THE CASE FOR PESO DEVALUATION

FRANK H. GOLAY*

During recent months, the Philippines has witnessed a violent controversy over economic policy which was focussed on the question of the peso exchange rate.[1] A temporary lull in the controversy was brought about by (a) the decision of President Magsaysay to reappoint Governor Cuaderno of the Central Bank; (b) the resignation of Chairman Montelibano of the National Economic Council; and (c) the successful mission of Governor Cuaderno to the United States to obtain dollar loans to bolster the sagging Philippine foreign exchange reserves.

The purpose of this paper is to develop the economic case for devaluation of the peso. Such an objective not only reflects the belief that a persuasive case can be made for this policy alternative, but that such an approach represents a convenient framework for assembling economic facts relevant to this important policy issue.

I

The principal objective of peso devaluation should be to stimulate Philippine export production and trade in order to earn larger amounts of foreign exchange. Increased foreign exchange earnings would, of course, be utilized (a) to provide more imports, (b) to expand other foreign exchange payments, and (3) to add to foreign exchange reserves.

The Philippines has not shared in the world-wide expansion in trade which has taken place in the postwar period. The volume of world trade in 1954 was 155 per cent of world trade in 1937-38.

TABLE I

WORLD EXPORTS: INDICES OF QUANTUM[2]

(Average 1937-38 = 100)

	World	*Europe*	*North America*	*Rest of World*
1951	140	142	215	108
1952	137	136	223	105
1953	147	150	231	113
1954	155	171	228	n.a.

* Professor, Institute of Asian Studies, University of the Philippines. The author, a member of the Department of Economics, Cornell University, spent 1955-56 in the Philippines on a Fulbright research grant. The opinions expressed in this paper are solely the author's.

[1] The controversy ranged over many questions of economic policy. However, the principal issues were those which involved the peso exchange rate either directly or indirectly. It was unfortunate that the advocates of devaluation chose to be circumscribed by avowals of support for a "sound peso" and were therefore in the unhappy position of denying the logical consequences of the policy alternatives they advocated.

[2] UNITED NATIONS, YEARBOOK OF INTERNATIONAL TRADE STATISTICS FOR 1953 at 18; for 1954 at 20. Excludes trade of Soviet Bloc.

Philippine exports during 1951-54 probably have averaged somewhat less than the volume of pre-war exports.[3] While this performance is comparable to that of Burma, Indonesia, Indocina, India, and Japan, it is inferior to the performance of many countries with a commodity pattern of trade similar to that of the Philippines and whose relative prices, as compared to pre-war, are not as inflated as in the Philippines.

TABLE II
EXPORTS OF SELECTED COUNTRIES: INDICES OF QUANTUM[4]

	Philippines (1937-40 = 100)		
	Excluding gold production	*Including gold production*[5]	*Malaya* (1938 = 100)
1952	105	93	156
1953	94	85	144
1954	109	95	158
	Cuba (1935-39 = 100)	*Australia* (1937-40 = 100)	*Mauritius* (1938 = 100)
1952	162	94	162
1953	167	118	164
1954	n.a.	115	168

The postwar expansion in world trade has not been shared equally between manufacturers and primary products (foods and raw materials) and trade in manufactures has expanded relative to trade in raw materials. Exports of North America and Western Europe expanded relative to those of other areas, while the developing, primary producing areas of Asia, Africa, and South America have not shared proportionately in the expansion in world trade.

The explanation of the failure of many primary producing countries to share in the general expansion in world trade has two principal elements. First, the income elasticity of demand for primary

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[3] Comparisons of the volume of pre-war and post-war export trade are materially affected by the base period selected for comparison. For example, comparisons made using 1937 as the base show post-war (1951-54) Philippine exports substantially larger than pre-war (1937). Such a comparison is of limited validity inasmuch as Philippine exports in 1937 were at low levels as compared to succeeding years. See UNITED NATIONS, YEARBOOK OF INTERNATIONAL TRADE STATISTICS FOR 1954 at 431 (1955).

[4] *Ibid.* Selection of countries for comparison primarily reflects availability of statistics.

[5] Official quantum indices do not include either gold production or trade. For purposes of assessing the impact of the existing exchange rates on foreign exchange earnings, such exclusion is unwarranted. With the exception of a negligible quantity of gold output diverted to domestic industry, Philippine gold production is used either to make payments abroad (imports, profit remission, disinvestment, etc.) or is added to foreign exchange reserves.

Philippine gold production during 1937-40 averaged ₱67.1 million annually or 26.3 per cent of average annual non-gold exports of ₱254.6 million during this period. Gold production has been introduced into the index by using the value of gold production in 1937-40 as the appropriate weight. Gold production (valued at ₱70 per ounce) amounted to ₱32.8 million, ₱33.6 million and ₱29.1 million in 1952, 1953, and 1954 respectively.

commodities tends to be relatively inelastic as compared to manufactures. As production and real incomes expanded throughout the world during the postwar period, a smaller proportion of income was spent on primary commodities, particularly foods. Therefore, production and trade in these commodities expanded less rapidly than production and trade in manufactures.

Second, recovery of production and exports in primary producing countries has been retarded by conditions which have tended to over-value the currencies of these countries and therefore to reduce the profitability of production for export. The principal explanation of the relative inflation in many developing, primary producing countries was the slow restoration of productive capacity destroyed during the war. Moreover, the prevailing political instability in many countries not only prevented newly independent governments from raising adequate revenues, but deteriorating security conditions severely handicapped recovery of production.[6]

Analysis of specific export commodities further supports the impression that the Philippines has not shared in the postwar expansion in production and trade. An attempt to analyze the impact of the peso exchange rate on Philippine export trade not only involves a comparison of Philippine exports of specific commodities to world trade in these commodities, but also a comparison of Philippine production to world production of such commodities. Over-valued currencies and the slow recovery of production have not only affected the volume of trade in primary commodities, but the relatively high prices (i.e., reduced quantities provided by world trade) have induced consuming countries to expand domestic production of these and competing commodities in order to obtain required supplies of these commodities.

