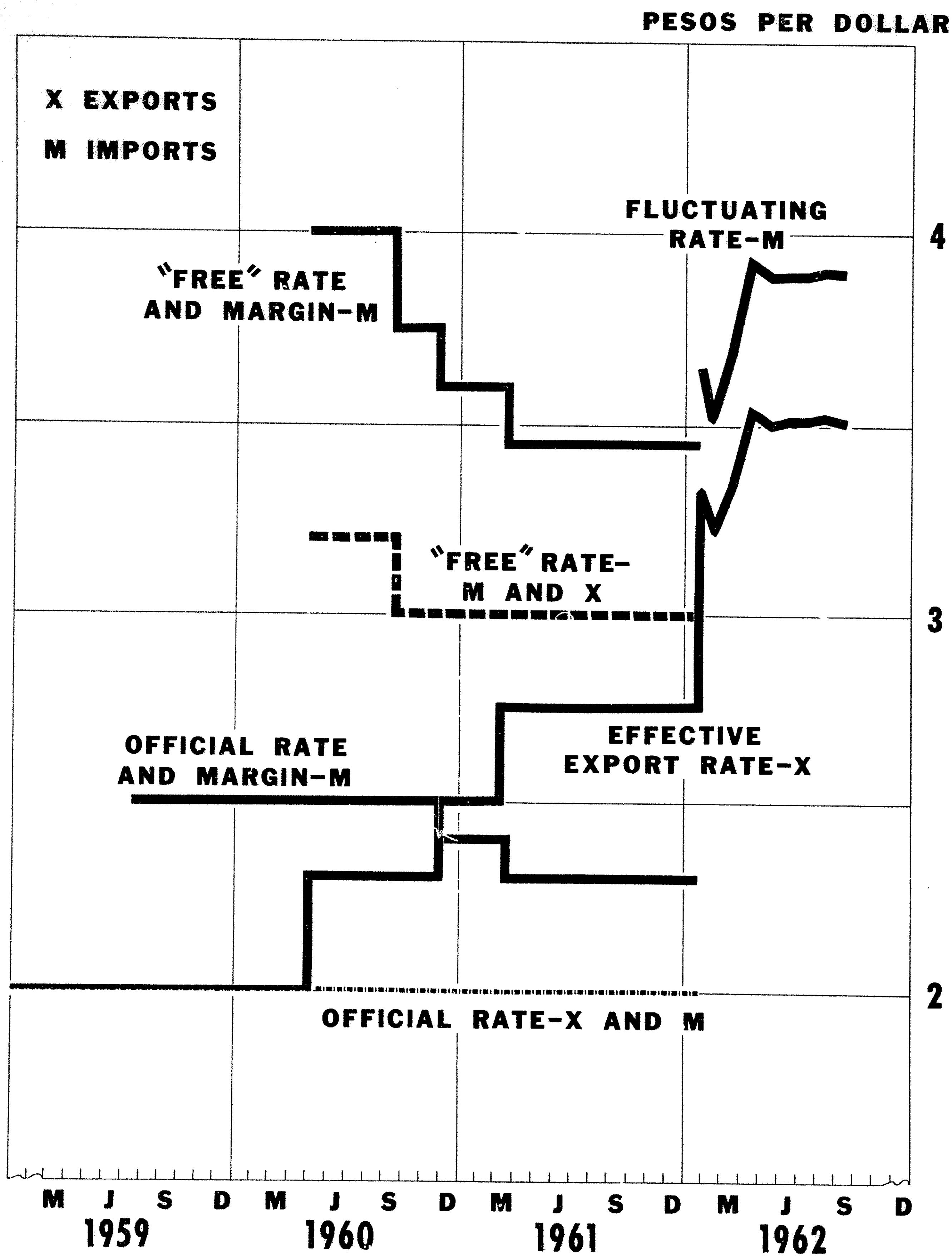
The margin fee and decontrol

On July 3, 1959, legislation was passed which gave the administration power to impose an exchange margin of up to 40 per cent on the sales of foreign exchange. On July 15, the central bank set the exchange margin fee at 25 per cent for the bulk of Philippine imports. Exchange for these imports was therefore sold at a rate of 2.50 pesos to the dollar. This was far from a realistic rate. The Hong Kong rate for the peso at that time was close to 4.00 pesos to the dollar. Since the exchange margin legislation had also provided that steps be taken over a four-year period to remove controls on imports, it was clear that the peso would have to be devalued further as the planned decontrol was carried out.

