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Philippine Inflation, The Balance of Payments and Economic Development

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Philippine Inflation, the Balance of Payments, and Economic Development

Two of the more important economic problems currently confronting the Philippines involve the balance of payments situation and the rate of inflation. Some observers might also include as a major problem the somewhat low rate of growth in per capita real GNP, but compared to most other LDCs, the Philippines has had a roughly average rate of growth.

This paper describes briefly the postwar Philippine economic performance and examines some of the main causes of the Philippine balance-of-payments problems. It also suggests some policy measures that could be undertaken to maintain internal and external equilibrium.

Review of Philippine Economic Performance

Before examining more closely the Philippine balance-of-payments problem, it would be helpful to review briefly the Philippine economic performance in the postwar period. The available data indicate that the Philippines has had a respectable rate of aggregate economic growth. From 1951 through 1970, the average annual increase in real GNP was 6.1 per cent. This could be characterized as a moderate rate of economic growth. On the other hand, the Philippine population growth rate has been relatively high. During the period from 1951 to 1970, the average annual rate of growth in population was 3.1 per cent.

Because of these two factors, _viz._ a moderate, rather than a high, economic growth rate, and a relatively high population growth rate, the increase in real per capita income has not been as high as in most other East Asian countries. However, the Philippine rate has been about the same as the average per capita growth rates in Latin America and South Asia.

For the first time in six years the Philippine growth rate slackened substantially in 1970. Last year real GNP increased only 4.4 per cent, compared to annual rates of 6.0 per cent or more in 1966-69. This slackening in the growth rate occurred primarily because of a lower rate of growth in the agricultural and manufacturing sectors, as well as a lack of buoyancy in construction and investment. Government expenditures stabilized last year and the economy was hit hard by a series of major typhoons.

This moderate pace of economic growth in the Philippines has been achieved in spite of a recurring problem of disequilibrium, which has been reflected primarily in periodic balance-of-payments problems in the postwar period.

Effects of exchange controls in the 1950's--The Philippine balance-of-payments problems began in the late 1940's after the authorities had decided to re-establish in December 1946 the pre-war exchange rate of ₱2.00 to the dollar, a rate which had been originally established in 1903. Since U. S. wholesale prices had approximately doubled between 1940 and 1949, while Philippine prices had roughly quadrupled, a more realistic rate would have been about ₱4.00 to the dollar. This soon became evident as a large trade deficit developed and the Philippines lost 61 per cent of its international reserves during 1945-49. To prevent a further loss in reserves, stringent exchange controls were established late in 1949 and maintained in varying degrees until January 1962.

The imposition of exchange controls during the 1950's turned out to be highly detrimental to the Philippine economy. To mention only two aspects, the exchange controls contributed to the establishment of an inefficient, uncompetitive manufacturing sector. Unlike its neighbor Taiwan, the Philippines has not been able to diversify its exports in the postwar period because its manufactured products have not been competitive in world markets. Another aspect is that because of the overvalued exchange rate for the peso in the 1950's, the average rate of export growth was relatively low, being only 6 per cent per year in the 1950's and there was no build-up of international reserves. The low level of reserves has aggravated the periodic balance-of-payments problems, and it has also meant that foreign businessmen and investors have not had as much confidence in the future of the Philippine economy as they might otherwise have had.

The exchange controls of the 1950's created so many problems, especially a growing revulsion at all the graft and favoritism which the controls encouraged, that in January of 1962 the exchange controls were abolished. The peso was left free to find its own level in the foreign exchange market and by May of 1962 had stabilized at ₱3.90 to the dollar.

<u>Balance-of-payments difficulties in the mid-1960's</u>--Due to various developments which will be discussed later, the Philippines again experienced balance-of-payments problems in the mid-1960's. As a result, many of the exchange controls which had been removed in 1962, were reimposed during the late 1960's. These balance-of-payments problems reached a climax in February of 1970 when a substantial portion of the foreign exchange controls were removed, and the peso was again floated in the foreign exchange market. The rate generally depreciated during the spring and summer of 1970, and in October of last year it was arbitrarily pegged at ₱6.43 to the dollar, where it has remained to date.

From this brief sketch it is clear that during the postwar period the Philippine authorities have made two significant attempts to restore equilibrium to the economy. The 1962 efforts eventually proved unsuccessful and the second attempt, which began in February of 1970, is still underway.

