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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Philippine Economic Problems

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1968

INTELLIGENCE MEMORANDUM

Philippine Economic Problems

Summary

The Philippines is not likely to make much progress in solving its economic problems over the next few years. Although the economy is expected to grow about 5 percent a year, the average Filipino will not benefit much. This is because the expected growth is unlikely to substantially exceed the rate of population growth, which is one of the most rapid in the world, and because a disproportionate share of any increase in per capita income probably will continue -- as in the past -- to be siphoned off by the small number of affluent landowners and industrialists who control the country's economic and political life. To make rapid progress the government would have to come to grips successfully with the problems of slowing the population growth, rapidly increasing the output of agriculture and industry, and making some forward movement on land reform and other socioeconomic issues which now stifle the production incentive of much of the labor force.

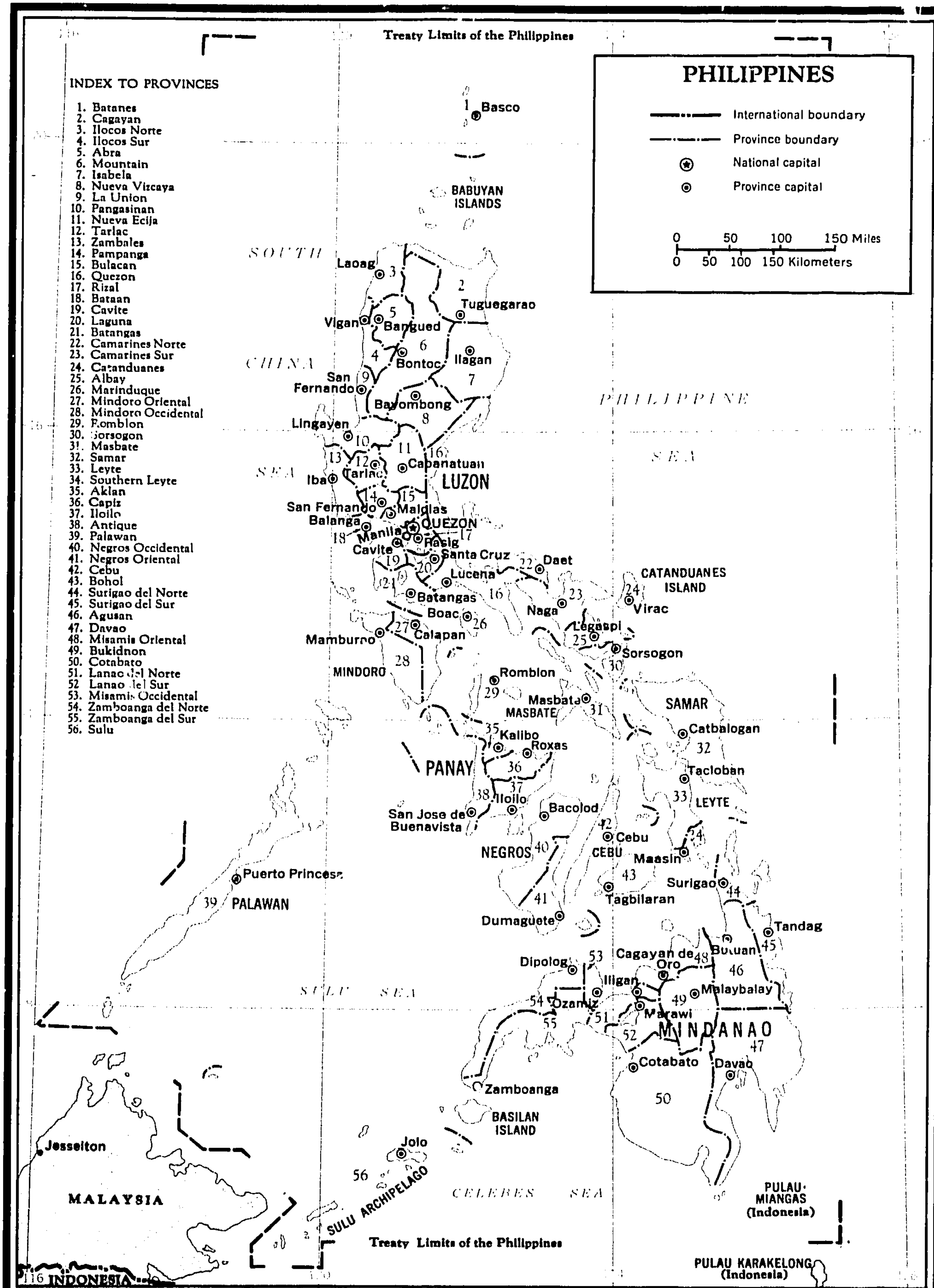
Although the government is aware of the economic cost of its rapidly increasing population, it has yet to begin a birth control program. And even if it did, a generation or so would elapse before the results could become visible. A sharp increase in agricultural production is highly improbable. In the past decade or so, food production about kept pace with population growth, thanks mainly to

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and coordinated with the Office of National Estimates and the Office of Current Intelligence.

bringing new land into cultivation. But suitable unused land is about exhausted, and future production increases will have to come mainly from higher crop yields. It is technically possible to increase yields sharply -- especially since Philippine yields are so low generally -- but a major effort by the government to promote irrigation, land reform, better farming methods, and improved seeds would be needed first. Now, at least, neither the funds nor the will for such an effort seems to exist. Although "miracle" rice seeds have been introduced, their future widespread use is far from certain, in part because they require substantial and precise use of fertilizer, water, and pesticides. Some progress has been made in the direction of self-sufficiency in rice production, but -- contrary to press reports -- this has not yet been achieved, nor is self-sufficiency likely to be won for the next several years at least.

