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Volume Title: Developing Country Debt and Economic Performance, Volume 3: Country Studies - Indonesia, Korea, Philippines, Turkey

Volume Author/Editor: Jeffrey D. Sachs and Susan M. Collins, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-30455-8

Volume URL: <http://www.nber.org/books/sach89-2>

Conference Date: September 21-23, 1987

Publication Date: 1989

Chapter Title: Trade Policy, Industrial Policy, and the Exchange Rate

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Chapter URL: <http://www.nber.org/chapters/c9049>

Chapter pages in book: (p. 433 - 460)

became more of a way of assuring foreign currency inflows than a means of creating capital stock. New projects were started as late as 1983, despite delays and stretch-outs of existing projects due to the inability of the government to come up with counterpart funds. Current expenditure, particularly operations and maintenance expenditures, were cut back to sustain investment, in some cases prematurely retiring the existing capital stock.

Finally, the Philippines shifted the public sector deficit from the national government to public corporations and later to government financial institutions and the central bank, using the borrowing ability of each to keep the system afloat, until the process could no longer be sustained.

### 3 Trade Policy, Industrial Policy, and the Exchange Rate

Trade and industrialization policy have been the vortex of Philippine economic debate. Trade policy has been more extensively argued in the Philippines than has any other economic policy, starting with the outcry over the administration of the import control program in the early 1950s and extending through the current debates on import liberalization. This prominence is reflected in research on the Philippine economy, and there is now an extensive literature on Philippine trade and industrial policy.<sup>1</sup> Trade policy issues are also central to our analysis of the Philippine debt crisis. In comparative studies of LDC borrowers, the extent to which exports grew appears to play a key role in determining whether or not countries were forced to reschedule.<sup>2</sup> In the Philippines in particular, trade and industrial policy were powerful forces behind the slide of the economy into crisis in the 1980s.

Despite the importance given to industrial and trade policy, Philippine industrial and trade performance has been largely disappointing. The initial period of import substitution led to rapid economic growth in the early 1950s. However, in what has now become a classic pattern of import substitution, growth slowed as the industries that were created reached the limits of the domestic market and as their high dependence on imports of capital goods and intermediates meant that the growth of the economy as a whole was limited by recurrent balance of payments crises. The Philippines went through an import decontrol program in the early 1960s, but with disappointing results. Economic growth remained sluggish, particularly in the manufacturing sector, and the country failed to develop significant new export industries.

For much of the 1970s it appeared that the Philippines had achieved a decisive break with its past. The Marcos martial law government was outwardly strongly export promoting and actively encouraged investment, both domestic and foreign, in export industries. Philippine export growth in the seventies was quite respectable, averaging 8.6 percent per year in volume. But what was more striking was the transformation in the export structure of the country that took place over this period. In the 1960s the Philippines was overwhelmingly dependent on commodities—coconut products, sugar, forest products, copper, and gold—for its export earning, as we point out in table 3.1. At the beginning of the 1970s these four product categories alone accounted for 76 percent of Philippine exports; by the end of the decade, their share had fallen to 46 percent. In their place was a group of nontraditional products, particularly electrical components and garments. For most of the decade, manufactured exports had increased by over 30 percent per year (de Vries 1980, 5).

But despite this success in diversification and the rapid growth of manufactured exports, in aggregate Philippine exports were still problematic. In table 3.2 we present a comparison of export shares in GDP for the Philippines and neighboring Asian countries. While the Philippines starts out in a large group with a low export to GDP share, the ratio never changes over the course of the decade, in contrast to the other countries listed in the table. In fact, the sluggishness of the Philippine export share is worse than is indicated in table 3.2. The structural transformation that took place during the decade shifted Philippine exports toward goods characterized by low margins of domestic value added and high import requirements. As a result, the growth in domestic value added, or alternately, the net foreign exchange generating capacity of the export sector, was much less than suggested by the growth of exports. A rough correction for this effect is shown in the

**Table 3.1** Share in Total Merchandise Exports (percentages)

Exports	1965	1970	1975	1980	1984	1986	1987
Coconut products	34.0	18.6	20.3	14.0	13.5	9.7	9.2
Sugar products	18.5	17.2	26.9	11.4	6.1	2.2	1.0
Logs, lumber & plywood	22.7	24.2	9.4	6.6	4.7	5.2	3.9
Copper and gold	<u>5.9</u>	<u>16.2</u>	<u>12.6</u>	<u>13.5</u>	<u>4.1</u>	<u>4.8</u>	<u>4.8</u>
Subtotal	<u>81.1</u>	<u>76.2</u>	<u>69.2</u>	<u>45.5</u>	<u>28.4</u>	<u>21.9</u>	<u>19.0</u>
Pineapple and bananas	1.8	2.5	5.0	3.6	4.4	5.3	N.A.
Electrical equipment and components	—	—	2.0	11.6	24.7	18.7	19.6
Garments	—	—	4.4	8.6	11.1	15.5	19.2
Other nontraditional manufactures	5.8	10.9	11.5	16.2	21.9	21.3	24.9
Others	11.3	10.4	7.9	14.5	9.5	17.3	N.A.

Source: NEDA, *Philippine Statistical Yearbook*, 1987; and IMF (1988b).

Note: N.A. indicates data were not available, and a dash means that the amount was negligible.

Table 3.2 Merchandise Export Shares in GDP (in percentages)

	1970	1974	1976	1978	1980	1982	1984	1986
Philippines	15.1	18.6	14.2	14.2	16.4	12.6	16.7	15.6
Indonesia	12.7	28.8	22.9	22.6	33.0	21.9	24.5	19.1
Korea	10.1	24.1	27.0	25.4	28.1	28.8	30.8	34.5
Malaysia	41.3	43.8	47.5	46.7	54.0	44.6	48.3	49.3
Thailand	10.5	18.1	17.9	17.5	19.3	18.6	20.2	20.6
Philippines								
Memo items:								
Exports net of consignment imports	15.1	17.7	12.6	12.4	14.0	10.3	12.5	N.A.
Service exports <sup>a</sup>	2.6	3.5	3.0	4.6	4.7	5.9	6.3	N.A.

Sources: Philippines: Central bank and National Census and Statistical Office. Others: Asian Development Bank, *Key Indicators of Developing Member Countries*, 1986.

Note: N.A. = not available.

<sup>a</sup>Net of interest receipts and government service exports (including U.S. base receipts).

second to last row of the table, which compares Philippine merchandise exports, net of consignment imports, to GDP. This ratio declines significantly over the decade. As a result of this export sector narrowing, the Philippines was left in a more difficult position from which to adjust to an adverse external shock.

The last line in table 3.2 illustrates a factor that sets the Philippines apart from most LDC debtors. Service exports were an important and increasing source of foreign exchange earning over the 1970s and 1980s. Most of this came from overseas labor earnings in construction, nursing, and domestic work, and this source increased in the 1980s as more Filipinos sought overseas employment.

Of course, Philippine trade policy affected the entire allocation of domestic resources and not just the export sector. Trade policy and also investment incentives have had a particularly strong impact on the Philippine manufacturing sector, a sector whose history has been puzzling and ultimately disappointing. In contrast to other countries in East and Southeast Asia, the manufacturing sector has not been a leading sector in the growth of the economy (table 3.3).

Philippine manufacturing grew rapidly in the early 1950s under the impetus of import protection. But once the initial burst of import substitution played out, output growth slowed considerably. Nor was the sector revived by the decontrol episode in the early 1960s. Manufacturing growth fell behind that of the economy as a whole, profits were low, and excess capacity and competition led to rising nationalist sentiments. The manufacturing sector recovered in the latter part of the decade, and in the early 1970s it appeared that the Philippines might have broken the dependence of the sector on the growth of the domestic economy, with a rapid growth of

Table 3.3 Comparative GDP and Manufacturing Growth

	Philippines	Indonesia	Malaysia	Thailand	Korea
<b>Real GDP Growth</b>					
1965-70	5.0	6.2	N.A.	8.6	10.4
1970-75	6.2	7.6	7.4	6.3	9.5
1975-80	6.2	7.9	8.6	7.6	7.5
1980-83	2.6	5.0 <sup>a</sup>	6.4	5.4	8.0
<b>Manufacturing value added</b>					
1965-70	6.9	7.8	13.9	10.2	22.1
1970-75	6.9	9.6	12.3	10.3	19.7
1975-80	6.0	15.0	11.3	10.5	14.8
1980-83	2.7	N.A.	N.A.	6.0	7.9
<b>Manufacturing employment</b>					
1963-70	2.9	4.9	16.3	5.1	10.7
1970-75	2.9	4.8	6.6	4.5	15.2
1975-80	4.1	4.2	0.0	5.7	6.2
1980-83	3.5	13.4 <sup>a</sup>	0.5	1.0	3.3

Sources: World Bank (1979), table 1.2; Asian Development Bank, *Key Indicators of Developing Member Countries*; and IMF, *International Financial Statistics*.

