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IMPORT SUBSTITUTION IN THE PHILIPPINES, 1954-1961: A HISTORICAL INTERPRETATION

by

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Import Substitution in the Philippines, 1954-1961:
A Historical Interpretation[1/]

The Philippines is a developing economy undergoing rapid transformation, especially in the present decade of the 1970's. But the method by which this process was triggered, which using current terminology can be characterized as an import substitution strategy, has been criticized, especially since the 1960's. The recent study by a mission from the International Labor Organization (ILO), entitled Sharing in Development: A Programme of Employment, Equity, and Growth for the Philippines, contains many passages critical of past Philippine development efforts, especially "import substitution." In this the ILO mission is but the latest to flog the beast, so to speak.

Yet the process which started in the first half of the 1950's with the objectives of reducing Philippine economic dependence (especially on the United States), of establishing a viable manufacturing sector, and Filipinizing economic activity was widely accepted when it was launched. The Filipino businessmen then and now enthusiastically fell in with the effort and are still today its strongest and most staunch intellectual defenders. Furthermore economic historians are aware of the fact that after the first industrial revolution in England, the world has seen no successful industrial revolution without import substitution as an essential element.

History

What are the reasons for the difference of opinion and who, it might be asked, enjoy the more accurate insight? Here an attempt will be made to view the question from a more historical direction, rather than from rigid and static economic theory. It is the burden of this paper that from the historical point of view the import substitution strategy in the Philippines, despite difficulties and errors in implementation, had much more to commend it than condemn it. Where there were mistakes and shortcomings, either built-in or man-made, the society and the country have had sufficient flexibility to deal with the problems and change direction.

The focus will be placed on the period from 1954 to the end of 1961 (strictly, to the third Sunday of 1962) when the hothouse of protection was in most vigorous operation. The key point of the historical judgement is modernization of the economy and society and what the period 1954-1961 meant in this regard.

<u>General Considerations</u>

First of all it seems useful to define more concretely what is meant by an import substitution strategy. To paraphrase Bruton, an import substitution strategy seeks to bring about economic development or "modify the nature of the economy in quite fundamental ways on the assumption that such modification is necessary before sustained growth is possible." To do this, a <u>primum mobile</u> or catalyst is needed and it is felt to be through "curtailing imports in order to create investment opportunities or to change the structure."2/ Bruton distinguishes this approach

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from an export-promotion strategy, which he defines as an attempt to promote industrialization <u>without</u> import substitution, as well as a strategy built around increasing agricultural productivity.

But the prewar "colonial" structure of the economy, while bringing great benefits for the country, was inappropriate for the changed post-World War II conditions. A Filipino economist has very aptly summarized the postwar changes in terms of seven D's: diplomacy, defense, demography, democracy, development, deficits, and disruption.[6/] An independent Philippines now had to carry the burden of diplomacy and defense; a rapidly expanding population meant new demographic relationships; postwar Philippine society was more politically aware and the people demanded more from a democratic government; higher material aspirations called for development; these pressures did not bring forth adequate additional revenues for the government and therefore budget deficits were endemic; and finally disruptive forces--from vested interests, mainly from the traditional agriculture exporting classes, determined to frustrate monetary discipline and from dissident Communist-oriented groups--were bent on subverting the economy and society. With all these, structural change was called for.

As early as 1933-34 the Philippine Economic Association, composed of prominent government technocrats as well as bankers and businessmen, had perceived the problems and the needed reforms of structure.[7/] Many from that Association, such as President Elpidio Quirino and Mr. Miguel Cuaderno, held substantial power in the postwar government and it is no accident that their perceptions were translated into policies and concrete actions soon after the war.

But before structural change could be attempted, the first task after the liberation of the Philippines in 1945 was rehabilitation from the vast devastation wrought by the war. Fortunately recovery was rapid, by 1949 prewar levels of production were achieved, and finally by 1953-54, the full sugar quota of 850,000 tons, which was the same as the prewar volume, was exported to the United States. Although not all economic activities were fully rebuilt, still it can be said that by that time rehabilitation was substantially completed.