Given this background, it would be helpful to examine next some of the basic causes of the Philippine balance-of-payments problems since the early 1960's.

Basic Causes of the Balance-of-Payments Problem

The most important factor contributing to the Philippine balance-of-payments problem has been the excessive expansion of bank credit. During 1963-69 about three-fifths of the domestic credit expansion reflected credit extended to the private sector, but in election years--such as 1963, 1967 and 1969--the volume of credit extended to the public sector increased sharply. The net credit extended to the public sector in 1969 was particularly large, and accounted for almost 80 per cent of the expansionary factors contributing to the 24 per cent increase of the money stock in 1969.

This excessive expansion of bank credit--including central bank credit--created strong inflationary pressures in 1963 and again in 1967-69. These pressures had only a moderate impact on domestic prices because the country's international reserves were drawn down and foreign borrowings were increased substantially in order to maintain the volume of imports at relatively high levels. However, these actions did not solve the problem of disequilibrium and merely postponed the time when strong measures would be necessary to restore equilibrium.

As a result of the inflationary pressures created by the excessive credit expansion, the exchange rate for the peso in the 1960's tended to become overvalued again. Although exports rose sharply by 31 per cent in 1963 after a fairly realistic exchange rate was established in 1962, the average annual increase in exports during 1964-66 was only 4 per cent, and in 1967 the dollar value of exports actually declined compared to the previous year. Imports tended to increase faster than exports after 1963, and in 1967-69 the trade deficit was very heavy, averaging about $250 million per year. This was in sharp contrast with the average trade deficit of about $30 million per year in 1964-66.

The substantial increase in the trade deficit in 1967-69 contributed significantly to a decline in the country's international reserves and also to the piecemeal reestablishment of many of the exchange controls that had been eliminated back in 1962. In 1968-69 the services account also turned moderately negative, after registering surpluses of about $125-30 million per year in 1965-67.

Poor climate for foreign investment--Another factor which has had adverse effects on the Philippine balance of payments has been the poor climate for foreign investment. While Taiwan and Korea have been successful in creating an attractive climate for foreign investment, the Philippine situation continues to leave much to be desired. During 1966-69, net direct investment in Taiwan and Korea was $112 million and $61 million, respectively, while in the Philippines there was a net outflow of $21 million. Last year the net outflow from the Philippines amounted to $24 million. Some of the many factors adversely affecting the foreign investment climate in the Philippines include governmental restrictions, legal uncertainties and in the case of some individuals, an unfavorable attitude toward foreign investment.

Competitive problems of manufacturing industries--A third factor adversely affecting the balance of payments, which was mentioned earlier, has been the uneconomic industry built up in the 1950's behind the protection of exchange controls and tariffs. This has meant that a high proportion of the Philippine manufacturing industries have not been able to compete in world export markets, and the Philippines has had to continue to depend mainly on the export earnings of its primary products. In the meantime, countries such as Taiwan and Korea--and even the Crown Colony of Hong Kong--have greatly diversified their exports, and during the 1960's maintained high rates of export growth. In the case of Taiwan, for example, industrial exports accounted for only 12 per cent of the country's total exports in 1956-58, but by 1969 the proportion had increased to 72 per cent. Similarly, Korean exports of manufactured products increased from only 14 per cent of total exports in 1960 to 77 per cent in 1970.

Philippine Actions to Restore Equilibrium in 1962

During the postwar period the Philippine authorities have made two major efforrs to restore equilibrium to the economy. The first effort was in January of 1962 when virtually all foreign exchange controls were abolished, the peso was left free to float in the foreign exchange market, stronger efforts were undertaken to reduce the Government's budget deficit, and monetary policy was tightened substantially to reduce the rate of credit expansion. The only significant exchange control that was retained was the requirement that exporters surrender 20 per cent of their export proceeds at the old official rate of ₱2.00 to the dollar. In effect this surrender requirement--which was abolished several years later--amounted to a 10 per cent tax on exports, and provided exporters with an effective rate of ₱3.52 to the dollar.[1/]

These measures brought fairly quick and impressive results. Exports increased 11 per cent in 1962 and 31 per cent in 1963. Central bank gross international reserves rose from $54 million at the end of 1961 to a peak of $194 million at the end of 1966. Consumer prices, despite the devaluation, increased only 5.8 per cent in 1962 and 5.6 per cent in 1963.