Note: N.A. = not available.

<sup>a</sup>1980-82

nontraditional manufactured exports and a growth rate for the sector well in excess of that of domestic GDP (table 3.4).

But the growth of manufacturing was not sustained, and a closer look reveals serious weaknesses in the sector. The most glaring weakness is its productivity performance. A recent study of manufacturing productivity concluded that total factor productivity in the sector *fell* by 1.23 percent per year over the 1970s. The decline was more rapid in the last half of the decade, when total factor productivity fell by almost 2 percent per year.<sup>3</sup> The poor productivity performance for manufacturing is an obvious candidate for explaining a problem mentioned in the introductory chapter, the high investment requirement of Philippine output growth. In comparison to other developing countries, both inside and outside the region, the Philippines invested more to grow less.

The second difficulty with the manufacturing sector was its inability to generate significant employment, in spite of the rapid growth of labor-intensive manufactured exports. The share of manufacturing in total Philippine employment actually peaked at 12 percent in 1956, and has remained just under that level in the period since. Again, this is in contrast to other countries in the region, where the manufacturing sector has played a lead in employment growth (see table 3.3).

Finally, the output expansion in the manufacturing sector as a whole proved extremely fragile. The rate of output growth in manufacturing hit a peak in 1977 and then declined steadily through 1985. Manufacturing and the investments that had been made in the 1970s proved extremely

**Table 3.4** Philippine Sectoral Growth Rates

Sector	1950-55	1955-60	1960-65	1965-70	1970-75	1975-80	1980-85	1985-87
Agriculture	7.1	2.9	4.8	3.5	4.3	5.3	0.5	2.0
Manufacturing	12.1	7.7	4.5	6.1	6.9	6.0	-2.7	2.8
Services	9.0	5.1	4.5	4.8	5.7	5.7	0.8	4.7
Domestic product <sup>a</sup>	7.9	4.6	4.8	5.0	6.2	6.2	-1.2	3.3

Source: NEDA, *National Income Accounts of the Philippines*.

<sup>a</sup>Net domestic product 1950-70, gross domestic product 1970-85.

vulnerable to the rise in oil prices and real interest rates in the early 1980s and to the accompanying international recession. Many of the industries that were developed in the 1970s saw massive drops in output in the 1980s.

Thus an analysis of the impact of trade and industrial policy has a large amount of ground to cover. Two critical and puzzling questions stand out. The first is the failure to shift resources toward the traded goods sector and the apparent export shallowing of the Philippine economy, despite the transformation of export structure that took place. The second is the inability to generate faster output and employment growth in manufacturing, and the weakness of the sector during the 1980s.

Four elements of Philippine trade, exchange rate, and industrial policy provide the explanation. The first is the structure of trade protection and incentives, which encouraged indiscriminate and inefficient import substitution. The second is the country's exchange rate policy, which has been characterized by delayed responses to payments disequilibrium, thereby hurting export industries, dampening export diversification, and discouraging backward linkages. Third, direct interventions by the government in the traditional agricultural export sector during the 1970s not only penalized that sector but also exacerbated its problems in the face of a highly volatile world price environment. And fourth, there was an expansion of government-controlled and government-associated corporations and with it, a tendency toward centralization and politicization of economic decision making during the 1970s. This chapter examines the first two factors; the next chapter discusses the last two.

### 3.1 Trade Policy and the Structure of Protection

Philippine trade policy and the industrial policy that grew out of it were more products of the response to crisis and the limited policy choices that the Philippines had under the Bell Act than they were conscious attempts to promote developmental goals. But once the trade policy regime was established in the 1950s, it quickly became the cornerstone of the country's

industrialization policy and rapidly developed a constituency concerned with its preservation.

The Philippines had suffered extensive damage during the Second World War, and in the late 1940s there were huge expenditure demands for reconstruction, which led to a rapid increase in imports. In addition, after the substantial wartime inflation, the prewar exchange rate of 2 pesos/dollar was unrealistically high, further increasing import demand. Exports recovered somewhat, aided by a rise in export prices, but payments balance was maintained largely through transfers from the United States. These payments for relief, veteran's pensions, and military expenditure totaled almost \$300 million in the period 1946–50 and covered over half of Philippine imports.<sup>4</sup> A large increase in public spending during the 1948 election campaign and the impending reduction of U.S. aid payments led to a balance of payments crisis. In December 1949 the eleven-month-old central bank initiated foreign exchange controls.

Foreign exchange controls were followed by legislation in 1950 that required licenses for all imports, allocated by an Import Control Board. Commodities were grouped by degree of "essentiality." The most stringent controls were imposed on nonessential consumer goods (i.e., luxuries and consumer durables) and the least stringent on essential consumer goods (e.g., pharmaceuticals, milk products) and essential producer goods (most machinery, fertilizer, fuels and lubricants). Domestic prices for the most heavily restricted imports rose sharply, leading to investment and production in a variety of consumer goods industries.

While the balance of payments crisis was the initial motive for import controls, industrial promotion rapidly became the rationale of the protective system as a domestic import-substituting industrial sector developed and economic growth, led by manufacturing, accelerated in the early 1950s. The industrialists who emerged would become a powerful lobby for import restriction in future policy debates, and the import-substituting strategy established in the 1950s would persist, largely unchanged, until the 1980s. The Philippine experience with import controls was typical of that of a number of LDCs. Domestic entrepreneurs responded quickly to profitable opportunities created by import restrictions, and manufacturing output grew rapidly. The share of consumer goods in imports dropped sharply, as the import pattern shifted toward raw materials and capital goods. However, the rapid growth of manufacturing in the early 1950s did not persist, and output growth became much more sluggish in the latter half of the decade.

Philippine tariff policy follows a parallel history. In the years immediately after independence, the Philippines was severely limited in its ability to impose and collect tariffs. Seventy percent of Philippine imports came from the United States, and the country was bound under the Bell Act to a very gradual schedule of implementing tariffs on these imports. The transition period was substantially shortened with the revised trade agreement between

the United States and the Philippines in 1955 (the Laurel-Langley Agreement), which permitted 25 percent of Philippine tariffs to be applied to imports from the United States in 1956, 50 percent in 1959, and 75 percent in 1962. The Philippines introduced a revised system of tariffs in 1957 that duplicated the protective system established by the import control program, with the highest duties on nonessential consumer goods. While the tariffs were redundant as protective measures, they did succeed in siphoning off some of the rents that had been created by the import control program.

The import control program itself had a rocky history. The initial surge in import prices led to the adoption of price controls for a variety of basic commodities. The import premium, as measured by the ratio of the black market to the official exchange rate, averaged 60 percent and reached 100 percent by the end of the decade. Charges of corruption and mismanagement dogged the import licensing process, even after authority for import control had been shifted to the central bank. By the end of the decade, pressure from the sugar bloc in Congress, continuing dissatisfaction with the corruption of the control system, slowing economic growth, and growing evasion of the exchange control system by exporters led the Philippines to dismantle the system of import control. Decontrol took place over a three-year period; by 1962 the peso had been devalued to P. 3.9 per dollar and licensing requirements for imports had been removed.

The impetus behind decontrol was largely reaction to the graft involved in the import control system and the feeling that exporters had been able to evade foreign exchange surrender requirements, rather than a conscious attempt to diminish the extent of protection of domestic industry and shift resources toward the exporting sector. In order to protect domestic industry from the effects of decontrol, the Philippine government raised duties on roughly 700 items, and further increases in tariffs followed (Baldwin 1975, 57). In addition, the share of Philippine duties applicable to imports from the United States under the Laurel-Langley agreement jumped from 50 percent to 75 percent in 1962, significantly raising duties on the large majority of Philippine imports.