As has been observed by Bruton and others [for countries embarking on an import substitution strategy, the crisis which triggered the vigorous efforts to restructure the economy was balance of payments and foreign exchange difficulties.] These came to a head in the [second half of 1949.] [Foreign exchange and import limitations were effectively enforced from December 9, 1949 and from 1949 to mid-1953 the battle consisted of efforts to dam the tide of foreign exchange outflow.] Nevertheless the beginning steps to industrialization and structural change could be taken, as the import controls were also used to promote new industrial ventures, especially by Filipinos.]

[Because of widespread public outcry against the corruption and abuse which had marked the implementation of the import control law, it was allowed to lapse without renewal on June 30, 1953.] The Central Bank however, under Governor Miguel Cuaderno, realized that [a continuing foreign exchange problem remained.] Fortunately, three and a half years of efforts had [succeeded in shoring up somewhat the balance of payments situation.] It was now possible to use exchange controls for other than the limited foreign exchange objective. Accordingly from the middle of 1953 the Central Bank set about devising a control system more suitable for such objectives. The election and assumption into office of a new President, Mr. Magsaysay, at the end of 1953 meant a fresh new spirit in government, not only of more youthful dynamism but also of more nationalism. A Retail Trade Nationalization bill came into effect (without the President's explicit approval by signature) on June 18, 1954--the first time that a Filipinization bill became law. This marked a very real change in direction.

? Because of the above background--the filling of the sugar quota, the accession of Mr. Magsaysay, the passage of the retail trade nationalization law, the more vigorous foreign exchange control policy--mid-1954 has been chosen to mark the close of the rehabilitation period and the start of the restructuring effort.

The chief instrument in the restructuring was exchange controls. These were used for two main purposes which were interrelated: firstly, to lay the base for a viable modern manufacturing sector and reduce the role of agriculture; secondly, to give to Filipinos a larger share of economic activity. A third objective might be mentioned: to enhance Philippine economic independence, especially *vis-a-vis* the United States, the largest trading partner, the main outlet for primary products exports, and the chief source of consumer and capital goods. The pursuit of economic independence also meant autarchy or enhanced self sufficiency in the production of goods as well as attempts to reduce foreign trade instability through diversification of products and markets. The principal approach to the solution of the problem of dependence was a gradual removal of trade preferences between the Philippines and the United States. But

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it is easy to appreciate that in addition import substitution was an obvious policy prescription.

The foreign exchange shortage was not severe during Mr. Magsaysay's term and exchange controls were not stringent. It is well known that businessmen could get generous allocations to cover their legitimate imports of machinery and other capital goods

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development beyon March to November, 1957 the international reserves mainly by foreigpm slightly below $300 million to almost zero. At the rev t tariffs inflationary pressure built up from large public borrowing u for we cic works launched by Mr. Magsaysay from 1955 onwards had become intolerable. The answer to these unfavorable turns in the economic situation was tight money (Circular No. 79 of the Central Bank on December 9, 1957), stricter exchange control, and a government "austerity" program.]

[The "austerity" program ended with the lavish Presidential inaugural ball on December 30, 1957; the tight money became increasingly an illusion from January 16, 1958 when the Central Bank started to loosen the reins, and so it remained for exchange controls to be the instrument for containing the inflationary pressure as well as preserving balance in payments. It also became necessary to tighten up credit. But it was measures on the foreign exchange side--for example less generous dollar allocations for businessmen, and a "margin" fee on foreign exchange purchased --which had to bear the burden of economic stabilization. In April 1960 a "decontrol" program was launched which was really a disguised *de facto* devaluation and multiple exchange rate system.]

The chief victims of reduced dollars and tighter credit were the businessmen. The import substitution drive sputtered, economic growth slackened. At the same time the corruption associated with exchange controls, including a "barter" system devised by vested interests to get around the control system, extended like an octopus, if not in substance, at least in the public's awareness of and repugnance with it.

1961 was another presidential election year. opponent was Mr. Macapagal (his Vice-President) who ma his election planks to abolish exchange controls. Three s afte his assumption of office as President, Mr. Macapagal carried out his pledge. On January 21, 1962 Central Bank Circular No. 133 abolished all exchange controls and set up a "free-market" for foreign exchange purchases, though earnings in foreign exchange still had to be surrendered to the Central Bank which purchased 80 per cent of these at the "free-market" rate and 20 per cent at the official parity of ₱2.00 to US$1.00.