The growth of industry, which was rapid in the reconstruction years following the end of World War II and during the Korean War-induced boom, has slowed considerably, and revival is not in sight. Philippine industry is plagued with a number of problems, many of which are self-induced, including high production costs which preclude successful competition in world markets, concentration on assembly operations which require substantial imported components, and a domestic market (especially in rural areas) which lacks effective purchasing power. Industrial workers are now worse off in terms of real income than they were a few years ago. The protective wall built around local industry by the government in the form of tariffs is weakened by extensive smuggling that is facilitated by [redacted] government bureaucracy. Foreign investment on a large scale would help substantially, but potential foreign investors are warned off by a highly hostile environment. Although Filipino statistics are highly suspect, it seems clear that more capital is leaving the country than is coming in. 25X6

For his part, President Marcos appears committed to economic development. His efforts, however, are likely to fall far short of expectations, since the government is composed largely of those who have a substantial vested interest in the *status quo*. The small coterie that rules the country is not likely to provide the initiative for change and is certain to stifle any reform which it sees as threatening its position.



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The Pattern of Growth

1. The growth of the Philippine economy, which was impressive in the decade following World War II, has been appreciably slower and more erratic in the past decade. Rehabilitation from the heavy war damage, undertaken with the help of substantial US aid, was essentially completed in 1949, and subsequently gross national product (GNP) in real terms increased at an average rate of nearly 7 percent a year through 1957 (see Figure 1). Beginning in 1958,

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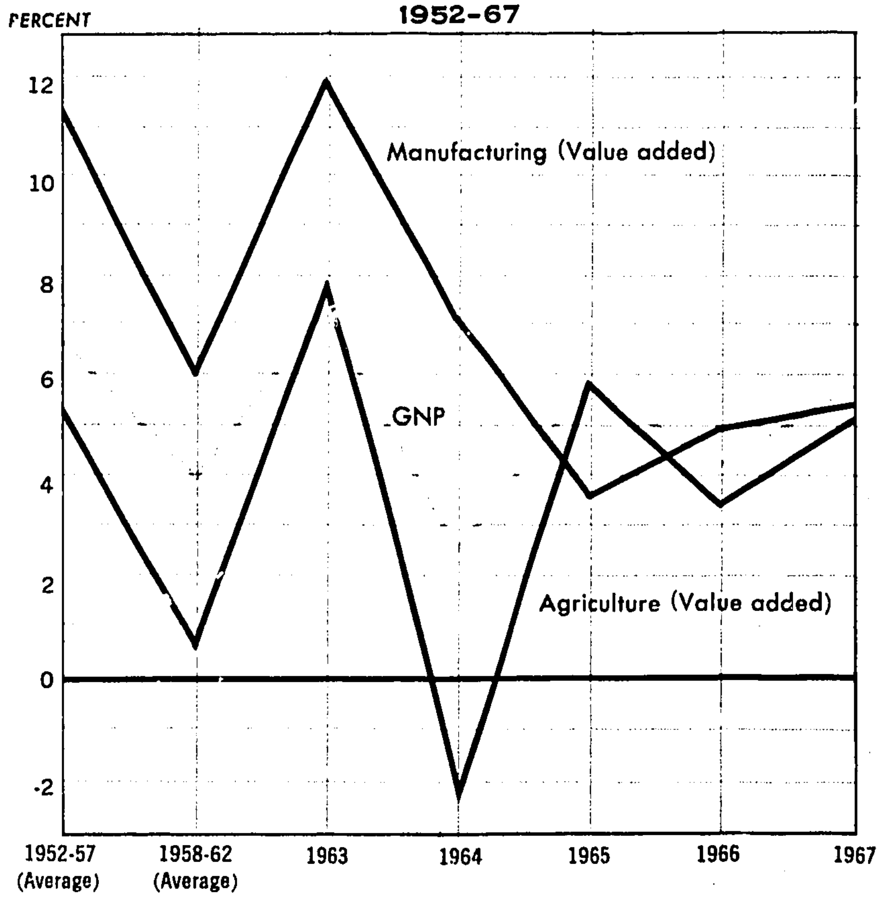
Figure 1