Even with the rise in tariff rates, the elimination of import licensing significantly lowered the degree of protection afforded to import-competing industries. Despite the rise of f.o.b. peso import prices by 101 percent from 1959 to 1962, the wholesale price index of imported goods rose only 22 percent. Measurements done by Baldwin (1975, 58, 100) indicate that the smallest price increases occurred for the most heavily restricted goods. However, despite the change in relative prices, decontrol does not appear to have led to industrial restructuring nor to the emergence of new industries geared toward exports. Manufacturing output growth slowed significantly in the wake of decontrol, as indicated in table 3.4. The slowdown was spread across all sectors of manufacturing, and there is little evidence of any structural change in this period.<sup>5</sup> Manufacturing exports increased, but not



dramatically, and not enough to raise the sector's growth rate. Manufacturing profits in general fell after 1961. Industry groups, particularly the Philippine Chamber of Industry, became more vocal in their complaints about excess capacity and competition and in their demands for support of existing Philippine firms.<sup>6</sup> Protests against foreign investment increased, and economic nationalism became a more potent force in the 1960s.

In contrast, the fortunes of the traditional export sector increased dramatically in the decontrol period; from 1959 to 1963 the wholesale price index for export goods increased by 20 percent relative to the index for local manufactures. The output response of the traditional sector was swift, although measuring the effect is complicated by the underreporting of exports in the late 1950s and by the increase in the U.S. sugar quota in 1962. Even with corrections for these effects, exports increased by about 50 percent in dollar terms from 1959 to 1966.<sup>7</sup> Afterward, the rate of export growth slowed considerably, averaging only 1.5 percent between 1966 and 1969.

An additional effect of the rise in the relative price of traditional exports was to switch agricultural land from food production to the production of export crops. The result was a rapid rise in domestic prices of foodstuffs, in addition to the inflation resulting from the exchange rate depreciation. This in turn led to a general drop in real wages. The food price inflation and the decline in urban real wages were the most politically sensitive of the decontrol outcomes, and they spawned domestic protests, particularly in 1963.

The prevailing opinion of the decontrol period in the Philippines was one of disappointment. Filipinos viewed the early 1960s as a period of relative stagnation, excess capacity, rising prices, and falling real wages. The failure of the decontrol period to spur economic growth weakened the ground of economic liberals, and would shift their attention to export promotion, without trying to change the existing incentives for resource allocation. Finally, the decontrol experience produced a more favorable view toward economic planning and government market interventions. An outgrowth of this sentiment was the enactment of a comprehensive system of industrial incentives in 1967, as well as a financial facility for distressed firms set up at DBP in 1966. The Philippine government also intervened more actively in allocating resources among industries after the decontrol episode. The Board of Investments (BOI) that was established by the Industrial Incentives Act of 1967 had substantial discretion in administering the incentives, as well as the authority to limit investments in industries with excess capacity.

The latter half of the 1960s saw more rapid growth and a recovery of the manufacturing sector, produced by the expansionary policies of the Marcos government. As the balance of payments worsened, there was a gradual reintroduction of exchange controls. But the Philippines did not return to comprehensive import controls before, or during, the payments crisis of

1970. The IMF stabilization program called for a depreciation of the peso, and the Philippine economy recovered rapidly in the early 1970s. One of the first economic policy measures of the martial law government was a tariff reform program in 1973, which was designed to limit the number of tariff rate categories and lower the dispersion among tariff rates. This was a tariff reform in only a limited sense. The 1973 tariff program increased the average tariff rate by 3 to 4 percent, and maintained the cascading structure of the Philippine tariff system (ILO 1974, 113). The tariffs established at this time remained until the early 1980s.

The structure of protection, as indicated by the sector or end-user estimates of effective rates of protection and by the average effective exchange rate, is presented in table 3.5. Because of the limited ability to impose or collect tariffs under the terms of the Bell Act, the Philippines developed a system of domestic sales taxation, differentiated by product and, in some cases, by domestic or foreign origin. The estimates of the effective

**Table 3.5**                      **Philippine Protection**

	A. Effective Protection Rate		
	1965	1974	1985
All sectors	48	36	28
Exports	-19 <sup>a</sup>	4	12
Sugar	183		
Nonexportables			
Import competing	59 <sup>c</sup>	37	35
Import noncompeting <sup>b</sup>	83 <sup>c</sup>	148	67
Agriculture and primary	10 <sup>d</sup>	9	3
Manufacturing	51	44	36
Capital goods	16	18	25
Intermediate goods	27	23	33
Inputs for construction	55	16	31
Consumer goods	70	77	42
	B. Average Effective Exchange Rate (pesos/dollar)		
	1950-59	1960-69	1970-80
Traditional exports	2.00	3.46	6.60
New exports	2.30	3.70	7.99
Essential consumer imports	2.06	3.91	8.12
Nonessential consumer imports	3.64	10.55	25.48

Sources: Power and Sicat (1971), Tan (1979), Baldwin (1975), and Senga (1983).

<sup>a</sup>Excluding sugar.

<sup>b</sup>Manufacturing sector only.

<sup>c</sup>Import noncompeting industries are those in which imports amount to less than 10 percent of domestic production.

<sup>d</sup>Weighted average of Power and Sicat's estimates for agriculture (17 percent), forestry (-26 percent), and mining (-17 percent).

rates of protection, which were drawn from Tan (1979) and Power and Sicat (1971), take into consideration the differential protective effect of these domestic product taxes.

An alternative estimate of sector protection is the effective exchange rate, the number of units of domestic currency actually paid or received per dollar in a given transaction. These were computed by Baldwin (1975) and Senga (1983), and include the effects of multiple exchange rates, tariffs and export taxes, discriminatory domestic sales taxes, subsidized borrowing rates, and margin deposit requirements.

Both measures are shown in table 3.5. During the 1960s and 1970s the highest effective rates of protection were given to the import-substituting consumer goods industries (primarily the nonessential consumer goods according to the central bank's classification system). The table also indicates the much lower protection given to exports and to the agricultural and primary sectors. The estimates in table 3.5 show that, despite the revisions in the tariff code in 1973, the general pattern in the structure of protection remained the same during the 1970s.

This conclusion is strengthened when the effects of tariff exemptions during the 1970s are included. Soon after the 1973 tariff reform, duty exemption privileges were granted to a number of public institutions and private enterprises. During the martial law period these exemptions became more widespread. The ratio of estimated duty exemptions to actual duties paid on all imports reached at least 22 percent during the latter 1970s from the 9 percent level during 1973–74 (Albuero and Shepherd 1986, 60). These duty exemptions were mostly on capital and raw material imports. Thus, the effective rate of protection overstates the protection given to capital goods industries and understates the actual protection given to consumer goods industries.

Despite the professed aim of the martial law government to revamp the system of incentives and encourage exports, Philippine trade policy remained firmly committed to encouraging production for the domestic market. Among countries in Southeast Asia, only Indonesia provided a higher effective rate of protection to imports relative to that given to exports (table 3.6).

This orientation of trade policy was reinforced in the 1970s by nontariff barriers. Nontariff barriers had been the principal means of industrial protection during the 1950s, but were deemphasized during the 1960s as part of the decontrol program. The 1970s and 1980s saw their increasing use, for reasons of balance of payments adjustment, industry protection, support of local content programs, safeguarding of public health and national security, and centralizing of importation.<sup>8</sup> Nontariff barriers paralleled the structure of protection of the tariff system; by 1977, 62 percent of all consumer good items were regulated, as compared to 24 percent of mineral fuels and lubricants, 23 percent of intermediate goods, and 17 percent of capital

**Table 3.6** Effective Rates of Protection, Selected Southeast Asian Countries

Country	Year	Exportables	Importables	Total Manufacturing
Philippines	1974	4	61	44
Indonesia	1975	-6	98	39
Malaysia	1978	13	53	34
Singapore	1979	4	1	3
Thailand	1980	24	89	65

*Source:* Findlay and Garnaut (1986, xix).