In his State of the Nation address on January 22, 1962, the day decontrol took effect, Mr. Macapagal signalled the end of an era. He explained that he had decreed decontrol because:

> "Firstly, the country has fully exhausted the potentialities for growth offered by the complement of policies ruling over the decade of the 1950's.
>
> Secondly, it has become obvious that the impetus to investments which exchange controls and various incentives provided has worked itself out.
>
> Thirdly, the country already enjoys to the fullest extent the export potential feasible under present exchange and trade policies."

With decontrol, the umbrella over import substituting enterprise was closed. The policy of vigorously fomenting and protecting import substitution was abandoned. From mid-1954 to the end of 1961 was only seven and a half years. That is how long the import substitution phase of Philippine economic development took place.

It is stretching the facts to say that the import substitution strategy in the Philippines animated Philippine development beyond that third Sunday of January, 1962. It has been claimed, mainly by foreign observers, that protection remained in the form of revised tariffs. But revised tariffs could not take the place of quantitative controls on imports. As almost any Filipino businessman knows, tariffs are of limited effectiveness in raising the prices of imports and thereby keeping them out; there are too many ways of getting around the tariffs. It is also in fundamental contradiction with the facts to allege that protection was maintained as before despite decontrol. If this was so, why was it that, as is common knowledge, innumerable firms faced very real difficulties of adjustment after the decontrol? Besides even before 1962 and increasingly since then, many products turned out in the Philippines were selling below the international trade price plus tariff; in other words the tariffs were irrelevant.[8/] A walk through any supermarket in Manila confirms that for many items--food, underwear and so on--local made products are cheaper than similar items on supermarket shelves abroad.

Adjustment from 1962

And so a third phase in postwar Philippine economic development was ushered in, which may be termed a period of adjustment. The adjustment had many sub-phases. From 1962 to 1965, the hothouse-bred industries were forced to face the chill winds of competition. Despite vicissitudes, by 1965 the situation of the manufacturing industries was more solid. So was the foreign exchange position--international reserves were rising and the exchange rate was stable at ₱3.90 to US$1.00 without Central Bank support.

From 1966 with the election of a new President, a shift in direction took place towards agricultural development and massive building of infrastructure in the rural areas (the slogan was "roads, rice, and schools"). But unfortunately this was accomplished with an easy money policy, ever larger government budget deficits, liberalized imports, and what proved later to be a particularly thorny problem, large foreign borrowings for public and private investments, often using short term loans to cover long term projects. However during this period--to be exact in 1966 soon after Mr. Marcos' four-year development plan was prepared--it was realized that export promotion was necessary if economic growth was to be sustained. A new direction of effort was again signalled and new export promotion offices were formed, but the drive was slow to gain momentum. Meanwhile in 1969, another election year, the consequences of the package of monetary and fiscal policies set in motion in 1966 finally hit the economy and combined with large government expenditures to support the reelection campaign of the incumbent, resulted in a severe deterioration of the foreign exchange situation. Early in 1970 the choice was either to reimpose exchange controls or to devalue by "floating" the exchange rate. The decision made was for the latter. This created great difficulties, albeit different ones from those which would have come with controls; in particular the devaluation aggravated the problem of debt service and set off a new wave of inflation which has not subsided to this day. Exporters of primary products gained windfalls, the investments previously made to expand copper and banana production coincidentally came on stream so that total exports of these rose, and in addition it now became easier for manufacturers, both old and new, to export their industrial products.

The point of this review of the period from 1962-1970 is that it was marked by a series of painful adjustments, so that the fruits of the import substitution movement of the 1950's were delayed by perhaps three to five years. Caution should therefore be displayed in assessing Philippine economic performance in the 1960's.

The Meaning of the Import Substitution Drive

It may now be possible to place the period 1954-1961 in proper perspective. What, in terms of economic history, was the meaning of the import substitution drive of that period which, to repeat, was only the seven and a half years from 1954 to 1961?