In the case of sugar, Philippine exports in 1952-53 averaged only 95 per cent of 1934-38 sugar exports, while world trade in sugar had expanded to 123 per cent of pre-war. Moreover, the period was characterized by relative expansion of sugar production in consuming countries, so that world trade provided a declining proportion of world sugar consumption. If Philippine sugar exports had expanded

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[6] Such a generalization should be surrounded by many caveats. For example, the partial recovery of trade in primary commodities is hardly consistent with the favorable prices which have prevailed for many commodities, e.g., rice, hard fibers, non-ferrous metals, etc. However, analysis of such policies as export taxation, double-pricing systems for agricultural commodities, and multiple exchange rates reveals that many countries have implemented policies which tended to prevent favorable prices from exerting their influence on production and trade.

at the same rate as world exports, current Philippine sugar exports would be 30 per cent larger than at present.[7]

TABLE III
SUGAR: PRODUCTION AND TRADE[8]
(000,000 metric tons)

	Average 1934-38	*Average* 1952-53	*Index* 1952-53 (1934-38 = 100)
World production	22.6	32.5	144
Philippine production	.96	1.13	117
World trade	11.5	14.2	123
Philippine trade	.86	.82	95

In the case of hard fibers which are competitive with abaca in world markets, a similar picture emerges. Philippine exports in 1952-53 averaged only 61 per cent of 1934-38 exports of hard fibers, while world trade had expanded to 110 per cent of prewar levels. The period was characterized by a relative expansion of hard fibers production in consuming countries so that world trade provided a declining proportion of world hard fiber consumption.[9] If Philippine hard fiber exports had expanded at the same rate as world exports, current Philippine exports would be expanded by 80 per cent. Similarly, if Philippine hard fiber production had kept abreast of the rest of the world, Philippine production would be 111 per cent greater than at present.

TABLE IV
HARD FIBERS: PRODUCTION AND TRADE[10]
(000 metric tons)

	Average 1934-38	*Average* 1952-53	*Index* 1952-53 (1934-38 = 100)
World production excluding Philippines	421	552	131
Philippine production	199	123	62
World trade	390	430	110
Philippine trade	180	110	61

[7] Philippine adherence to the International Sugar Agreement is occasionally cited as an obstacle to expansion in Philippine sugar exports. It is unlikely that the Philippines would, or should, allow membership in the International Sugar Agreement to be an obstacle to the implementation of policies designed to restore the pre-war position of the Philippines in sugar production and trade.

[8] UNITED NATIONS, FOOD AND AGRICULTURAL ORGANIZATION, YEARBOOK OF FOOD AND AGRICULTURAL STATISTICS FOR 1954, Vol. I (Production), Vol. II (Trade), New York (1955). Sugar production and trade includes raw sugar, refined sugar, molasses and such products as muscovado converted to centrifugal raw sugar equivalent.

[9] Actually, such a comparison understates the relative decline in trade in hard fibers because to a considerable extent synthetic fibers (nylon, etc.) have been introduced in cordage manufacture as a substitute for natural hard fibers. Moreover, there has probably been considerable substitution of wire rope for cordage.

[10] UNITED NATIONS, FOOD AND AGRICULTURAL ORGANIZATION, *op. cit. supra* note 8. Hard fibers include: abaca, sisal, henequin, maguey, salvador sisal, and tula istle.

In the case of vegetable oil equivalent, Philippine exports sharply expanded over pre-war levels. Philippine exports in 1952-53 averaged 133 per cent of prewar, while world trade had declined to 78 per cent of prewar. In spite of the substantial expansion in Philippine exports, Philippine production of vegetable oil equivalent increased less than world production as consuming countries rapidly expanded production of oil seeds and oil kernels.

TABLE V
VEGETABLE OIL EQUIVALENT: PRODUCTION AND TRADE[11]

(000 metric tons)

	Average 1934-38	*Average* 1952-53	*Index* 1952-53 (1934-38 = 100)
World production	14,500	17,500	121
Philippine production	496	575	116
World trade	4,930	3,860	78
Philippine trade	345	470	133

Philippine gold production also has failed to make a recovery in the postwar period comparable to the recovery of world production. Although there have been extensive premium markets and subsidy schemes which have significantly affected the returns to gold producers, the basic price of gold of $35 per ounce has remained unchanged since 1933 while prices and production costs have risen throughout the world. The fixed price of gold has had a pronounced effect on world gold production which in 1952-53 amounted to only 73 per cent of prewar. Philippine production on the other hand, amounted to only 48 per cent of 1937-41.

TABLE VI
GOLD PRODUCTION[12]

(000 kilograms)

	Average 1937-41	*Average* 1952-53	*Index* 1952-53 (1937-42 = 100)
World production	1009	741	73
Philippine production	30.6	14.8	48

Not only has Philippine gold production made only a partial recovery, but the various schemes for stimulating gold production which have been implemented in the Philippines,[13] including outright subsidy and permission to make premium sales outside the exchange

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[11] *Ibid.* Production and trade in vegetable oil, oil seeds and kernels converted to oil equivalent. Includes: olive oil, palm oil, soy bean oil (15.5%), cotton seed oil (15.5%), linseed oil (27%), rape seed oil (40%), sesame seed oil (55%), sunflower seed oil (28%), coconut oil (63%), castor bean oil (46%) and peanut oil (43%). Where it was necessary to convert seeds and kernels to oil equivalents, the ratios used are indicated in parentheses.

[12] UNITED NATIONS, STATISTICAL YEARBOOK FOR 1954 (1955).

[13] For a short, concise account of Philippine policy with respect to gold production and the exchange control system, see AMERICAN CHAMBER OF COMMERCE JOURNAL, Vol. XXXII, No. 1, January 1956 at 9-10.

and import control system have been important obstacles to effective implementation of exchange and import controls.[14] For example, during 1949-1955, Philippine gold production totalled 2.8 million ounces of which 403,181 ounces were sold to the Central Bank. The remaining output, totalling 2.4 million ounces valued at P168 million at the official (P70 per ounce) price of gold was marketed at premium prices outside the control system.[15]

The four groups of commodities analyzed accounted for eighty-three per cent of the value of Philippine exports during 1937-40. If Philippine production and trade in these commodities had expanded at the same rate that world production and trade in these commodities have expanded in recent years, Philippine foreign exchange earnings would be substantially greater than they are today.

