

PROSPECTS FOR STRATEGIC ECONOMIC ALLIANCE BETWEEN THE U.S. AND THE PHILIPPINES

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The purpose of these remarks is to review some of the more important economic issues faced by the Philippines since independence. In undertaking this review I consider it desirable to highlight differences between American and Filipino perceptions of the issues or the policies required to deal with them. Second, it will be helpful to suggest some promising areas of bilateral strategic alliances where these two countries can cooperate on new policy areas for mutual economic benefit.

Foreign Trade and GDP Growth

In the early years of independence the Philippines chose an import substitution growth strategy which both focused on the development of indigenous industry and was highly interventionist in implementation. This was a widely accepted strategy among economists of that era, and did in fact provide the country with very satisfactory GDP growth rates for a little over a decade, i.e. until the early 1960s. But it had to be abandoned-albeit gradually, and some would say, grudgingly. A major problem with import substitution was that it tended to stultify growth in foreign trade. But as Philippine economic

history makes abundantly clear, periods of rapid export growth (e.g. the second half of the nineteenth century and the first quarter of the twentieth)- are also the periods of most rapid GDP growth. Controversely, the periods of sluggish export growth - e.g. the 1930s and the 1980s - usually represent periods of stagnation in GDP growth.

Given these facts, there is nevertheless a difference in perceptions of trade and as an overall growth strategy. Americans have generally favored free trade along with an open economy. Filipinos on the other hand have been concerned with the aspect of "foreign domination" attendant with an open economy posture, along with the vulnerability that goes along with dependence on one or a few foreign (country) markets.

These approaches to trade and growth are not mutually exclusive provided each party observes certain critical guideposts in policy design. On the American side the requirement is that the U.S. will continue to support Asia Pacific Economic Cooperation (APEC) and the smooth inauguration of World Trade Organization (WTO) rules. Thus will be phased out some of the trade barriers most opposed by countries like the Philippines (e.g. textiles under the multi-fibre agreement). Above all, if America decides that the pace of trade liberalization or the resolution of trade conflicts through organizations like WTO and APEC are not satisfactory, she should not proceed to adopt retaliatory policies such as those outlined under Super 301 or unilateral action by the United States Trade Representative (USTR).

On the Philippines' side, the country will have to remain open to foreign investment. In addition, it should look forward

to the development of a growing domestic market as an additional source of demand growth - as Japan and Korea have demonstrated. To accomplish this, more attention must be given to improved income distribution. In the Philippines, the income gains from trade have not been distributed widely, and domestic markets remain very narrow. I estimate that the real wage rate of unskilled workers was constant from 1848 to 1941, and fell by about 30 percent between 1941 and 1980. (MacMicking, 1848; Joint Philippine-American Finance Committee, 1946; Central Bank of the Philippines, 1980). In other words, all the increased *per capita* purchasing power for the past 130 years has gone to the a wealthy elite and to a fairly narrow middle class located in the major cities. Obviously, production for the local domestic market has very limited real growth potential in these circumstances. A shift in income distribution is essential. One way to achieve this is to focus on raising agricultural exports and productivity which will stimulate real income growth in the rural areas (Derosa and Bautista, 1996). Another would be to monitor wage bargaining practices more closely in an effort to improve competition in the labor market.

Infrastructure for Development

It is widely agreed that development requires the creation of an infrastructure - both physical and human capital - for successful development. The size and quality of this infrastructure go a long way toward determining the rate of output growth. In the Philippines, the Commonwealth government laid down the basis for an expanded infrastructure. During the first four decades of this century government services increased by about twelve times. Much of this increase was in

the areas of education and public health. By 1950 the Philippines was far out in front of other Southeast Asian nations in terms of educational levels and declining mortality rates. During independence, expansion of this human services thrust has continued, although at a somewhat reduced rate because of the country's fiscal policy logjam.

In the area of physical infrastructure, the record is mixed. Expansion of irrigation - on which agricultural productivity so heavily depends - has seen essentially two periods of rapid expansion during the past century. The first was undertaken by the American government in response to a major rice crisis in 1910. Rice imports, which had been growing steadily during the 1890s and early 1900s, reached a level of nearly 25 percent of total imports between 1910 and 1912. The American administration, eager to balance the Philippine external accounts and to insure its own fiscal solvency and to head off popular unrest, embarked on an extensive irrigation program. This program, which started with construction of the San Miguel works on the Pampanga River and culminated with the Angat project in Cagayan, raised the productivity of agriculture and reduced rice imports to a trickle by 1920. However, little additional work was done on the further expansion of irrigation under the American regime, and indeed during the first two decades of Philippine independence. Then in the early 1970s the threat of a rice crisis once again loomed on the economic horizon. And, just as had occurred 50 years before, it prompted political leaders to take action - this time with World Bank help. The result was similar: rice imports not only declined but the country actually became a rice exporter by the next decade.