*Note:* Effective rates of protection weighted by value added. Industries are classified by whether net exports are positive or negative.

goods.<sup>9</sup> Although tariff rates stayed constant after the 1973 tariff revision, the increase in nontariff measures raised the average level of effective protection given to domestic industry in the 1970s and increased the variability of protection across industries.

### 3.2 Fiscal Incentives and Export Promotion

The granting of fiscal incentives has been an important tool of industrial promotion in the Philippines since independence. Several laws granting fiscal incentives for investments in priority industries were enacted, with some modifications over time in their nature, mechanics, and industry coverage. The incentives initially took the form of exemptions from domestic taxes, but broadened over time to include exemptions from customs duties (especially on imported capital equipment and parts), tax deductions, and tax credits. At the same time, the granting of fiscal incentives, initially indiscriminate, became somewhat more defined with the passage of the Investment Incentives Act of 1967 and the subsequent establishment of the BOI. Nonetheless, there was a high degree of continuity among the incentive recipients; most of the firms that benefitted during the 1960s were the same ones that benefitted from fiscal incentives during the 1950s (Power and Sicat 1971, 79–82).

The Investment Incentives Act of 1967 and the Export Incentives Act of 1970 provided the framework for fiscal incentives during the 1970s. The Industrial Incentives Act distinguished two priority sectors: “preferred” industries, where existing capacity was considered to be smaller than what the domestic market and likely export potential could support, and “pioneer” industries, which would introduce new products or processes to the Philippines. Investments in preferred industries by registered firms benefitted from accelerated depreciation, tax exemptions on imported capital equipment, and tax credits on the purchase of domestic capital equipment. Pioneer industry investments were eligible for the same benefits, as well as exemptions from all internal revenue taxes except the corporate income tax.

In addition, firms in pioneer industries could be wholly foreign-owned, while the maximum foreign ownership for registered firms in preferred industries was 40 percent. The act also allowed exporters access to inputs at world market prices by providing a tax credit for import taxes paid.

The act established the BOI, attached to the Ministry of Trade and Industry, to identify priority sectors through its Investment Priorities Plan, process applications, and administer the incentives. In addition, the BOI was given authority to limit investment in "overcrowded industries," an outgrowth of the complaints over excess capacity and competition during the decontrol period.

Support for exporters was liberalized and extended by the Export Incentives Act of 1970, which gave registered exporting firms tax and duty free imports of capital equipment, tax deductions for various business development expenses, and duty drawbacks on imported intermediate goods. The act, and a later revision by presidential decree, also provided a subsidy through tax deductions to domestic employment and procurement by exporting firms for a five-year period. This subsidy was calculated by formula and did not fully compensate firms for purchasing inputs domestically at higher than world market prices. The incentives under the act were later supplemented with presidential decrees establishing export processing zones and bonded warehouses, and with a preferential rediscounting facility at the central bank to encourage export finance.

The industrial incentives legislation embodied a two-pronged approach that would characterize Philippine industrial policy until the 1980s. The export promotion features of both the Industrial Incentives and Export Incentives Acts provided subsidy to exporters and, more importantly, allowed them to acquire inputs at world market prices. However, the adoption of these measures was in addition to, rather than instead of, policies that encouraged production for the domestic market. The Philippines retained the existing system of trade protection for domestic industry and supplemented it with industrial incentives and, in many cases, further protection. Thus, industrial incentives extended the system of import substitution measures, while simultaneously seeking to counteract their discouraging effect on exports.

Two additional features of the industrial incentives were important in the Philippines. Rather than an open-ended encouragement of industrial activity, the availability of incentives depended on industry capacity measures—what policymakers thought the domestic market and likely export potential could support. Once capacity in an industry reached that level, the industry was removed from the Investment Priorities Plan and no further incentives were given to new entrants or to expansion. In addition, in 1970 thirty industries, including cement and textiles, were designated as overcrowded, and neither new investment nor expansion could take place in these industries without BOI approval.<sup>10</sup>

This focus on capacity carried over to the design and implementation of the incentives themselves. Incentives were given for the establishment of firms and new capacity, rather than for the profitable operation of these firms. Although the legislation included some incentives for expansion and replacement, these were deemphasized in favor of new investment. And once firms were established, the incentive system and restrictions on investment and entry tended to protect them from competition.

The second feature of the industrial incentives was their effect in encouraging the use of capital. The most important of the incentives were duty exemptions on imported capital equipment and accelerated depreciation of investment, both of which lowered the cost of capital to participating firms. The capital-cheapening effect of the full range of BOI incentives has been estimated to have been between 39 and 42 percent.<sup>11</sup> In addition, firms that were registered with the BOI had preferred access to low interest rate funds from state financial institutions, which further reduced their cost of employing capital.

The bias toward capital intensity was also a characteristic of the drafting of the Investment Priorities Plan and the implementation of the incentives program. In the 1970s, Philippine policymakers decided on a strategy of industrial deepening, encouraging the development of domestic industrial intermediates producers and, later, capital equipment producers.<sup>12</sup> The largest industrial recipients of BOI incentives during the 1970s were copper smelting and refining (36 percent of total benefits in 1977), pulp and paper, chemicals and chemical products, and synthetic textile fibers. Intermediate industries are in general capital intensive, and of the total distribution of industrial and export incentives, almost two-thirds went to industries with above average capital intensity (World Bank 1980, 31–32).

Two additional programs followed this strategy of industrial deepening. The first was the Progressive Manufacturing Program (PMP), which was originally adopted for automobiles in the mid-1970s and later extended to trucks, motorcycles, and consumer electronics. The PMP was designed to force the use of locally manufactured intermediates by progressively reducing the allocation of foreign exchange for imports. In exchange, participating firms received protection from foreign competition and from new domestic entrants. Despite the small size of the Philippine domestic market, each program attracted a number of participants, five for automobiles and nine for the truck program.<sup>13</sup> The second program was the Major Industrial Projects (MIPs), described in the previous chapter on government expenditure.

Evaluating the overall importance of the industrial incentives is a difficult task. In aggregate they were relatively small, amounting to about 0.6 percent of GNP in 1978 and 0.8 percent in 1985. The incentives were heavily concentrated in manufacturing, where they were about 3 percent of value added and 10 percent of profits. However, for individual firms the incentives

were often quite large and important. A survey of 164 BOI registered firms in 1985 found that BOI incentives represented 30 percent of value added and 100 percent for firms in the metal products industry.<sup>14</sup> In addition, the BOI provided subsidy without expenditure in a variety of ways. As mentioned above, BOI incentives were often supplemented by access to low cost funds from state financial institutions. In addition, many of the nontariff barriers that were introduced during the 1970s were designed to protect registered firms in the industrial incentives programs and were administered by the BOI.

### 3.3 Reform in the 1980s

After years of analysis and growing criticism, both within and outside the Philippines, the system of trade protection and industrial incentives began to change in the early 1980s. Under the first World Bank structural adjustment loan (SAL), the Philippines agreed to a tariff reform and import liberalization program. The tariff reform program called for a substantial reduction in rates, as well as a more uniform structure of tariffs, to be phased in between 1981 and 1985. In tandem with the tariff reform, the Philippines agreed to an import liberalization program designed to eliminate licensing requirements for imports of most consumer goods, as well as some intermediate and capital goods.

The tariff reform program was completed on schedule and changed the character of Philippine tariff protection substantially. The average tariff rate declined from 42 percent in 1980 to 28 percent in 1985.<sup>15</sup> The effective rate of protection for manufacturing declined from 44 percent in the 1974 tariff system to 36 percent in 1985 (see table 3.5). The disparity in effective rates of protection among exports, import-competing manufactures, and import-noncompeting manufactures was reduced. However, the data also indicate that the gap between the primary sector (agriculture, forestry, and mining) and the manufacturing sector widened because of the more than proportionate decline in the average effective rate of protection for the primary sector.

In contrast to the tariff reform program, import liberalization proceeded much more fitfully. Firms whose products were removed from import licensing requirements in many cases appealed successfully to President Marcos, who later issued presidential decrees reestablishing import control for many products that had been removed from the list. By 1986 the Philippines had made little or no progress on import liberalization.