Instead of taking four years to remove exchange controls as provided in the July legislation, the Government, under two different administrations, gradually decontrolled and devalued in four stages over a period of two and a half years.

The changes in the import and export rates since early 1959 are indicated in Chart 1. Between mid-1959 and January 1962, the Philippine exchange system moved from a unitary rate of 2.00 pesos to the dollar to a system involving a single fluctuating rate for imports (which since April has been about 3.90 pesos to the dollar) and a mixed rate for exporters consisting of 80 per cent at the freely fluctuating rate and 20 per cent at the official rate of 2.00 pesos to the dollar. (Since April this rate has been about 3.50 pesos to the dollar.) As indicated in the chart, the exchange system during the first three stages of devaluation and decontrol was quite complex and the precise changes in the system are outlined in the table below.

PHILIPPINE EXCHANGE RATES



Changes in Philippine Exchange System

Effective	Item
April 25, 1960	First Stage: "Free" rate of ₱3.20 to the dollar established. Exporters received 25 per cent of proceeds at "free" rate. Margin left at 25 per cent. (Prevailing rates: 2.00, 2.30, 2.50, 3.20 and 4.20)
Sept. 12, 1960	"Free" rate appreciated to ₱3.00 to the dollar. Exporters receive 30 per cent at "free" rate. (Prevailing rates: 2.00, 2.30, 2.50, 3.00, and 3.75)
Nov. 28, 1960	Second Stage: Margin cut to 20 per cent. Exporters receive 50 per cent at "free" rate. (Prevailing rates: 2.00, 2.40, 2.50, 3.00 and 3.60)
March 2, 1961	Third Stage: Exporters receive 75 per cent at "free" rate.
March 15, 1961	Margin cut to 15 per cent. (Prevailing rates: 2.00, 2.30, 2.75, 3.00, and 3.45)
Jan. 22, 1962	Fourth Stage: Freely fluctuating rate established. Exporters receive 80 per cent at fluctuating rate.

During these various stages, gradual decontrol was achieved by the administrative transfer of an increasing proportion of imports to the more depreciated exchange rate categories where import licensing was supposedly unrestricted. In actual practice, however, restrictions tended to remain in force since importers were not allowed to purchase more "free" market foreign exchange than their earlier quota allowed without prior approval.

With the relaxation of credit and fiscal controls from mid-1960, inflationary pressures were created in late 1960 and 1961. The phased decontrol and devaluation stimulated speculation and a holding back of some exports during the last half of 1961 in anticipation of a further devaluation. Similarly, imports tended to rise somewhat and capital flight was stimulated. The administration of President Garcia, faced with elections in November of 1961, chose not to implement full decontrol during the last half of the year, evidently fearing adverse results at the polls. This choice apparently backfired, since the economic situation continued to deteriorate, with reserves dropping $89 million in 1961 to a low of $102 million. This may have been a factor in President Garcia's failure to win reelection.

The new administration of President Macapagal acted rapidly after installation in office at the end of December. On January 22, 1962, President Macapagal implemented the fourth stage of the decontrol program. He acted with some haste because of his wish to implement the program before Congress convened. The President had the power to act while Congress was not in session. He feared that the program would be hamstrung if it were subjected to Congressional approval, especially since his party did not win control of both houses of Congress.

A freely fluctuating exchange rate for both current and capital transactions was introduced and all exchange controls were abolished except for a requirement that 20 per cent of export proceeds be surrendered to the central bank at the rate of 2.00 pesos to the dollar. This provision was adopted in lieu of an export tax. Import duties on 754 commodities were changed, with duties on "essential" goods generally being lowered and duties on other items being raised. Also in January, credit controls were tightened with the central bank's discount rate being raised from 3 to 6 per cent and commercial bank reserve requirements from 15 to 19 per cent.

Because the administration believed in January of 1962 that the proposed decontrol and devaluation would pose a serious threat to Philippine reserves, a special mission was sent to the U. S. in that month to arrange for a package of stabilization credits. It was later announced that credits totaling $300 million had been negotiated, but a complete breakdown of these credits was never made public. They included a $28 million drawing on the IMF (later in April an additional $40 million IMF stand-by credit was also approved); a $23 million gold collateral loan from the Federal Reserve System; a $33 million credit from the Export-Import Bank of Washington; and credits from AID, the U. S. Treasury Stabilization Fund and U. S. commercial banks.