Economic development means not only economic growth but also a change in the structure of economic activity and institutions so as to apply modern science and technology which historically happen to have had their roots in the West. In a word, economic development means modernization of an economy and society. In most successful instances and certainly in all the leading developed nations, the economic development has taken the form of industrialization. For most relevant situations therefore, economic development has meant modernization through an industrial revolution.

These, it would seem, were the indicated character and direction of Philippine economic development--modernization and industrial development. As it happens, these were indeed the perceived goals of the economic development drive launched after the rehabilitation phase was over. These objectives were often enough expressed in the public statements and the concrete actions of the leaders of the country as to be indisputable. It is possible to question whether or not these were and are proper goals, but today there is hardly any more debate about the legitimacy and propriety of these objectives, at least for the Philippines.

In the 1950's in addition to the general goals of economic growth and development which, as above stated, required modernization and industrialization, there were other objectives: Filipinization of economic activity and economic independence. Two other goals, employment and equity, did not seem as pressing then as they perhaps appear now. In any case historical experience has shown that economic growth by itself goes a long way to contributing to the solution of the problems of employment and equity.

The success of the efforts of the 1950's should be judged against the above aims. Any view which demands that an initial effort at economic development, especially one which took place over less than eight years, should solve all the problems of a society would seem to be unfair and unjust.

The process of economic development requires a fortunate conjuncture of many forces. Among the economic factors required are not only capital formation, labor supply, and technology, but also capable managers and dynamic entrepreneurs. Furthermore economic development goes beyond economics--there must be complementary development in the cultural, social, and political spheres. To bring about these changes, a "critical minimum effort" or a "big push" or "primer mover" is necessary. This is not automatically forthcoming unless a minor scale Toynbee system of challenge and response presents itself. Governments, and one might also generalize for peoples, seldom take big steps until they are faced with a crisis.

In the case of the Philippines in the 1950's what appeared was not just one crisis but several: political independence, balance of payments difficulties, an economic structure no longer suited to changed needs and conditions, social unrest which in the extreme was expressed in violent form in a Communist-led subversive movement. The government was not ineffective, but it was inexperienced in many areas for these were problems which may now seem ordinary for developing nations but certainly at that time were new not only to the Philippines, which after the war was the first former colony to attain independence, but also to the world as a whole.

In accordance with then prevalent economic theory, the ostensible and open thrust of the Philippine economic development was through investment in capital--to make it easy and cheap for businessmen, especially Filipinos, to set up their factories. In explaining the rationale of a system of an overvalued peso and reliance on exchange controls, one of the leading architects of the movement, Miguel Cuaderno, has stated that he knew the Philippines was going to have to industrialize and he wanted to provide the needed capital goods cheaply.[9/] Today it is a fashionable criticism to say that such an approach leads to inappropriate technology and factor proportions mix. That should not be denied, but one should not make a blanket denunciation of import substitution purely on that ground. In the first place, the primary lesson, reaching back to Adam Smith, should never be forgotten: that capital increases productivity. Secondly, not all new technology increases capital intensity; new processes or machines may also be capital saving. Thirdly, often there is little scope for choice of technology in turning out a specific product. Fourthly, businessmen in search of "flexibility" do often opt for larger plants and excess capacity. Finally, as applied to the Philippines, it is an open question how serious was the actual scope of inappropriate technology and here the evidence is by no means unequivocally unfavorable; in fact, in the absence of definite statistics, a tentative judgement can be made that it was not really serious.

But the effort went beyond mere capital formation. It is well known that many nations have built up factories madly but have not succeeded in setting up a viable industrial sector. Capital equipment is not enough; there must be the manpower--the labor, the managers, the entrepreneurs to run the factories. The real effort of the exchange control system of the 1950's was directed towards the business sector: to turn the face of Philippine business towards the twentieth century, to give the businessmen opportunities to establish themselves solidly, and to create a new, much enlarged, and ever-growing class of strongly motivated and dynamic Filipino entrepreneurs.

In economic terms perhaps the most significant contribution of the Americans during their 40-year period of stewardship over the Philippines had been the establishment of a system of mass education. This built up a large reservoir of literate and skilled workers. At the higher education level, a particular feature of the system was the numerous schools of accounting, commerce, and business administration: the first degree in commerce was granted by the