• These two episodes show what can be done when politics experiences the firm pressure of economic reality and when the political leaders clearly understand the connection between the two. In the immediate future, the Philippines will continue to benefit from continued attention to water control. However, there are limits to the effectiveness of this strategy. The country will eventually find it necessary to look to more inventive strategies to raise agricultural productivity. In this effort cooperation with U.S. and ASEAN in the development of regional research centers will probably turn out to be an important component of the solution.

The Financial System

The major function of any financial system is to generate savings. Saving is performed by households, businesses and by the government. The volume of savings determines the volume of investment or capital formation. A rapid rate of capital formation increases worker productivity, which in turn makes a country's products more competitive worldwide, and at the same time providing the basis for an increase in real wages. At the present time, the financial sector in the Philippines is extremely weak. The nation's saving rate of around 16 percent is the lowest in Southeast Asia (where the average is above 30 percent), and one of the lowest among developing countries in Asia. The weakness is particularly evident in the extremely low rate of household savings and the low level of government fiscal revenues and savings.

A major reason for the low national saving rate is the weakness of the banking system. Mismanagement and pirating of the banking system during 1970s and 1980s led to insolvency

of a number of domestic institutions and growing mistrust of banks by depositors. The result was that Filipino households either invested their savings in tangibles like construction and real estate or moved money to foreign institutions. This situation can only be corrected by opening up the financial sector to foreign investment - a move that has already been taken. Foreign investors applaud this policy. Many Filipinos, on the other hand, worry about the influence of a few foreign countries on a vital sector of the national economy. But the reality is that Filipino banks were so badly undercapitalized that no feasible alternative was really available.

A second reason for the low rate of Philippine savings is the weakness of fiscal policy. Fiscal policy involves the structure of taxes, the level of government revenues, government expenditures and the size of the government surplus or deficit. In most rapidly growing Southeast Asian nations, the government runs a surplus, at least in some years. This contributes to the national saving rate. For example, if the private sector saves 20 percent of national income and the government runs a surplus equal to 4 percent of national income, the national saving rate is 24 percent. But if the government runs a deficit of 4 percent, the national saving rate drops from 24 to 16 percent. The expansion of fiscal revenues and improvement in the allocation of government expenditures is absolutely essential to raising the growth rate of saving and ultimately income, in the Philippines. The weakness of the domestic financial system is one of the main reasons for the failure of Philippine growth to 'catch up' with other SEA nations. What is happening now is that households prefer to invest in construction and real estate speculation, leading eventually to an oversupply structures. Meanwhile, capital investment in machinery and other non-

construction items is sorely neglected, keeping works productivity low. The base for exports continues to be cheap labor, as opposed to efficient labor.

Fiscal reform is the gordian knot of Philippine development. It has a long history. When the American Insular government took charge in the early 1900s, it was faced with a fiscal system inherited from Spain which generated not more than 4-5 percent of GDP in government revenues. Originally, the Taft administration planned on a program of American private investment and increased foreign trades which would be taxed to augment the Insular government finances. When Taft's program became stalled in the U.S. Congress, Taft turned to a "free trade" program in which Philippine exports would enter the U.S. duty-free and American products coming to the Philippines would also be free of duty. But pursuit of this policy created a fiscal dilemma because the existing system depended heavily on taxation of imports and exports, as well as on the cedula or head-tax. With a deficit facing the American Insular government, a new tax system was hastily drawn up (Hord, 1907). In its essentials, the new system put much greater reliance on internal taxes, particularly excise taxes on the production and trade in specific commodities, like alcohol and tobacco. However, it did not produce any change with regard to income taxes. Nor did it deal effectively with real estate taxes. This latter was an egregious omission in view of the fact that sugar production and exports were now heavily subsidized by the American consumer. The net upshot was that although the American revision of the Philippine fiscal system raised government revenue to about 7 percent, the system had little of what economists call elasticity. That is, government revenues as a percent of GDP grew only slowly.