The Philippine Government gave assurances that it intended to permit the new exchange rate to fluctuate freely. This meant that the reserves of the central bank would not be used to support the rate and that the central bank would refrain from entering the market to add to its reserves, at least in the initial stages. From a technical point of view there would have been no need to augment the Philippine liquid reserves under these conditions. However, it was felt that speculation against the peso would be reduced if it could be announced that the Government had received large credits that might be available to help stabilize the rate.

The central bank did not stick to its intention to refrain from supporting the peso after January 21st. On January 23 the central bank's gross international reserves totaled $72 million, including the $28 million obtained from the IMF. Adding the $23 million borrowed from the Federal Reserve System at the end of January, the reserves would have risen to $95 million had the central bank stayed out of the exchange market except to sell its share of the export proceeds. Actually, the central bank's reserves fell short of this by $9 million at the end of January and they declined to a low of $64 million on March 9. This indicates that during this period the amount of central bank support for the rate exceeded $30 million. This explains why the peso showed unexpected strength in the first few weeks after decontrol. It started off at 4.50 pesos to the dollar and appreciated to 3.48 to the dollar by February 1st. It began to weaken in March when the central bank withdrew its support. It depreciated to about 3.90 pesos to the dollar by April, where it has since tended to remain.

The movement of reserves indicates that the central bank has operated on both sides of the market since March. Fluctuations have been relatively small, the central bank gross reserves having stabilized at between $70 million and $80 million since the beginning of April. However, during the intervening months the central bank repaid the Federal Reserve loan, indicating that it withheld from the market at least $23 million that it obtained from exporters.

It is not clear why the central bank intervened to support the peso in the early weeks of decontrol. It may have been a tactic designed to cushion the shock and create a favorable first impression. It certainly had this effect, but it was, of course, short-lived.

It is possible that the intervention resulted from a technical misunderstanding. Prior to complete decontrol, the central bank had entered into forward contracts which committed it to sell about ₱500 million in foreign exchange at the rate of 2.00 pesos to the dollar. For the first month or two after decontrol, the bank met these commitments, not by going to the free market to procure its exchange, which would have been appropriate under a policy of non-intervention, but by drawing down its reserves. This appears to have been justified on the gound that the forward commitments constituted a kind of abnormal debt which was additive to the demand for foreign exchange for current requirements. It was apparently feared that the rate would be unduly depressed if the central bank placed this additional demand on the market. This was obviously not the case. The forward commitments represented nothing more than advance purchases of exchange to cover normal requirements, or speculation against the peso which did not represent any desire of the buyer to use or hold foreign exchange once the devaluation had been effected. The appreciation of the peso in the early weeks after devaluation showed that there was no abnormal demand for foreign exchange in this period and that it would have been quite safe to pursue a policy of complete non-intervention. This was eventually realized and beginning about April the bank began to meet its forward commitments by obtaining exchange in the free market.

During the early months of decontrol, the Philippine authorities remained concerned that the package of stabilization credits was not sufficiently large to meet their obligations. However, at the new realistic level of 3.90 pesos to the dollar, these fears proved unnecessary and the preoccupation with the size of the credits gradually disappeared. Once the economy had stabilized and a realistic rate had been achieved, there was no real pressure on reserves and hence no real need for foreign stabilization credits.

Economic developments since decontrol

In view of the developments in the ten months since devaluation and decontrol last January, the program, on the whole, can be termed a success. The balance of payments has improved substantially, price increases have been relatively moderate and confined largely to imported goods, and the basic groundwork has been laid for establishing a new fixed exchange rate at a realistic level. Operating in the framework of free exchange markets and monetary stability, the Philippines should benefit substantially in the coming years from an inflow of foreign investment and sound economic development at home under the stimulus of a free market economy.

One of the main arguments against decontrol and devaluation was that it would be strongly inflationary, increasing the prices for essential imports, raising the incomes of exporters, and creating a wage-cost inflationary spiral. The actual Philippine experience has been one of relatively moderate increases in prices, mainly confined to imported goods. Wholesale prices in the January-September period this year rose 6 per cent compared to 3 per cent a year earlier. The cost of living index rose 7 per cent during the same period this year compared to 2 per cent in 1961 and 6 per cent in 1960 during the same period.