The Philippine government also agreed to reforms in its investment incentives program under the two SALs. The Investment Incentives Act of 1983 eliminated a number of benefits that were based on the use of capital and substituted instead tax credits based on value added and net local content. As a result, the capital-cheapening effect of the incentives program was substantially reduced.

These changes in trade and industrial policy came late in the game for the Philippines and were quickly superceded by other events. The tariff reduction program was partially reversed by import surcharges that were imposed starting in 1982 for balance of payments purposes. After the debt moratorium in October 1983, the Philippines reverted to foreign exchange allocation, effectively establishing the same system of protection by degree of essentiality that had long characterized Philippine policy. And in a more fundamental sense, the Philippine attempt to even the balance of incentives across industries was overshadowed by growing exchange rate overvaluation in the early 1980s, a subject to which we now turn.

### **3.4 Exchange Rate Policy**

The history of Philippine exchange rate policy is characterized by consistently delayed responses to overvaluation, followed by large, discrete changes in the exchange rate. In almost every case, devaluation came after the emergence of a balance of payments crisis, and often required substantial external pressure. As a result, the Philippines has failed to achieve a real exchange rate that was both stable and at a level that encouraged the development of Philippine exports and profitable import substitution. Despite a much higher wartime inflation than in the United States, the Philippines maintained its pre-World War II exchange rate after independence. The government responded to the payments crisis in 1949 by imposing import and foreign exchange controls during the 1950s, and pursued a conservative monetary and fiscal policy that resulted in a level consumer price index for the decade of the 1950s. The peso was devalued in 1962 as part of a decontrol program which was brought about by balance of payments difficulties and stagnating economic growth at the end of the 1950s. This marked the first Philippine devaluation since 1903.

Expansionary monetary and fiscal policy during the last half of the 1960s led to a balance of payments crisis in 1969–70. In response, the government initially imposed foreign exchange rationing; eventually, the peso was floated in 1970 and it subsequently depreciated by 51 percent. The Philippines officially followed a managed float during the 1970s, in which the government would intervene in the foreign exchange market solely to smooth out fluctuations around the trend. However, except for a 7 percent depreciation in 1975, the changes in the peso-dollar rate were very slight and averaged only a 1.6 percent annual rate of depreciation between 1973 and 1980.

Under pressure from a widening current account deficit in the 1980s, and increasing difficulties in raising external funds, the Philippines began gradual devaluations of the currency: 5.2 percent in 1981 and 8.1 percent in 1982. In the crisis year 1983 there were much larger depreciations and a fall in the peso exchange rate from P. 9.2 per dollar at the end of 1982 to P. 19.8 per dollar at the end of 1984.



It is of course the real, and not the nominal, exchange rate that governs allocation of resources. The decontrol and 1962 devaluation produced a substantial real depreciation that was gradually eroded, but only partly reversed, in the 1960s. During the 1970s and early 1980s the Philippines experienced a number of large changes in relative prices, making a description of the course of "the" real exchange rate difficult. Table 3.7 presents several relevant definitions of the real exchange rate over this period.

Although the series in table 3.7 vary, they tell a roughly similar story. The devaluation of 1970 created a significant depreciation of the real exchange rate that was extended by the international commodity price boom between

**Table 3.7** Philippines Relative Price Indexes

Year	PTraded/ PNontraded (1)	REER Export Markets (2)	REER Asian Competitors (3)	Terms of Trade (4)	PExports/ PGDP (5)	Manufacturing Real Wage (6)
1967	85	73	79	127	94	N.A.
1968	88	73	80	123	95	108
1969	92	74	82	121	90	107
1970	97	109	111	119	118	103
1971	100	107	106	111	109	105
1972	100	100	100	100	100	100
1973	110	108	108	113	125	87
1974	115	96	100	115	159	77
1975	112	104	107	88	125	86
1976	107	102	104	78	102	81
1977	105	101	101	71	95	86
1978	102	108	104	78	98	85
1979	101	101	97	82	105	85
1980	97	99	92	69	96	91
1981	93	96	93	60	90	N.A.
1982	91	91	93	59	74	N.A.
1983	93	109	109	61	91	N.A.
1984	103	109	109	60	101	N.A.
1985	98	96	93	56	83	N.A.
1986	92	117	100	60	88	N.A.
1987	90	123	102	65	91	N.A.

Notes: N.A. = not available.

- (1) Traded goods prices are a weighted average of gross value added deflators for agriculture and forestry, mining, and tradable manufactures. Nontraded prices are a weighted average of deflators for construction, electricity and gas, and services. Weights are 1972 value adds.
- (2) REER is real effective exchange rate. Dollar wholesale prices in major Philippine markets divided by dollar prices in the Philippines. Markets are the U.S., Japan, Germany, Netherlands, and Korea. Increase is real depreciation.
- (3) REER is real effective exchange rate. Weighted average of consumer price indexes in dollars in Korea, Indonesia, Malaysia, Thailand, and Singapore, divided by Philippine CPI in dollars. Weights are 1980 exports. Increase is real depreciation.
- (4) Export unit value divided by import unit value.
- (5) Gross value added deflators from national accounts.
- (6) Basic manufacturing wage divided by GDP deflator. Wage series discontinued in 1981.

1972 and 1974. After 1974 there is a gradual fall in the competitiveness of Philippine traded goods production, one that shows up most heavily in the commodity-price-dominated relative price of exports in column (4). What stands out from the table is the fact that the real exchange rate did not increase sharply during most of the 1970s, despite the rapid domestic economic growth and the high rate of foreign borrowing during this period. The reason that the Philippines avoided the significant currency overvaluation that characterized many of the LDC borrowers is that the external borrowing was accompanied by an equivalent rise in investment expenditure, the equipment portion of which was almost entirely imported. Therefore, the domestic demand impact of the increase in Philippine expenditure was smaller than in other LDCs.<sup>16</sup>

The real appreciation that occurred in the Philippines occurred relatively late, in the period after 1979, with a sharp appreciation of the real exchange rate measures in the three years to 1982. This was the period in which a variety of events raised the domestic inflation rate—the unsuccessful attempt at economic stimulus in 1980 and 1981 and the domestic financial crisis in early 1981. The real appreciation of the peso also coincides with the recovery of the U.S. dollar from its 1978 trough. Since the Philippines maintained an almost stable exchange rate with the dollar, the peso in large part followed the course of the U.S. real exchange rate.

While the swings in the real exchange rate are not dramatic, what is striking from the table is the secular fall in two important measures. The first is the substantial drop in real wages, starting with the 1970 stabilization episode and continuing through the decade. Philippine wage data is not particularly accurate, but the fall in real wages is difficult to reconcile with the apparent growth of real GNP during the decade.<sup>17</sup> The second and contrary indicator is the almost unbroken fall in the country's terms of trade, starting in the 1960s. Even at their peak in 1974, Philippine terms of trade were below their 1969 level; by 1981, Philippine terms of trade had declined by 50 percent. Thus, the backdrop against which these real exchange rate changes took place increases their importance. With the kind of adjustments the Philippine economy was forced to make, the real appreciation that took place after 1979 was a major blunder.

A number of reasons explain the tendency of the Philippine government to delay exchange rate adjustments to payments imbalances during the post-World War II period. The decision to maintain the prewar exchange rate was in fact out of Philippine hands; the country had agreed to forgo exchange rate changes without the approval of the United States, in exchange for U.S. war rehabilitation funds. The historical precedent of having maintained a fixed exchange rate from the beginning of the century until 1962 may have also created a reluctance to devalue.

But two other reasons played the more important role in Philippine reluctance to adjust the exchange rate until external payments crisis made it

inevitable. The first was the identification in the minds of Philippine policymakers of the exchange rate as a nominal magnitude associated with domestic inflation, but not with the allocation of resources (at least outside of agriculture) nor with the development of new industries. The second reason was the development of a strong domestic constituency opposed to devaluation, and the failure to develop a constituency for devaluation that was both influential and legitimate.