What conditions are necessary for devaluation to produce larger foreign exchange earnings from exports? First, higher peso prices will have to induce an expansion in export production. The existence of underemployed and unemployed resources will facilitate expansion of export production. Such expansion will not require bidding away resources from other uses which would tend to produce inflationary increases in resource prices (wage rates, interest rates, and land rents). The postwar expansion in Philippine base metals production, the response of Virginia leaf tobacco producers, and the impending expansion in Philippine coffee production suggest that Philippine producers, both large and small, respond rationally to favorable peso prices.[16]

Second, will an expansion in Philippine exports produce larger foreign exchange earnings. This will depend upon the elasticity of demand for Philippine exports. While it is conceivable that an increase in Philippine exports would produce a relatively large decline in world prices and therefore in foreign exchange proceeds, such a result is unlikely. The marginal increase in Philippine export production would be sold in world markets at world prices and a relatively large expansion in Philippine exports will represent a relatively smaller change in world supplies of any competitive commodity group. Economists have long understood that regardless of the elasticity of world demand, the elasticity of demand confronting a single country supplying only a small part of the supply entering world

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[14] Exchange and import controls are technically successful to the extent that all exchange transactions are channelled through the control authority.

[15] AMERICAN CHAMBER OF COMMERCE JOURNAL, Vol. XXXII, No. 3, March 1956 at 125.

[16] Devaluation will tend to make profitable production of commodities which are not profitable at the present peso exchange rate. The relevant appraisal of the response of export production to higher peso prices resulting from devaluation should include potential as well as existing export commodities.

trade will tend to be relatively elastic. Appraisal of peso devaluation should, of course, consider the probability of retaliatory devalution by competing producers. The chances of retaliation will be minimized in a period of expanding world production and trade.[17]

The recommendation that Philippine production for export be expanded (particularly if made by a non-Filipino) may be discredited by the contention that the spokesman is advocating a policy which will perpetuate the "colonial" characteristics of the Philippine economy, i.e., the lopsided dependence on primary production for export.

If devaluation is rejected on grounds that further expansion in primary production for export is not in the interest of the Philippines, the assumptions implicit in this argument should be thoroughly understood. Such a position involves the belief that primary production for export and more "desirable" production to replace imports and to supply the domestic market are alternatives — that investment in export industries is somehow investment that otherwise would be made in domestic production. This is clearly specious in an economy where there are unemployed and underemployed resources. In all cases of relatively rapid economic development, primary production has not declined as industrialization took place, but expanded at the same time. Moreover, analysis of cases of accelerated economic growth does not indicate that development is accompanied by a decline in raw material production and exports but an absolute increase although a relative decline in the importance of such production and trade. Resources invested in Philippine export production are not resources denied to Philippine industrialization although many appraisals of Philippine economic policy reflect such a belief.

Second, such an argument betrays a failure to understand the economic rationale for foreign trade. Economists have long understood that specialization and trade are techniques of indirect production which increase production efficiency.[18]

What will be the impact of devaluation on other foreign exchange receipts? An argument against devaluation arises when

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[17] There are healthy differences of opinion regarding the potential efficacy of devaluation on production for export and upon foreign exchange proceeds. For example, Governor Cuaderno of the Central Bank of the Philippines has been quoted as follows: "Considering the elasticity of world demand, there is no indication that after devaluing the Philippine peso, foreign exchange earnings in foreign markets of the principal export products of the island would increase. It does not seem possible also, that the production of commodities for export (except sugar which has a limited market) would increase appreciably. Moreover, there is no assurance that competitor countries would not take retaliatory measures." Manila Daily Bulletin, May 11, 1956, p. 20.

[18] For example, the Philippines can produce automobiles directly or can produce sugar, copper, abaca, etc., which can be exchanged for automobiles.

there are substantial amounts of foreign exchange receipts fixed in peso amount and which, in event of devaluation, would tend to be reduced by the ratio of devaluation.[19] An example of such payments would be current United States military outlays in the Philippines for bases construction. If the peso should be devalued, it would require fewer dollars to accomplish an equivalent amount of construction and Philippine foreign exchange earnings would thereby be reduced.

The importance of this argument in appraisal of devaluation will depend upon the volume of Philippine foreign exchange receipts used to make peso payments and which therefore are related to the exchange value of the peso. The principal non-trade receipts are those received by beneficiaries of United States Veteran's Administration outlays for pensions, "G.I." benefits, disability payments, etc. The bulk of United States Veteran's Administration payments are denominated in dollars and would not be affected by the peso exchange rate.[20] Another large element in non-trade receipts are United States economic and military aid payments. Would a devaluation be followed by a reduction in the dollar amounts of such payments? There is considerable evidence that relative costs play a minor role in the allocation of United States economic and military aid. The distribution of aid appropriations seems to reflect strategic and political considerations rather than economic considerations. To the extent that this is true, the dollar payments (Philippine dollar receipts) will be independent of the peso exchange rate. It is unlikely that the United States would react to a devaluation of the peso by reducing the relative size of the Philippine economic and military aid program.

The impact of devaluation on foreign investment is impossible to predict—there would be consequences which would favor investment and consequences which would adversely affect foreign investment. To the extent that devaluation would reduce the peso costs of investment, it would induce larger amounts of investment which would tend to offset the reduction in dollar receipts.[21] Similarly, to the extent that devaluation increases the profitability of export pro-

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[19] For an exposition of this argument as applied to the Philippines, *see* Charles Wolf, Jr. and Konrad Bekker, *The Philippine Balance of Payments*, FAR EASTERN SURVEY, Vol. 19, February 22, 1950, pp. 4-43.

[20] It should be pointed out that for years the recipients of Veteran's Administration payments have been required to sell them to the Central Bank at the unrealistic "official" rate of two pesos per dollar. An appropriate devaluation would introduce a desirable equity into the treatment of this group of Philippine citizens.

[21] To the extent that foreign investment represents foreign exchange costs, i.e., imports of materials, plant and equipment, such investment does not affect Philippine foreign exchange receipts or payments.

duction, it will induce greater foreign investment in export production where such investment has tended to be concentrated. Moreover, to the extent devaluation increases protection to domestic industries by increasing the cost of imports, investment (both Philippine and foreign) in production for the domestic market will be increased.