Despite the sharp change in the exchange rate for essential imports from 2.00 to 3.90 pesos to the dollar, importers' profit margins were apparently large enough to absorb the bulk of this change in costs. Prices of imported consumer goods rose only 17 per cent in the February-September period this year.

The rise in exporters' incomes, which has been restrained somewhat by the 20 per cent export surrender requirement, has not lead to a sharp rise in imports. In the first half of 1962 imports rose only 3 per cent over the level a year earlier, compared to a 5 per cent rise in the first half of 1961 over a year earlier.

As a result of the tight money policy, bank credit rose only 5 per cent in January-September period this year compared to 23 per cent a year earlier. Money supply increased 2 per cent against a 7 per cent rise a year earlier. Production in the manufacturing, agricultural and mining sectors continued to rise during the first half of 1962. On the fiscal side, there was a budget surplus of P112 million during the first half of 1962, more than offsetting the deficit of P98 million in the last half of 1961, and providing a net surplus of P14 million for the fiscal year ending June 30, 1962.

Another argument was that with decontrol, consumers would run wild and imports would mushroom, international reserves would be rapidly drained away, and large-scale capital flight would take place. Actually, none of these dire consequences occurred. Imports have risen only moderately, and since mid-February, international reserves of the central and commercial banks have remained intact at a level of about $130 million while foreign exchange obligations and commitments have been reduced substantially. Central bank commitments to sell foreign exchange were reduced from P495 million pesos at the end of January 1962, to P66 million at the end of October. Detailed information is not yet available, but the general trend of international reserves indicates that there has been little, if any, net capital outflow since January. The maintenance of a fairly stable level of reserves, coupled with a significant reduction in exchange obligations, also suggests that the central bank has not been supporting the fluctuating rate to any significant degree.

A third argument, stated earlier, was that Philippine exports were at sufficiently high levels so that further expansion was unnecessary, which in any case, would be hindered by demand and supply inelasticities. While the gain has not been spectacular, commodity exports in the first half of 1962 were up 6 per cent in value over their level a year earlier and 4 per cent in terms of volume. Production of such export goods as wood products, tobacco and cigars, embroidery, and light manufacturers are reported to have expanded substantially in response to increased foreign demand. Total foreign exchange receipts during the first half of 1962 increased substantially to a level significantly above that in the corresponding periods of the three preceeding years.

The argument that exports were at sufficiently high levels so that further expansion was unnecessary overlooks the point that export growth, and hence the general economic growth of the country, would have been even higher with a realistic rate of exchange and a free exchange system. A major factor in the high rate of growth in Japan in the past decade has been the rapid rate of growth of its exports. A high rate of growth in exports is also essential if the imports needed for economic development are to be soundly financed. A country aiming to achieve a substantial rate of economic growth cannot do this under conditions of stationary export volume, but must have a growing volume of exports.

Conclusion

From the above, it is evident that decontrol and devaluation has not produced the dire consequences predicted. In fact, developments have been quite encouraging and the Philippines can take credit for having boldly rid itself of a regime of import restrictions and foreign exchange controls which had gradually become discredited as problems arising from the overvalued rate grew in intensity during the 1950's. Over the years, the exchange controls had bred corruption and a proliferation of domestic business enterprises of questionable competitive strength.

While the Philippine technique of decontroling and devaluing in four stages had the advantage of being more palatable politically than a one-step devaluation and decontrol, the latter method generally has more to recommend it than the former. One of the main advantages of a one-step operation is that exchange speculation, including a withholding of exports and a speeding up of imports, is generally avoided. There is also more certainty sooner as to the ultimate level of exchange rates, which is an aid to business planning and operations on both current and capital account.

The experience of the Philippines in the past 15 years is not unlike that of many other underdeveloped countries, especially in Latin America and South Asia. Faced with overvalued exchange rates and internal monetary expansion, many of these countries have chosen to intensify exchange controls in order to halt the drain in their international reserves, rather than devalue and stabilize internally. Developments in the Philippines have shown that most of the devaluation and decontrol fears of these countries are actually illusory.