With a constant exchange rate and conservative macroeconomic policy the Philippines achieved a nearly stable price level during the 1950s. When the peso was devalued in 1962, the increase in earnings from sugar and coconuts led to a shift of land away from food crops, resulting in higher domestic food prices and a higher rate of inflation. The domestic inflation rate subsided in the late 1960s, despite expansionary policy, in part due to the increase in rice yields from the development of new high yield varieties. In the early 1970s, the combination of devaluation, higher external prices for export crops and rice, and extremely bad weather in 1972 was responsible for the acceleration of inflation.

The link between exchange rate changes and domestic food prices, both through direct import costs and the diversion of land into export crops, was viewed as the key determinant of domestic inflation in the Philippines by the middle 1970s, both in the minds of policymakers and in analysis of price change in the Philippines.<sup>18</sup> This has led both to a reluctance to devalue and, when devaluation took place, to taxation of export producers, often used as a way of funding domestic price stabilization schemes. In addition, the lack of development of new manufacturing export industries during the early 1960s created a skepticism about the ability of exchange rate changes to create new traded goods industries.

Perhaps most important for describing exchange rate policy in the Philippines was the lack of a strong domestic voice arguing in favor of lower exchange rates and the avoidance of overvaluation. In the first decades after independence, those who would benefit from devaluation had little public legitimacy. Devaluation would have further increased the income and political power of the sugar interests, who were resented by many Filipinos for their ostentatious life style, and who already benefitted from the U.S. sugar quota premium and the Bell Act proscription on export taxes. Similarly, the perceived existence of foreigners in agricultural trading made a peso devaluation (which was thought to benefit the foreign traders more than the farmers) inconsistent with the nationalist, pro-Filipino aspirations of the time.

By the 1970s, the sugar bloc, the most important pressure group among the traditional exporting industries, had declined in political and economic power because of the termination of the U.S. sugar quota in the early 1970s and the increased control of the industry by the government and its appointed sugar administrator, Eduardo Cojuangco. The nontraditional garment and

semiconductor exports were growing so fast during the 1970s that the exchange rate did not appear to be a critical bottleneck. In addition, investors in these industries were either foreign or new domestic industrialists without a significant power base. The only group which consistently called for a more realistic exchange rate during the decade was a small group of government technocrats and academics, as well as the multilateral agencies, and their voice did not carry sufficient weight in domestic politics.

The establishment of import-substituting industries in the 1950s led to the emergence of an important pressure group that was opposed to peso devaluations. With heavy tariff and nontariff protection, the output of many industries became essentially nontraded, and peso devaluation would have lowered the prices of these goods relative to tradables. Because their imported raw materials and machinery were fully traded, with complete pass-through of exchange rate changes, a peso devaluation would have resulted in a profit squeeze for these industries. This is what had happened in 1962; manufacturing profits in general, and especially those of industries highly favored by the 1950s control system, declined substantially with decontrol and peso devaluation (Power and Sicat 1971, 43).

As a result, the potential of the exchange rate in shifting resources, developing new industries, and spurring adjustment was never exploited. In the 1970s and especially the early 1980s, the Philippines allowed a real appreciation of the peso, despite external signals that a major devaluation was in order. Philippine trade and exchange rate policy never addressed the problem raised by the substantial secular deterioration in the country's terms of trade and its buildup of external debt.

### **3.5 The Structure of Philippine Industry**

We turn now from a discussion of policy to outcomes. Trade policy and the structure of incentives since the 1950s encouraged the establishment of a largely import-substituting manufacturing sector. Import substitution was concentrated in consumer goods during the 1950s. As a result, the share of consumer imports to total imports declined from 37 percent in 1949 to about 23 percent during the early 1950s, and dropped further to about 14 percent by 1960 (Power and Sicat 1971, 39).

Table 3.8 presents the ratio of imports to domestic supply in selected manufacturing industries. The table indicates that domestic substitution of food imports was largely completed during the 1950s. Import controls also accelerated import substitution in wearing apparel, and publishing and printing. Among producer goods, import controls led to the substitution of domestic production for imports of textiles, paper and paper products, and nonmetallic mineral products during the 1950s.

The pace of import substitution slackened during the 1960s, particularly for intermediate goods industries such as textiles and basic metals. This

**Table 3.8** Share of Imports in Domestic Supply (percentages)

Industry	1948/49	1961	1969	1974	1979	1983
Food manufactures	32	9	N.A.	N.A.	N.A.	2
Dairy products	<sup>a</sup>	<sup>a</sup>	45	39	21	26
Textiles	86	46	40	23	18	22
Wearing apparel	32	13	3	1	0	2
Paper & paper products	98	49	34	25	23	27
Publishing & printing	35	10	14	11	12	10
Rubber	N.A.	11	13	15	12	25
Basic industrial chemicals	90	33	70	80	58	57
Other chemicals	<sup>b</sup>	<sup>b</sup>	28	37	22	20
Petroleum & coal products	N.A.	24	6	6	12	10
Cement	63	21	14	1	1	0
Other nonmetallic minerals	<sup>c</sup>	<sup>c</sup>	20	23	15	10
Basic metals	N.A.	54	52	51	37	30
Fabricated metal products	N.A.	37	28	28	19	30
Nonelectrical machinery	N.A.	75	84	84	70	50
Electrical machinery	N.A.	51	52	45	55	56
Transport equipment	N.A.	62	57	59	52	48

Source: NEDA, *Philippine Input-Output Tables*, various years. Data for 1948/49 from Baldwin (1975).

Note: N.A. = not available.

<sup>a</sup>Included in food manufacturing.

<sup>b</sup>Included in basic industrial chemicals.

<sup>c</sup>Included in cement.

reflects the impact of the import decontrol and peso devaluation, which increased potential product competition from abroad at the same time that (imported) input costs increased. Import substitution picked up again during the 1970s, particularly for textiles, basic metals, and fabricated metal products. This second round of import substitution was the result of the increased use of nontariff barriers. Nontariff barriers specifically for the purpose of industry protection were imposed on imports of textile fabrics, synthetic yarns, fibers and paper board products, synthetic resins, and liquid caustic soda among others.

What is clear from table 3.8 is the extent to which the import substitution strategy has dominated the development of Philippine industry. Some sectors have progressed farther than others in replacing imports with domestic production, but by 1983 domestic output provided more than 40 percent of domestic supply in all sectors listed, and 70 percent or more in most. This across-the-board representation of Philippine industry carries on within individual industries. For example, Philippine textile plants are unspecialized, integrated operations, designed to serve the full range of domestic market demand. This lack of specialization and the relatively small Philippine market has meant higher costs and, in the case of textiles, lower quality and a higher yarn fault rate.<sup>19</sup>

### 3.6 Growth of Exports

In contrast to the broad range of production for the domestic market, exports have been much more concentrated within certain industries, as is evident from table 3.9. The vast majority of Philippine manufactured exports have depended either on domestic natural resources (wood products, furniture, and within chemicals, coconut oil) or labor-intensive manufactured exports within apparel and electrical machinery.

Philippine merchandise exports, broken down into major commodities, are shown in table 3.10. As is clear from the table, export earnings hit a peak in 1980 when favorable crop yields coincided with high international prices, but then declined into the 1980s. The share of merchandise exports in GDP shows an uneven pattern, as it was affected by real exchange rate changes and changes in the terms of trade, but little change over the entire period.

Behind the merchandise export total are two divergent trends. There was an extremely rapid growth in exports of manufactured products after 1972, in both nominal and real terms. In contrast, the growth of earnings from the traditional export sector was more sluggish, and total dollar earnings

**Table 3.9** Ratio of Exports to Total Output

Industry	1961	1969	1974	1979	1983
Other food manufactures	N.A.	N.A.	8.5	15.1	12.9
Beverages	0.2	1.2	1.3	0.4	1.1
Tobacco manufactures	4.5	5.5	1.0	0.1	0.1
Textile	2.0	1.5	6.1	12.9	15.3
Wearing apparel	0.0	18.7	9.3	29.3	37.0
Leather & leather products	—	—	11.1	54.6	54.9
Lumber, plywood & veneer	13.0	15.5	27.5	35.8	26.6
Other wood products	<sup>a</sup>	43.9	N.A.	58.9	20.1
Furniture & fixtures	0.9	3.9	34.0	32.8	52.3
Paper & paper products	—	1.7	2.8	1.7	3.4
Rubber & plastic products	—	1.4	1.0	4.2	2.9
Basic industrial chemicals	7.2	6.3	6.1	24.0	13.9
Other chemical products	<sup>b</sup>	2.2	1.6	2.1	2.4
Petroleum & coal products	—	7.1	1.2	1.6	4.1
Cement	—	1.7	21.2	5.2	1.6
Other nonmetallic minerals	—	1.1	7.4	5.3	4.1
Basic metals	—	8.3	6.7	11.7	2.6
Fabricated metal products	0.2	0.6	0.6	1.9	16.2
Nonelectrical machinery	—	1.8	4.0	2.9	3.1
Electrical machinery & parts	—	2.5	1.7	51.1	70.4
Transport equipment	—	2.1	0.3	4.5	5.8

Source: NEDA, *Philippine Input-Output Tables*, 1961, 1969, 1974, 1979, and 1983.