On the other hand, to the extent that devaluation increases the peso costs of imported capital goods, domestic investment would be reduced. Similarly, devaluation will tend to reduce the profitability (in terms of foreign currencies) of existing foreign investment by making less favorable the rate at which peso profits can be converted into foreign currencies.

Of course, it is unrealistic to analyze the effects of devaluation on foreign investment in isolation. If some combination of tariff and exchange rate policies (devaluation) should make it possible for the Philippines to reduce the intensity of controls on foreign payments, the benefits on foreign investment might be substantial. There is considerable evidence that potential foreign investors are reluctant to endure the uncertainties which inevitably accompany the administration of stringent import and exchange controls. On balance, it would seem that devaluation would not reduce foreign investment and might very well induce a significant expansion in such receipts.

With regard to other payments, the impact will be mixed. Inward remittances, to the extent that the remitter takes into consideration the peso cost of living, would tend to decline in terms of foreign currencies. Receipts from tourism would tend to decline immediately as the tourist's foreign exchange would purchase more pesos. However, to the extent that a more favorable peso exchange rate induces more tourists to visit the Philippines, it would tend to maintain or even to increase foreign exchange receipts. Freight and insurance costs would be higher in pesos, but would not change in terms of foreign currencies. Similarly, peso costs of Philippine travel abroad would be higher while peso costs of a given amount of foreign purchasing power in remittances would increase. Under these circumstances, there would be an increase in the peso outlays for such payments.

It is necessary to take into consideration the impact of existing exchange controls which have severely limited Philippine non-trade payments for remittances, transfers of profits and disinvestment, tourism, etc. If devaluation, together with appropriate tariff policies should be followed by relaxation or removal of controls, the immediate consequence would probably be an increase in foreign exchange

payments for these purposes — in spite of the substantial increase in the peso costs of such payments. However, as has been pointed out, this is a hoped for consequence of devaluation — that the stimulus to export industries would bring about an increase in foreign exchange proceeds which would support higher levels of Philippine imports and other payments.

A second major argument for devaluation involves the belief that devaluation, combined with recent (and prospective) changes in Philippine tariff policy will minimize the "latent disequilibrium" in Philippine external payments.[22] To the extent that such disequilibrium is reduced, the adverse consequences of exchange and import controls will be minimized.[23]

The restriction of imports and other foreign payments by the control ssytem has established strong economic incentives. As might be expected, the leading opponents of devaluation include those who are benefitting economically from the structure of import and exchange controls. The principal beneficiaries have been the participants in importing activities who have shared in the windfall arising out of import restriction. The past six and a half years of controls have witnessed the growth of strong interests with a stake in continuation of the control system.

For example, one government policy which will be adversely affected by devaluation will be "Filipinization" of import and retail trade which has been increasingly implemented by exchange and import controls. The capacity of Filipinos to take over import and retail activities is facilitated by the system of controls. First, the system of controls permit arbitrary allocation of increasing amounts of available foreign exchange to Filipino importers. Second, the restriction of import quantities ensures that participation in importing and retailing activities will be relatively profitable. Relatively in-

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[22] The term "latent disequilibrium" is introduced here because it is true that equilibrium in Philippine external payments has been maintained since 1949 by exchange and import controls which severely restricted imports and other foreign payments to the level of available foreign exchange. However, probably no one would argue that if controls were removed, external payments would be in substantial equilibrium. Devaluation of the peso together with new tariff rates which went into effect following the revision of the Philippine-United States Trade Agreement might very well reduce the "latent disequilibrium" to the point where some part of the control structure could be dismantled.

[23] There has been little Philippine discussion of the far reaching change in Philippine tariff policy which has materialized in recent months. First, the revised Philippine-United States Trade Agreement provides for rapid acceleration in the proportion of Philippine tariff duties collected on imports from the United States. Second, Executive Order No. 150 of December 31, 1955 provided for substantial increases in Philippine tariff rates. Third, the Philippine Congress is in the process of establishing a new tariff policy and there are strong indications that new legislation will sharply increase basic tariff rates.

experienced Filipino business men are given a significant competitive advantage under the current "trade nationalization" program.[24]

The argument presented here is not to be construed as a case for immediate dismantling of the control structure. The utility of exchange and import controls has been widely demonstrated since the beginning of World War I. Many countries have learned to utilize exchange and import controls to implement a wide range of economic policies only remotely related to the maintenance of equilibrium in foreign payments.[25] The undesirable consequences of exchange and import controls do not arise out of the control structure, but are in proportion to the intensity of controls, i.e., the extent to which controls restrict imports and result in peso prices of imports in excess of their peso costs.

This leads to a further observation regarding the timing of the dismantling of the control system. No economist would argue that the effects of devaluation will be instantaneous. This will be particularly true of the effects of devaluation on export proceeds. Foreign exchange earnings will increase only as production increases, i.e., to the extent that supply is elastic. Output of some Philippine export commodities may respond relatively quickly to the stimulation of devaluation, e.g., lumber production and some mineral output. On the other hand, for the bulk of Philippine export commodities, the expansion of supply can only be relatively slow. The beneficial consequences of devaluation will accumulate for a prolonged period following devaluation. For this reason, it may be desirable to retain the structure of import and exchange controls.

Producers/exporters, particularly the spokesmen for the sugar industry have attempted to make a case for devaluation on consideration of equity involved in this policy decision. They have argued that it is "inequitable" that they be required to surrender their export proceeds to the Central Bank at the rate of two pesos per dollar while the foreign exchange, which in terms of relative purchasing

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[24] This observation should not be interpreted as a criticism of the "Filipinization" policy. However, the bulk of Filipinos who subsidize the "new" Filipino importers and retailers through the relatively high prices paid for imported commodities have the right to expect that this subsidy will not be permanent. The case for "Filipinization" which is analogous to the "infant industry" argument for protection never suggests that the subsidization by high import prices and guaranteed profits for new Filipino traders will be continued indefinitely at the expense of the consuming public.