The newly independent Philippines inherited this fiscal system, and although some changes were made, fiscal revenues have continued to exhibit a low growth elasticity. Philippine government revenues as a percent of GDP continue to be among the lowest in Southeast Asia, and only half that of rapidly growing countries like Malaysia (not to mention high-performers like Singapore). The solution to this century-old fiscal logjam is not only a radical revision of the tax system, but also a streamlining of the government expenditure structure - both parts absolutely essential for significant acceleration in GDP growth. Some headway has been made by privatization which has the effect of paring down the government expenditure side. Still, there remain areas of activity in the production of public goods where the participation of government is essential. A fundamental revision of the fiscal system will require a massive domestic political effort. But it is not impossible. Political action on rice production took place when the country's leaders looked down the barrel of an economic crisis. Today, the crisis is equally pressing. The task is to make clear the relationship between growth, real wages and financial sector reform. In this effort multilateral institutions such as the IMF or the ADB may be helpful in the planning stage. But ultimately design and implementation rest squarely with Filipino leaders.

Foreign Exchange Rates

The Philippine economy is highly sensitive to the foreign exchange rate. The country's economic history is replete with examples of GDP growth effects resulting from changes in the value of the peso. When, in the last decades of the nineteenth century, the peso declined in value from \$1 to approximately

\$0.45 by 1900, Philippine exports expanded rapidly. Again, when the U.S. dollar was devalued in 1934 (and along with it the peso which was fixed to the dollar), an export boom of historic proportions in the mining industry was ushered in which lasted until World War II (Hooley, 1996). Other examples in more recent years could be added: But the point is that the foreign exchange rate is and always has been a major determinant of GDP growth in this country.

In the past, the peso has been anchored to the dollar. In the future, the exchange rate of the peso vis-a vis other currencies is now becoming increasingly important. The reason is the growth in Asia Pacific Trade. Some countries in the region (e.g. Indonesia) follow a policy of a crawling peg which slowly but steadily depreciates the rupiah. When the peso does not depreciate, or if it appreciates, as it has done recently, this confers a competitive advantage to Indonesian exports. It also provides Indonesia with a larger share of other economic benefits, such as increased employment for example. As Asia Pacific trade expands, increased attention will have to be given to the creation of some kind of band of exchange rates, although possibly a rather flexible band. This is a task the Philippines and the U.S. can cooperate on, and indeed will require close cooperation if trade in the region is going to continue its rapid expansion. The dollar may still remain the anchor currency for Pacific Rim countries, but the relationship of other countries' currencies to the dollar and to each other will become the focus of more sophisticated multilateral arrangements. In the task to sort out a new exchange rate system, the possibilities for mutual cooperation and benefits is great for both America and the Philippines.

Defense

This last area is one of the most promising for Filipino-American cooperation. We all know that the old system of insuring international security in the Philippines (and Southeast Asia) which was organized around the U.S. bases at Clark Field and Subic has ended. What we do not yet know is the kind of system that will take its place.

First, let the obvious be said. Continued growth in Asia Pacific trade can only take place within the context of a stable security system embracing all nations in the region. It was the absence of such a system that thwarted the resuscitation of trade growth in the late 1930s and led eventually to the outbreak of World War II. In those years, there were a series of meetings in London and Geneva among the great powers which tried to establish a workable security agreement. These efforts ended in failure. Nowhere was the failure more evident than in the Western Pacific which, in effect, invited adoption of aggressive naval and military postures by ambitious leaders.

The situation today is different, but also dangerous. On the one hand, the danger of nuclear war has declined. Confrontation between Russia and the U.S. in Asia has actually shifted toward cooperation - as evident by the growth of trade and investment between Eastern Siberia and Alaska. On the other hand, the "great powers" have much less control over developments in this area than they once did. And while many countries in the world have substantially reduced military spending as a percent of GDP, the reduction in Asia is only minimal, and some countries in the Asia Pacific region have actually increased the share of GDP going to the military. In

dollar terms, Asian countries' military spending between 1990 and 1995 increased by \$15 billion, with \$9 billion of the total accounted for by the newly industrializing countries. This military build-up, along with the proliferation of weapons of mass destruction, creates new potential for the flare-up of conflicts along the east coast of the Asia mainland - from the Kurile Islands to the Spratleys to the Archipelago region of Southeast Asia.

The serious threat here is the loss of control by the larger nations. A promising way to deal with the situation is to shift to a multilateral security strategy. It should be the goal to include in a new organization all the important powers in the region and especially those states on whose territories conflicts have or are likely to break out. There is tremendous potential for cooperation between the Philippines and America in the creation and functioning of such a multilateral security strategy. Both would benefit handsomely from increased security in the region. Both have potentially unique contributions to make toward success of such a strategy. Both have a comparative advantage in the pursuit of such a course of action by virtue of their present international positions.