Note: N.A. means data were not available, and a dash indicates the amount was negligible.

<sup>a</sup>Is included in lumber, plywood & veneer.

<sup>b</sup>Is included in basic industrial chemicals.

**Table 3.10**                      **Philippine Exports by Commodity (in millions of U.S. dollars)**

	1972	1975	1978	1980	1982	1984	1985	1986	1987
<i>Traditional exports</i>	910	1,667	1,943	2,959	1,935	1,610	1,196	1,096	1,367
Coconut products	227	462	872	781	563	690	440	470	561
Coconut oil	83	226	585	537	374	543	328	333	381
Sugar and products	217	615	213	590	396	272	161	108	71
Forest products	226	225	324	420	290	265	193	201	243
Logs	164	167	145	92	79	88	39	26	0
Minerals	240	365	534	1,168	686	383	402	267	224
Copper	191	212	250	545	312	115	84	90	109
<i>Other agricultural</i>	85	176	297	483	429	418	419	407	711
<i>Nontraditional manufactures</i>	95	411	1,076	2,109	2,457	3,136	2,857	2,986	3,642
Electrical equipment & components	2	47	253	671	1,000	1,329	1,056	904	1,119
Garments	2	100	326	500	539	600	619	748	1,098
<i>Total exports</i>	1,106	2,294	3,422	5,788	5,021	5,391	4,629	4,842	5,720
(percent of GDP)	(13.1)	(14.5)	(14.2)	(16.4)	(12.6)	(16.7)	(14.1)	(15.6)	(16.5)
<i>Shares of total exports</i>									
Traditional exports	82.3	72.7	56.8	51.1	38.5	29.9	25.8	22.6	23.8
Other agricultural	7.7	7.7	8.7	8.3	8.5	7.8	9.1	8.4	12.4
Nontraditional manufactures	8.6	17.9	31.4	36.4	48.9	58.2	61.7	61.7	63.7
<i>Quantity index, traditional exports</i>	100.0	88.0	99.7	99.6	90.0	60.9	59.5	80.7	71.7

Source: World Bank (1987), vol. 3, table 3.5; and NEDA, *Philippine Statistical Yearbook*, 1987.

Note: N.A. = not available.

declined sharply after 1980. The combination of both of these factors was responsible for the marked shift in the structure of Philippine exports in the 1970s and continuing into the 1980s.

The rapid growth of nontraditional manufactures exports appears to confirm the success of the Philippine strategy of export promotion, and was one of the primary reasons for the optimism concerning the Philippine economy among international agencies and commercial banks during the 1970s. Several factors were behind this rapid export growth. The first was the provision of investment incentives and incentives for domestic value added contained in the Industrial Incentives Act of 1967, the Export Incentives Act of 1970, and later amendments to these two acts. While not unimportant, the effect of the direct incentives to export was relatively small. A World Bank mission calculated the value of export incentives as constituting between 3 and 9 percent of the exports of registered firms between 1973 and 1977.<sup>20</sup> A later estimate put the effect of the incentives for domestic employment and procurement at between 5 and 10 percent of value added, depending on the input structure and profitability of the firm.<sup>21</sup> This conclusion is strengthened by the fact that much of the export took place through bonded warehouses, which were ineligible for the incentives.

Much more important were the provisions of these two acts, supplemented by the establishment of export processing zones and the authorization of bonded warehouses, which allowed exporters to purchase inputs at world market prices. It was this access to inputs, plus the changes in real exchange rates during the 1970s, that made the rapid growth of nontraditional exports possible (see table 3.7). Even more important for the kind of export industries that developed was the fall in real wages of approximately 25 percent that took place in the early 1970s. By the mid-1970s, Philippine wages for garment workers were roughly half that of Korea and a quarter of those in Hong Kong.<sup>22</sup>

Philippine manufactured exports are highly concentrated in a few products. Electrical components and garments together make up about 60 percent of the total of manufactured exports. Within electrical components, exports are concentrated in the assembly of semiconductor devices and microcircuits, and within garments, on finishing of consigned imports of women's wear and garments for infants and children. Each industry depends heavily on imported inputs. Estimates of domestic value added vary, but are about 25 percent for garments and 15 percent for electronic components. These ratios appear to have remained constant in the Philippines, unlike other less developed country exporters which have succeeded in raising their value-added margin through subcontracting.

The weak performance of traditional export commodities counteracted the rise in manufactured exports. The growth in export receipts from the traditional commodity export sector during the 1970s was entirely due to inflation; a quantity index formed using 1978 weights varies over the decade,



but ends up at the same level in 1980 as in 1972 (see table 3.10). Over the next four years the quantity of Philippine traditional exports declined by 39 percent, with a little over half of the decline coming in 1984. The importance of the stagnation and decline of the traditional export sector is hard to overstate; had the quantity of these exports grown at the same rate as real GDP and all other things remained equal, Philippine exports would have been 53 percent, or \$2.8 billion higher in 1984.

There are various explanations for the poor performance of the traditional export sector. The Philippines was hit by the low growth in international demand for commodities after the first oil shock and the accompanying weakness in their prices. Two features peculiar to the Philippines were also responsible for reductions in export quantity. At the beginning of the 1970s, exports of forest products, mainly logs, made up a quarter of Philippine traditional exports. However, the deforestation that had occurred in the Philippines led to increased concern for conservation and increasingly severe restrictions on log exports. By 1980, recorded log exports had dropped by 90 percent.<sup>23</sup>

The second feature is the dependence of Philippine sugar exports on U.S. quota allocations. The Philippines is a higher than average cost producer of sugar, and historically almost all Philippine exports have gone to the United States under quota. High sugar prices and the dismantling of the U.S. sugar quota in the 1970s led to a diversification of destinations, but the importance of the U.S. market was reestablished with the reinstatement of U.S. import quotas in 1981. And, as total U.S. imports have been reduced in the 1980s, Philippine exports have been correspondingly squeezed.

But much of the responsibility for the performance of the traditional export sector must be laid to Philippine policies. Philippine trade policy has consistently discriminated against the sector, promoting import-substituting manufacturing and then nontraditional export products. As a consequence, the commodity export sector has suffered negative effective protection, as outlined above. The 1970s saw the institution of additional policies that discriminated against traditional exports. After the 1970 devaluation of the peso, Philippine authorities introduced taxes of 4 to 10 percent on most commodity exports. Although supposedly temporary, these measures were never repealed and became a permanent feature of martial law policy.<sup>24</sup> Coconuts, the most important of the traditional products, had the largest taxation. A levy on the first sale of copra was introduced in 1973, initially to finance a price stabilization fund for domestic coconut products, but later to support a Coconut Industry Development Fund. The amount of the levy varied somewhat over the next ten years, but averaged about 20 percent of the export price, and eventually exceeded 30 percent.

Thus, at a time when world prices were turning against commodity producers, the Philippines raised the effective taxation of the commodity sector. Beyond this, government and quasi-governmental intervention

increased dramatically during the martial law period in the most important sectors, coconuts and sugar. By the end of the decade, each was under the control of a Marcos crony, who had a monopoly over purchases from the industry. These interventions are described in more detail in the following chapter, but the siphoning off of rents from sugar and coconuts, in addition to the taxes that were collected, further weakened the incentives for producers in those industries.