[25] The suggestion that there is a case for exchange and import controls will be poorly received by many economists. However, the usefulness of controls to economic mobilization for war is probably no longer controversial.

power of currencies is worth much more, is allocated to importers in exchange for pesos at the rate of 2.34 pesos per dollar.[26]

This argument has no place in the case for devaluation developed here. The decision to devalue should reflect the interests that the Philippine government did not accompany exchange and import controls (beginning in 1949) with complementary policies which would have diverted the windfall arising out of the restriction of imports to the government where it could have served the interests of all the Philippines.[27]

Present levels of Philippine export production and trade are not unprofitable. The low levels of export production and trade reflect the response of entrepreneurs to profit prospects inherent in the official rate of exchange for the peso. The entrepreneur, confronted by adverse profit expectations restores the profitability of his activities by reducing the scale of his activities. This is the fundamental explanation of the relatively retarded levels of Philippine export production and trade. The basic argument for devaluation is that it will stimulate relatively stagnant export industries and thereby increase foreign exchange earnings. Therefore, with the important exception of the sugar industry, devaluation should be permitted to exert maximum effect upon the profitability of export production. There will be strong pressure to divert to the government by export taxation, any windfall on current levels of exports which will arise from devaluation.[28] Such a policy will go far to counteract the potential benefits from devaluation and therefore should be strongly resisted.

The Philippine sugar industry is clearly a special case. Exports of sugar under the Phillppine quota in the United States market as well as sales in the domestic (Philippine) market have been highly profitable. This arises out of the fact that the United States implements a sugar price policy designed to bring about domestic (U.S.) sugar production equal currently to about one fourth of United States sugar consumption.[28a] Inasmuch as the United States is at a comparative disadvantage in the production of sugar, to provide a sufficient

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[26] To be realistic, the Special Import Tax of 17 per cent which became effective on January 1, 1956, should be considered as replacing the Special Tax on Sales of Exchange. The effect of these taxes has been to make the effective rate of exchange for import payments equivalent to 2.34 pesos per dollar.

[27] The recent changes in Philippine tariff policy should go far toward achieving this policy objective.

[28] The peso proceeds from current (pre-devaluation) levels of exports would tend to increase in proportion to the ratio of devaluation.

[28a] During 1948-53, continental United States produced 11.8 million metric tons of sugar. This amounted to 27.8 per cent of United States sugar availability during this period. UNITED NATIONS, FOOD AND AGRICULTORAL ORGANIZATION, YEARBOOK OF FOOD AND AGRICULTURAL STATISTICS, Vol. VIII (1954), Part I, (Production) and Part II (Trade).

incentive to bring about the desired domestic production, sugar imports into the United States are limited by absolute quota to levels which results in a price for sugar in tht United States currently approximately double the world (free) market price of sugar. The principal beneficiaries of this policy are the sugar producers in those countries assigned a quota in the United States market.

The monopoly windfall to Philippine sugar producers with quotas in the United States market has been extended to all Philippine sugar production by the implementation of domestic (Philippine) sugar price policies which result in a peso price for sugar to Philippine consumers equivalent (abstracting from transportation differentials) to the United States price.

The profitability of Philippine sugar production quotas is readily confirmed. First, Philippine sugar exports have tended both in the prewar and postwar period to be stabilized at the level of the United States quota and to be made almost exclusively to the United States. Second, there exists an active market for unused annual quota rights in which the privilege of exporting sugar to the United States is given a monetary value. Similarly, there are many owners of sugar quota lands who do not grow sugar, but who live off the proceeds of the "rental" of quota rights to bonafide sugar producers.[29]

The case for devaluation therefore must recognize that the sugar industry, already profitable because of access to the sheltered United States market, is a special case in which the stimulus of devaluation should be allowed to exert maximum influence on marginal production but must not be allowed to swell the existing monopoly returns to this industry. It would not require exceptional patriotism on the part of the Philippine sugar industry if it should take the initiative in proposing policies which would divert any windfall on existing production arising out of devaluation to the government where it be-

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[29] Whether intended or not, one consequence of United States sugar price policy has been to subsidize the Philippine economy to the extent of the difference between the proceeds of Philippine sugar exports to the United States and the value of these exports in the world sugar market. Currently, this subsidy amounts to approximately one half of Philippine sugar export proceeds or around ₱100 million, or about three times current levels of United States economic aid. It is difficult to conceive a less efficient way to subsidize the Philippine economy which must rely on a "trickling down" process by which the monopoly profits of the sugar industry are diffused to the rest of the economy through the consumption and investment expenditures of participants in the sugar industry. In other words, the windfall arising out of United States sugar price policies to which the claim of the Philippine people is paramount, has exerted only a fraction of the potential contribution that it might have made to Philippine economic growth. The Philippine government as well as the United States must share the blame for the failure to divert this windfall to the Philippine government where it belongs. For example, the United States tried to guarantee this inefficient process by prohibiting Philippine export taxation in the 1946 Trade Agreement.

longs, and content itself with the possibility of expanding sugar exports to markets other than the United States.[30]

Another argument for devaluation rests on the probable impact of such a policy on government revenues. The realization of Philippine aspirations for accelerated economic growth will ultimately depend upon the rate of Philippine capital formation (investment) including social investment by the government. Current levels of Philippine capital formation are relatively low when compared with the capital formation required in cases of rapid economic growth. Government economic functions are severely limited by present levels of government revenues.

Devaluation would result in an immediate increase in import (peso) values equal to the ratio of devaluation. Inasmuch as the bulk of import duties are based on value (ad valorem), devaluation would produce substantial amounts of government tariff revenues.[31] To the extent that devaluation results in expanded foreign exchange earnings, this should be followed by an expansion in imports and an increase in tariff revenues. Moreover, to the extent that devaluation increases the profitability of exporting, the possibility of raising revenues by taxation of exports would be increased.[32]

Tending to offset the increase in government revenues arising out of devaluation will be the increase in the cost of government functions arising out of the increase in peso costs of government imports as well as any inflationary increases in the Philippine cost and price structure that might follow devaluation. Inasmuch as the overwhelming bulk of government expenditures are peso expenditures, the expansion in government revenues which would tend to follow devaluation would almost certainly exceed the increase in the peso costs of existing levels of government activities.

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[30] Many Filipinos verbalized their opposition to devaluation in terms of their suspicions that the proponents of devaluation, i.e., the sugar industry, were pursuing their self-interest without concern for the welfare of the country as a whole.