Effects of excess credit expansion--However, the benefits from the 1962 devaluation and stabilization measures were largely lost because of an excessive credit expansion in 1963 and in 1967-69. In 1963 domestic credit rose 28 per cent contributing to a 15 per cent expansion in the money supply. This excessive expansion was partly counteracted by a decline in the money stock in 1964 and a slower rate of expansion in 1965 and 1966. But in 1967-69 domestic credit increased at an average annual rate of 17 per cent and the stock of

1/ The effective rate for exporters is ₱3.52 per dollar since 20 per cent of the export proceeds are surrendered at the ₱2.00 to the dollar rate (₱0.40) and 80 per cent at the ₱3.90 to the dollar rate (₱3.12).

money at an average annual rate of 14 per cent. The export growth rate dropped sharply to only 2 per cent in 1964 and remained at the very low annual rate of 2.7 per cent throughout the rest of the 1960's.

In order to cope with the increasing balance-of-payments problems in the late 1960's, the Philippine authorities drew down their international reserves, increased their borrowing from American banks and also borrowed from the International Monetary Fund in 1967 and 1968. In recent years a consortium of American banks has twice agreed to a stretch-out of central bank short-term indebtedness. In October 1968, the Philippine central bank converted $81 million of its short-term debt to medium-term loans, and in October 1970 about $225 million of central bank debt, due mostly to American commercial banks, was converted to medium-term credits. These actions, of course, accomplished nothing to restoring international equilibrium and merely postponed the eventual day of reckoning. Strong action to deal with the problem, which by early 1969 was quite serious, was put off until after the Presidential elections in November of 1969.

<u>Philippine external debt</u>--In the meantime, the Philippine external debt increased substantially in the late 1960's. Outstanding public and private foreign debt increased from about $600 million at the end of 1966 to about $1.0 billion at the end of 1967. In 1968 and 1969 it increased a further $300 million and $400 million, respectively, to total about $1.7 billion at the beginning of 1970.

The structure and size of the debt has created some serious problems for the Philippines. About one-fourth of the debt is payable this year and an additional two-thirds is scheduled to be repaid within the next four years. This has burdened the Philippines with a high ratio of debt service to gross foreign exchange earnings. The ratio is estimated to be 33 per cent this year and about 30 per cent per year over the next four years. In effect, the heavy borrowing permitted the Philippines to maintain relatively stable prices in 1968-69, but the country will be paying for this stability in the early 1970's by way of the heavy burden of foreign debt.

<u>Stabilization Effort in 1970</u>

The second major effort of the postwar period to restore basic equilibrium to the Philippine economy was initiated in February of 1970. As a result of an agreement reached with the International Monetary Fund, the Philippines agreed to let the peso float freely on the foreign exchange market, to remove many of the foreign exchange controls that had been reimposed in the late 1960's, to restrain credit expansion, and to reduce the size of the government's budget deficit.

<u>Freeing the peso</u>--As indicated earlier, the free market rate for the peso depreciated from ₱3.90 to the dollar on February 20, 1970, to ₱6.43 to the dollar in early October of 1970 and it has been pegged ever since at that level. Export taxes of 8 to 10 per cent are currently charged on approximately 22 major export commodities. These export taxes

(which are officially called "stabilization taxes") are to be reduced 2 percentage points a year and eliminated altogether on June 30, 1974, unless the Philippine Congress passes new legislation slowing down the phase-out of the taxes. Importers are still not free to import any commodities that they desire, since imports are subject to an informal and selective control system. Approval is currently not being granted for about 900 consumer commodities which have been classified as non-essential, semi-unclassified, and unclassified. In addition, imports of completely-knocked-down automobile units, rice, corn, used clothing, certain raw coffee beans, and four types of vegetables are prohibited. Virginia tobacco can be imported only on a one-to-four basis for the purpose of blending with tobacco exports, and approval is granted on a case-by-case basis for most machinery and equipment imports with a unit value of $50,000 or higher.