We are now in a position to answer one of the questions posed at the beginning of this chapter, that is, why there was such a sluggish performance of exports relative to gross domestic product, while at the same time there was a dramatic change in the structure of Philippine exports and a rapid growth in exports of manufactures. Behind this lay the fact that Philippine export promotion had a very narrow base. What Philippine export promotion measures did was allow producers to obtain imported inputs at world market prices, leading to the development of export reprocessing based on imported materials and the low wages of Philippine labor. The retention and augmentation of the system of protection for manufacturing firms producing for the domestic market meant that value-added margins of these export producers would stay very thin; the higher cost and lower quality of domestic materials precluded the growth of domestic sourcing. The high degree of protection of the domestic market also tended to limit export products to industries where materials transport costs were low and labor input requirements high. Garments and electronic components fit those requirements perfectly, and export growth was highly concentrated in these two sectors. Thus, Philippine export growth was intensive rather than extensive.

The rapid transformation of the structure of Philippine exports is misleading since it was based as much on the low growth of traditional export products as it was on the rapid growth of nontraditional exports. Unfavorable external conditions were partly responsible, but these were greatly exacerbated by Philippine policies which explicitly and implicitly taxed the traditional sector. The rapid shift in export structure, propelled from both ends, resulted in the narrowing of the value-added base of the country's exports since the domestic content of the nontraditional manufactures was much lower than that of Philippine agricultural and mineral commodities. Thus, as exports of manufactured goods expanded, imports of materials increased *pari passu*. The resulting structure was one in which a greater increase in gross exports was necessary to generate a net increase in foreign exchange earnings when external funding faltered.

### **3.7 Trade Policy and Manufacturing Performance**

The remaining question raised at the beginning of this chapter concerns the weak performance of Philippine manufacturing in the 1970s and early 1980s. Productivity growth for the sector as a whole was negative throughout the

1970s, with a particularly sharp fall after 1975. Employment generation was also low, despite the growth of labor-intensive manufactured exports. Finally, the growth rate of manufacturing output started to decline after 1977 and largely collapsed in the 1980s, again despite the continued growth of manufactured exports.

As described above, Philippine trade policy continued to protect the domestic manufacturing sector during the 1970s through existing tariffs and an increasing use of nontariff barriers, despite the adoption of export promotion. The domestic manufacturing sector remained closed to foreign competition, as well as being insulated from the exporting segment of the industry. As a result, the growth of the sector was largely determined by domestic demand and by industrial incentives policy.

The industrial policy that was in fact adopted by the Philippine authorities encouraged the development of intermediate industries as a part of a process of industrial deepening. This policy thrust was reinforced by the shift in domestic demand toward investment and the particularly rapid growth of construction, activities with an especially high demand for materials. The outcome was a pronounced shift in manufacturing output growth toward intermediate industries, as well as capital goods, during the last half of the 1970s (table 3.11).

**Table 3.11** Growth Rates of Real Manufacturing Production  
(in percentage change per year)

	1970-75		1975-80
Fastest growing			
Beverages	23.0	Nonferrous metals	32.9
Machinery	23.0	Industrial chemicals	28.1
Plastics	22.2	Footwear	27.6
Apparel	16.3	Paper products	23.7
Furniture	14.5	Wood products	21.9
Food	13.3	Glass	21.3
		Transport equipment	21.2
Total manufacturing	6.8		5.4
Memo items:			
Consumer goods	13.1		2.1
Intermediates	3.3		9.5
Capital goods	6.2		12.4
Food	13.3		1.2
Petroleum products	10.8		-2.0
Other K-intensive <sup>a</sup>	6.8		13.8
L-intensive <sup>b</sup>	8.8		7.3

*Source:* Hooley (1985), using data from the annual surveys of manufacturing adjusted to reflect firms with twenty or more workers.

*Note:* Growth rates are valued at 1972 prices.

<sup>a</sup>Capital-intensive industries include paper, chemicals, nonmetallic minerals, glass, iron and steel, and nonferrous metals.

<sup>b</sup>Labor-intensive industries are the remaining industries, except food and petroleum products.

As is clear from table 3.11, output growth was also concentrated in industries with above average capital intensity. This was partly the result of the shift in demand toward intermediates, described above, as well as the nature of industrial incentives and government-sponsored finance, which lowered the cost of capital. Again, this took place despite the rapid growth of labor-intensive manufactured exports. The shift toward capital-intensive industries provides an explanation for the low growth payout of Philippine investment (or, alternately, the country's high ICOR) since capital-intensive industries require more investment per unit of output. In addition, the shift toward these industries helps explain the low employment generation of Philippine manufacturing.

Shifts in the industry composition of manufacturing output also lie behind much of the poor productivity performance of Philippine manufacturing. During the 1970s, most manufacturing industries registered positive total factor productivity growth. For the decade as a whole, within industry productivity growth added 0.34 percent per year to total factor productivity in manufacturing, while interindustry shifts lowered manufacturing productivity by 1.57 percent per year.<sup>25</sup>

Other factors lay behind the poor performance of the manufacturing sector. During the martial law period there was increasing government intervention in the industry, as well as increased activity by publicly owned corporations. From 1965 to 1980 the share of government corporations in total assets of nonfinancial corporations doubled to 27 percent (Hooley 1985, 28).<sup>26</sup> The importance of this in explaining the low productivity growth of the sector has been stressed by Hooley, who found total factor productivity in government corporations to be only 56 percent of that of privately owned corporations (29–30). In addition to direct government intervention, firms owned by Marcos associates played an increasing role in domestic activity, largely through acquisition. The impact of government intervention and crony capitalism is discussed in more detail in the next chapter, in which we argue that both played a role in the deteriorating performance of domestic industry.

Trade, exchange rate, and incentives policies played a crucial role in the slide of the Philippines toward debt crisis. Although deceptively successful in developing manufactured exports and shifting total export composition, Philippine policy failed to respond to the worsening external environment and the country's foreign debt accumulation. The depletion of forestry resources and the secular decline in the terms of trade should have led to a real exchange rate depreciation that would have provided across-the-board encouragement to exports and efficient import substitution. Instead the Philippines allowed a gradual appreciation of the real exchange rate, encouraged manufactured exports while maintaining and strengthening the protection of domestic industry, and increasingly taxed the traditional export sector. The result was a significant hollowing of the country's export base, greatly reducing its foreign exchange earning capacity.

The combination of trade protection, investment incentives, and domestic growth propelled by investment and construction took its toll on Philippine industry. Output shifted toward more capital-intensive, lower productivity industries, limiting the growth that the Philippines got out of its investment and foreign borrowing. But these industries were also dependent on the continued momentum of borrowing and investment and proved extremely vulnerable to the recession of the early 1980s. The sharp declines in many of these industries worsened the recession in the early 1980s, and many of these firms ended up in the hands of the government, either through rescue operations or the assumption of guaranteed external loan obligations.

## 4 Government Interventions and Rent Seeking

In the popular imagination the legacy of the Marcos administration was the accumulation of vast wealth by Ferdinand Marcos, his family members, and various individuals, or “cronies,” who were closely associated with him. Corruption and the accumulation of wealth through government did not originate with Marcos, nor was it unusual in the Philippines as opposed to other countries in or outside the region. But the scale on which corruption and the generation of rents took place in the Philippines under Marcos was at a qualitatively different level. What observers in the Philippines referred to as crony capitalism, and what less charitable observers outside the country referred to as “government by kleptocracy,” was of such a scale as to have macroeconomic consequences, and plays its own important role in the slide of the Philippines into crisis.

The use of government power to generate and distribute wealth, what economists have termed “government rent seeking” had three critical consequences. First, quasi-governmental control and monopolization of the two principal commodity export crops, sugar and coconuts, was responsible for much of the sluggish growth of traditional and total exports. Second, the particularistic way in which the government issued regulations and granted access to credit to favored firms and the way in which crony business empires were built weakened and demoralized the private, nonassociated business sector and encouraged capital flight. Finally, when the crony empires dissolved in the 1980s, the government was left with a huge burden of failed assets, called loan guarantees, and unmet domestic payment obligations, creating a fiscal problem of major dimensions. We start our story with two of the most insidious interventions, those in sugar and coconuts.