[31] This effect would be reinforced by the substantial increase in effective levels of Philippine tariffs negotiated in the Revised Philippine-United States Trade Agreement. Under this Agreement, the Philippines, beginning January 1, 1956, collects 25 per cent of Philippine tariff duties on imports from the United States. The proportion of Philippine tariff duties collected on imports from the United States increases rapidly and by January 1, 1962, seventy-five per cent of existing tariff rates will be collected. In addition to this basic change in Philippine tariff policy, Executive Order No. 150 of December 31, 1955, increased all Philippine tariff rates by thirty per cent and provided for additional increases up to several hundred per cent in some seventy commodity classifications.

[32] As argued previously, the windfall arising out of current levels of sugar exports under the United States quota would be a logical base for export taxation. With the important exception of existing sugar exports, export taxation should be avoided as it will directly offset the objective of devaluation.

II

The principal argument advanced against devaluation is that it will be inflationary. Following peso devaluation, the foreign currency prices of Philippine imports will tend to remain unchanged, while the peso cost of imports will tend to increase by the ratio of devaluation.[33] This would indeed be the case in a free market situation and there would be a tendency for peso prices to rise by the ratio of devaluation.[34]

Such a conclusion would apply very imperfectly to the Philippines. Since the end of 1949, the Philippines have been implementing stringent import controls under which the quantities of imports have been restricted. The smaller quantities of imports allowed under import controls have been marketed at prices the market would bear, i.e., the lucky holders of import licenses have behaved rationally.

As a result, beginning in 1950, there has been a sharp and persistent divergence of peso prices of imports and the prices of domestically produced goods. This price divergence cannot be accounted for by changes in the foreign currency prices of imports, or by such tax measures as the Special Tax on Sales of Foreign Exchange. The logical, and sufficient explanation of the divergence in prices is the impact of import controls and the windfall accruing to importers (and others engaging in import activities) arising out of the restriction of import quantities. The windfall arising out of import restrictions has been the motivation of the anomalies, corruption and bribery which have plagued the implementation of import controls in the Philippines, and which have tended to reduce the confidence of the average Filipino in his government.[35]

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[33] For example, if the peso exchange rate should be changed to three pesos per dollar, an import item which costs $1.00 and which previously could be obtained in exchange for two pesos will now exchange for three pesos.

[34] Implicit in this argument is the belief that while the increase in peso prices of imports would reduce the quantity demanded in the Philippines, the proportion of world import trade accounted for by Philippine imports would be relatively small. Therefore, the decline in Philippine imports (which might be substantial in terms of Philippine imports of a given commodity) would be so small when related to total world trade in a given commodity that the impact of the decline in Philippine imports of a given commodity on the world price of that commodity would be negligible.

[35] The pressures exerted by persons seeking highly profitable import licenses, as well as the anguished protests of individuals whose "economic freedom" has been infringed by import and exchange controls have contributed to the widely held impression that import controls cannot be efficiently or honestly enforced.

TABLE VII
SELECTED STATISTICAL DATA RELEVANT TO APPRAISAL OF THE INTENSITY OF PHILIPPINE IMPORT CONTROLS, 1950-54.[36]

	Volume of imports 1948-49=100	Index of nat'l income 1949=100	Retail prices Manila	Philippine Price Indices 1949 = 100 Wholesale Prices				Unit value of imports 1948-49=100
				Home goods	All imports	Essential imports[37]	Non-essential imports[37]	
1950	61	110	100	92	122	116	128	95
1951	76	123	110	101	153	145	161	108
1952	69	125	106	95	136	127	147	106
1953	72	128	103	93	129	n.a.	n.a.	101
1954	84	132	98	88	125	n.a.	n.a.	97

If the peso should be devalued, the initial reaction of importers would be to raise prices in order to maintain customary "profit" rates including the windfall arising out of import controls. However, the capacity of importer to raise prices may be quite limited. In the first place, if prices are raised a smaller quantity of imports can be marketed. In the absence of a decline in foreign exchange proceeds, any decline in consumption of imports following attempts on the part of importers to "pass on" increased costs arising out of devaluation will reduce the demand on available foreign exchange and additional amounts of foreign exchange will be available for potential importers who did not receive allocations of exchange under the more stringent controls required prior to devaluation. In the absence of a decline in foreign exchange availabilities, "new importers" will presumably have access to foreign exchange "saved" by the reduction in import quantities which would tend to follow increases in the peso prices of imports.[38]

This argument is reinforced when we consider the probable consequences of devaluation on foreign exchange proceeds. With the possible producer, devaluation of the peso and the change in Philippine export supplies will not significantly affect the world prices of Philippine export products. Therefore, there are no

[36] CENTRAL BANK OF THE PHILIPPINES, ANNUAL REPORT, 1954.
[37] CENTRAL BANK OF THE PHILIPPINES, ANNUAL REPORT, 1952.
[38] For example, it was widely predicted in the spring of 1951 that the imposition of the Special Tax on Sales of Exchange would be followed by price increases as importers/retailers "passed on" the tax to consumers. While there was an initial attempt to pass on the cost of the tax, a liberalization of import allocations tended to frustrate the intentions of importers/retailers and by the end of 1951, both wholesale and retail prices of imported goods were at levels prevailing in the first quater of 1951 prior to the enactment of the Special Tax on Sales of Foreign Exchange. Analysis of the behaviour of peso prices of imported goods since 1949 confirms the impression that under stringent import controls, import policy rather than foreign exchange costs, will be the ultimate determinant of the peso prices of imports. For a more detailed analysis of the impact of the Special Tax on Sales of Exchange, see CENTRAL BANK OF THE PHILIPPINES, ANNUAL REPORT, 1951, pp. 14-17, and ANNUAL REPORT, 1952, p. 14.

grounds for believing that devaluation in the short run would adversely affect Philippine foreign exchange proceeds. On the other hand, if, as argued previously, devaluation gives a strong stimulus to export production, over the longer run, this would tend to produce additional amounts of foreign exchange.

If Philippine foreign exchange earnings should increase following devaluation, the additional amounts of foreign exchange can either be used to make foreign payments, including imports, or accumulate as foreign exchange reserves. Given Philippine aspirations for economic growth and the projected increases in income under development plans, accumulation of foreign exchange at a rate which would reduce imports below current levels would be exceedingly irrational. Therefore, if foreign exchange earnings should increase following devaluation, some part of the increased earnings would probably be used to acquire imports. If this would be the case, it would be clearly deflationary, i.e., other things being equal, increased quantities of imports could only be sold at lower peso prices.