Balance of payments improved--As a result of the various actions taken since February of 1970, the Philippine balance-of-payments position has improved, international reserves have increased, the budget deficit has declined, and bank credit expansion has decelerated. During 1970 commodity exports rose 24 per cent over the previous year to a level of $1,082 million. Imports, on the other hand, declined 4 per cent in 1970 and totaled $1,090 million. As a result of these favorable developments, the trade deficit decreased sharply from $257 million in 1969 to only $8 million in 1970. The current account deficit registered a similar improvement, declining from $234 million in 1969 to $48 million in 1970. The overall balance-of-payments position changed from a deficit of $136 million in 1969 to a surplus of $38 million in 1970.

As a result of this improvement in the balance of payments, gross official international reserves increased from $121 million at the end of 1969 to $251 million at the end of 1970. By April 30 of this year they had increased further to $277 million.

The government's budget deficit has also been reduced substantially. In the fiscal year ending June 30, 1970, current receipts covered only 69 per cent of total central government expenditures, but for the past fiscal year, it is estimated that about 91 per cent of expenditures will be covered by current receipts. Unfortunately, this improved budget performance is due mainly to the new export taxes mentioned earlier, and an increase in tariffs on crude oil, beverages, fruits, and various other imports.

As a result of tighter monetary and fiscal measures, the rate of domestic credit expansion slackened from 17 per cent in 1969 to 11 per cent in 1970. This slackening in the rate of credit expansion largely reflected the improved fiscal performance. The money stock generally declined through August of 1970 and then increased sharply by 15 per cent in September-December, mainly because of the increase in Philippine international reserves.

Sharp rise in domestic prices--Unfortunately, there has been a very sharp rise in Philippine prices since early 1970. In the four years prior to 1970, consumer and wholesale prices increased at an average annual rate of 3.4 and 3.1 per cent, respectively. But in 1970, consumer prices (12-month average) were 17 per cent higher than in the previous year, and wholesale prices were 19 per cent higher. The latest data indicate an even higher rate of inflation, reminiscent of some of the Latin American rates of inflation. In the first quarter of this year, consumer prices were 23 per cent higher than in the same period a year earlier.

Some of the major factors creating the upward price pressures were the effects of the devaluation of the peso, increases in statutory minimum wage rates as well as in public utility rates, disruptions to business operations caused by civil disturbances, continued import restrictions, and a series of destructive typhoons which damaged crops and idled industrial establishments. The 1970 increase in prices was broad-based, and included both domestic and imported goods.

Brief mention should also be made of the adverse impact on the economy of the reduction in U. S. military expenditures in the Philippines. On a balance-of-payments basis, these have been declining in recent years, and fell from a peak of $95 million in 1968 to about $30 million in 1970. This aspect further underlines the need for adequate policy measures to maintain a high level of export growth in the years ahead.

Conclusions

In view of the major economic developments just discussed, it is clear that the Philippines needs to continue its efforts to restore and maintain equilibrium in both the internal and external sectors of the economy. Among other things, this will involve the avoidance of inflationary government budget operations, restraining the rate of aggregate credit expansion, and maintaining a realistic exchange rate for the peso. Other important measures include the eventual elimination of exchange controls, the phasing out by 1974 of all export taxes, and the introduction of a more realistic structure of interest rates in order to mobilize a greater volume of domestic savings. A first step in connection with this last objective would be to amend the 1916 usury law.

One of the major economic problems in the Philippines--from a subjective point of view--relates to the matter of attitudes. What is essentially needed is a more outward-looking attitude. This would involve making the investment climate in the Philippines as attractive as in such neighboring countries as Indonesia, Korea, and Taiwan. It would involve perceiving the importance of a strong international reserve position. (In some Philippine sectors, a rise in international reserves is viewed as a deterrent to economic growth.) It would involve getting concerned if the exchange rate becomes unrealistic. In this connection, it is not reassuring that the free rate for the peso in Hong Kong is now about ₱7.00 to the dollar, and that the exchange rate for the peso is no longer being allowed to float, despite the current rate of inflation of about 23 per cent. Consideration might be given to introducing the successful Brazilian system of small periodic adjustments in the exchange rate so as to maintain a high rate of export growth.

Unless a determined effort is made by the Philippines in the coming years to undertake many of the measures just described the economic gains made since February of last year could be frittered away and the country could again experience the kinds of balance-of-payments difficulties it has had in the past.