To summarize the argument present here, devaluation will produce inflationary increases in import prices only if accompanied by a reduction in the quantity of imports. In the case of the Philippines, there are strong grounds for concluding that devaluation (per se) will not reduce foreign exchange receipts and will probably over the longer run produce substantially larger foreign exchange earnings. If devaluation is followed by a reduction in import quantities—a necessary condition for inflationary increases in import prices—it will result in an irrational increase in Philippine foreign exchange reserves.[39] In view of the avowed governmental policy of fostering economic growth and the objective of price stability, it is almost inconceivable that the government would not take steps to expand imports, i.e., to use the increase in foreign exchange earnings to provide commodities essential to Philippine economic growth.

A second inflationary effect of devaluation will arise out of the increase in peso prices of exports. To the extent that Philippine export commodities are consumed domestically, the peso prices of these commodities will tend to increase by the ratio of devaluation. While this undoubtedly will be inflationary, the consequences should not be exaggerated. For example, in 1953-54, only in the case of coconut oil and logs, timber and lumber, was a major part of production consumed domestically.

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[39] This follows from the fact that Philippine foreign payments, not trade payments alone, have been in balance over the past six and a half years. Therefore, if foreign earnings increase at the same time that payments for imports are reduced by devaluation, an increase in foreign exchange holdings will result.

TABLE VIII
PHILIPPINE PRODUCTION, TRADE, AND CONSUMPTION OF EXPORT COMMODITIES

	(000 metric tons) Average production 1953-54[40]	Average exports 1953-54[41]	Average consumption 1953-54[42]	Value of consumption 1953-54[43] (₱000,000)
	I	II	III	IV
Copra	874	683	191	69.0
Coconut oil	144	62	82	44.6
Copra meal and cake	70.0	69.6	.4	.1
Abaca	106.5	105.0	1.5	.8
Sugar, centrifugal	1165	826	339	82.6
Logs, timber and lumber (000,000 bd. ft.)	1767	489	1287	168.9
Tobacco, leaf	19.7	10.0	9.7	7.2
Total				373.2

The principal export commodities tabulated in Table VIII accounted for ₱626.6 million or 79.4 per cent of average annual exports of ₱789.0 million (f.o.b.) during 1953-54[44] The estimated average annual value of Philippine consumption of these commodities in 1953-54 was ₱373.2 million or 5.2 per cent of estimated average annual private consumption expenditures of ₱7,156 million during this period.[45] It becomes quite evident that the inflationary impact of devaluation on the peso prices of export commodities will directly affect only a relatively small part of Philippine consumption expenditures.[46]

It is also necessary to discuss the impact of devaluation on the price of rice which looms large in the Philippine standard of living. Opponents of devaluation have pointed out that rice is an import commodity. They argue that the price of imported rice will tend to rise by the ratio of devaluation and that the price of the marginal rice imports will determine the price for rice domestically produced. The Philippines are on the margin of rice self-suffi-

[40] CENTRAL BANK OF THE PHILIPPINES, ANNUAL REPORT, 1954, p. 30.
[41] Bureau of Customs.
[42] Column I minus column II.
[43] Ratio of average consumption to average exports (column III/column II) multiplied by the f.o.b. value of exports.
[44] Exports of desiccated coconut, cordage, canned pineapple and ores, concentrates and metals of chromite, iron, manganese and copper, of which virtually the entire Philippine production was exported amounted to ₱116.3 million annually during 1953-54. These commodities together with those tabulated in Table VIII accounted for 94.2 per cent of the value of Philippine exports during 1953-54.
[45] CENTRAL BANK OF THE PHILIPPINES, SIXTH ANNUAL REPORT, 1954, p. 12.
[46] Moreover, it should be pointed out that the increases in prices of export commodities consumed domestically will result in reduced consumption of these commodities and the diversion of additional production to export markets. This will result in increased export earnings.

ciency and imports during 1953-55 amounted to 44,200 metric tons or 1.4 per cent of average annual production during these years. It is, of course, true that in a competitive, free market situation there would be only one price for rice, and the price of all rice consumed in the Philippines would be set by the price (peso) of marginal rice imports.[47] However, it should be pointed out that the government can easily insulate the domestic economy from the impact of the price of marginal rice imports.

Virtually all the countries of the world implement agricultural price policies which insulate domestic agricultural markets from world markets. In countries such as the United States, United Kingdom, and most of Wetsern Europe, policies are implemented which maintain domestic prices above world markets and the producer is thereby subsidized. In Burma, Thailand, India, Ceylon, etc., the reverse is true, and the consumer is subsidized by domestic prices below world prices. It is almost inconceivable that the Philippine government would not take steps following devaluation, to minimize the inflationary impact of the increase in peso costs of the relatively small quantity of marginal rice imports.

Another aspect of the case against devaluation may be summarized at the "incipient inflation" argument. This involves the belief that while the directly inflationary consequences of devaluation are important, more disastrous would be the impact on resistance to inflationary economic policies. It is, of course, true that the potential benefits of devaluation can be dissipated if devaluation is not coordinated with relatively conservative monetary and fiscal policies which would tend to maintain the relative price incentives established by devaluation. For example, it is possible that substantial devaluation, which would stimulate export production would be followed by a large scale development program financed, not by tax receipts, but by the sale of government bonds to the banking system. The injection of income into the economy would tend to increase peso prices and costs which would wipe out the competitive advantage established by devaluation. Similarly, the benefits of devaluation can be dissipated by inflationary monetary policies, i.e., private credit expansion.

The importance of this argument should not be understated. It is true that the recent controversy over economic policy saw the proponents of devaluation arrayed in support of large scale developmental expenditures to be financed by inflationary sales of government bonds.

[47] No producer in a free market situation would sell his rice for less than he could obtain abroad, i.e., he would have the alternative of exporting his rice.

However, it should be pointed out that the "incipient inflation" argument is not an argument against devaluation, which potentially could have imporant beneficial consequences, but is an argument against policies which would dissipate the beneficial consequences of devaluation. Since devaluation will require considerable time to exercise maximum effect on export production and trade, it is essential that complementary economic policies be implemented to prevent the dissipation of the potential benefits of devaluation. Devaluation is not a panacea, and it should only be resorted to only where monetary and fiscal discipline necessary to its success exists.

Finally, it should be pointed out that peso devaluation combined with recent changes in tariff rates will tend to produce substantial amounts of government revenues. While the ultimate impact of an expansion in government revenues on prices and costs will depend upon the use of the additional revenues, they probably will have a deflationary impact. To the extent that increased revenues (a) are not offset by tax reductions, or (b) are utilized to make expenditures which otherwise would be financed by inflationary sales of bond issues to the banking system, the increase in government revenues would tend to be deflationary.

Still another argument encountered in the controversy over devaluation is that devaluation has been tried in a number of postwar situations and has not worked. For example, the consequences of devaluation of the pound sterling in 1949 are dismissed with the observation that the United Kingdom still has a balance of payments problem and is today confronted by inflationary pressures. However, appraisal of the relevant statistics suggests that devaluation in 1949 had the desired effect for those countries which devalued.

The United Kingdom, which by 1947-49 was exporting at levels substantially in excess of prewar, experienced further export expansion in excess of that experienced by the world as a whole. Similarly, all of Western Europe which devalued by varying degrees in 1949 experienced a rapid expansion in exports and increased the relative share of this area in total world exports. While the Philippines experienced a comparable expansion in exports following 1949, this expansion took place from an incomplete recovery of the export industry and as of 1954, Philippine exports probably had not recovered to prewar levels.

On the import side, an informative picture emerges. United Kingdom imports prior to devaluation had been restricted by stringent import and exchange controls to levels compatible with foreign exchange earnings. Following devaluation and an improvement in United Kingdom export earnings, the intensity of controls was re-

duced to bring about an expansion of imports and in recent years United Kingdom imports have expanded to pre-war levels. The expansion of imports following devaluation should not be interpreted as evidence of the ineffectiveness of devaluation, but that policies, i.e., relaxation of controls, were implemented to take advantage of the improvement in export earnings.

TABLE IX
STATISTICS RELEVANT TO APPRAISAL OF EFFECT OF CURRENCY DEVALUATION IN 1949[48]

	Index of export volume average 1937-38=100			Index of import volume average 1936-39=100		
	1947-49	1950-52	1953	1947-49	1950-52	1953
United Kingdom	129	168	166	82	93	99
Non-Soviet Western Europe[49]	82	134	148	n.a.	n.a.	n.a.
Philippines[50]	66	102	102	222	162	169
World excluding the United States	88	123	130	n.a.	n.a.	n.a.
World as a whole	105	134	147	105	134	147

The important impression, so far as the Philippines is concerned, is tha tdevaluation did stimulate exports and was followed by both an absolute increase in the export proceeds of the devaluing countries and an increase in the relative share of these countries in world trade. Moreover, the countries which devalued, utilized the improvement in foreign earnings to do two things; first, they used some part of the increase in foreign exchange earnings to add to reserves, which had declined to such levels that devaluation was necessary, and second, they utilized a portion of the increased foreign exchange earnings to reduce the intensity of import controls and hereby expand imports.

III

The basic argument for devaluation is that it will stimulate export production and thereby increase foreign exchange earnings. The Philippines has not shared proportionately in the world wide expansion in trade which characterized the postwar period. Not only have the export industries remained relatively depressed, but the limited foreign exchange earnings have required the Philippines to exist on lower levels of imports thant would have been necessary if export potentials had been more fully developed.[51]

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[48] UNITED NATIONS, YEARBOOK OF INTERNATIONAL TRADE STATISTICS FOR 1954.

[49] It will be recalled that, with the exception of Switzerland, these countries devalued in the fall of 1949.

[50] For indexes of Philippine imports, 1937 = 100. Philippine export indices do not include production or trade in gold.

[51] For example, Governor Cuaderno of the Central Bank has been cited as of the opinion "that the adoption of the so-called dollar retention system would cause more hardships to the national economy, *especially in this country (Philippines) which does earn enough foreign exchange to pay for the importation of capital goods and materials needed by established industries.*" Manila Daily Bulletin, May 11, 1956, p. 20.

Considerations of equity as well as concern for the welfare of the Philippines as a whole, requires that the sugar industry be given special treatment under peso devaluation. Present sugar production, both for export and domestic consumption, is highly profitable by reason of the Philippine quota in the United States sugar market. It is essential that the windfall arising out of devaluation not be allowed to swell the monopoly windfall accruing to the sugar industry on present levels of production and trade. The claim of all the Philippines to the windfall inherent in the United States sugar quota is paramount. Informed Americans can only deplore the fact that for years the United States has chosen such an inefficient and inequitable technique to inject a substantial subsidy into the Philippine economy.

The principal argument advanced against devaluation is that it will be inflationary. To the extent that devaluation produces an increase in foreign exchange earnings, it will permit an expansion in Philippine import which have been restricted by stringent import and exchange controls. An increase in imports would not be inflationary as it would increase the supply of goods and services available to the Philipine economy.

Appraisal of the economics of peso devaluation leaves on depressed by the basic pessimism implicit in the arguments of the opponents of devaluation. Devaluation is rejected because the Philippines would not be able to expand exports and thereby regain its prewar relative position in international trade. Devaluation is rejected because the Philippines does not have the monetary and fiscal discipline necessary to realize the potential benefits of devaluation. Devaluation is rejected because the Philippine is not potent enough to prevent the relatively small, but articulate and politically powerful sugar industry from increasing further the monopoly returns to this industry. Moreover, the positive program implicit in the anti-devaluation position confronts the Philippines with the prospect of prolonged deflation and economic contraction necessary to make the present official exchange rate a realistic (equilibrium) rate.

The question of exchange rate policy for the Philippines has many ramifications other than questions of equity in the treatment of different economic groups. The welfare of all the Philippines is involved. In particular, it should be pointed out that economic considerations may be involved which relegate the question of potential United States loans to minor importance. The policy decision with respect to devaluation should consider much more than the relative changes of the protagonists receiving (not receiving) a United States loan as a reward (punishment) for the right (wrong) decision.

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