PHILIPPINES: RATES OF CHANGE OF GNP, MANUFACTURING, AND AGRICULTURE IN 1955 PRICES
1952-67



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when manufacturing growth slowed (in part because the easiest investment opportunities were used up) and agriculture began to stagnate, GNP growth slowed to an average of about 4 percent a year during 1958-62 and 5 percent during 1963-67. Moreover, the rate of growth of GNP since 1963 has been irregular, ranging from 2.5 percent to 7.6 percent. Much of the variation reflects fluctuations in agricultural production, which accounts for about one-third of GNP. For example, both 1964 and 1966 were poor crop years, with GNP increasing by only 2.5 percent and 4.2 percent, respectively. Although Philippine data indicate that gross investment averaged a high 21 percent of GNP during 1962-67, this claim must be treated with considerable reserve.*

2. Manufacturing has been the most dynamic sector of the economy since World War II. Manufacturing output increased about 11½ percent annually between 1951 and 1957 but then declined to about 6 percent. Agriculture also increased most rapidly during the first half of the 1950's -- by more than 5 percent annually between 1952 and 1957 -- primarily because the Korean War stimulated demand for Philippine export crops. With the slackening of world demand for these commodities, annual agricultural growth slowed to less than . percent during 1958-62. But then it accelerated to nearly 4 percent during 1963-67 as Philippine devaluation and increased world demand again stimulated export agriculture. The share of manufacturing in national income increased from nearly 12 percent in 1953 to nearly 20 percent in 1967, while that of agriculture declined from almost 43 percent to 32 percent (see Figure 2).

3. Economic growth and change have not basically improved the lot of the average Filipino. His mode of life is much the same now as before World War II. Population growth, which has been accelerating and is now close to 3.5 percent a year, has taken up a large and increasing share of the growth of output. Between 1962 and 1966, per capita national income in real terms increased only 1.2 percent annually, and in 1967 it increased 2 percent. Moreover, the extreme concentration of land ownership and other forms of wealth and the income gap between the wealthy elite and the majority of Filipinos, already

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** The Philippines recently revised sharply upward its estimate of gross investment, which accounted for 14 percent of GNP in 1965 in the old series, and 22 percent for the same year in the new series. As a result, all aggregate data in this memorandum must be considered approximate rather than precise.*

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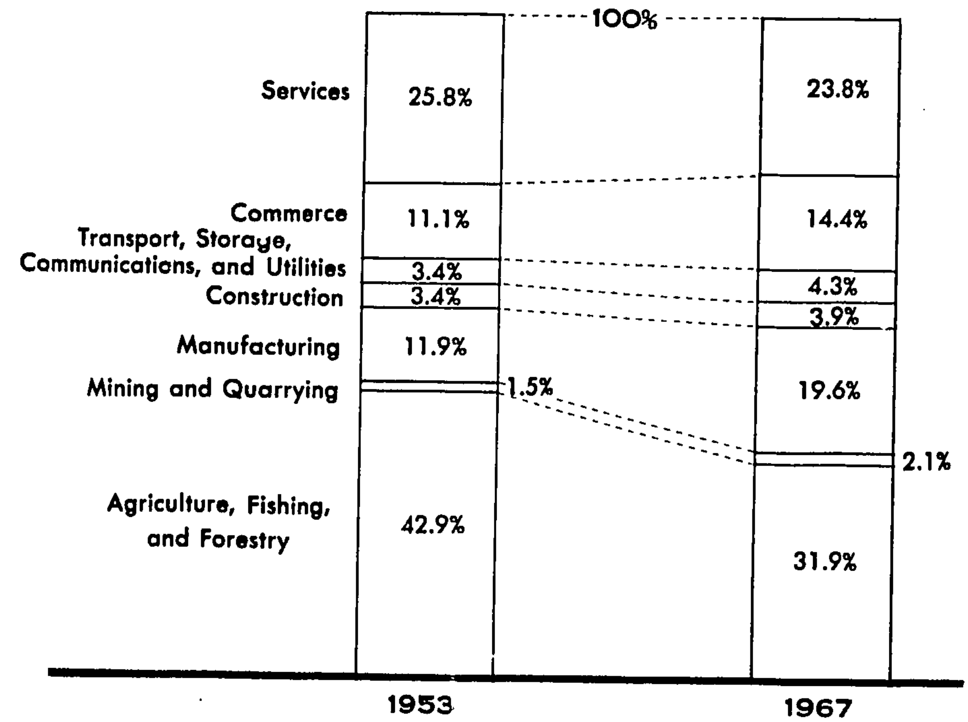
Figure 2

PHILIPPINES: PERCENTAGE DISTRIBUTION OF NATIONAL INCOME,* 1953 AND 1967



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*Based on current prices.

vast before the war, seems to be increasing. Although Manila is aware of the high economic costs of rapid population increase, it has not yet sponsored a birth control program. But even if it did begin a large-scale program soon, a generation or more would be required to measurably reduce population growth.

4. Philippine farmers are especially poor, and about one-half are sharecroppers. Rural incomes have gone up since devaluation, but most of the gains probably have accrued to large landowners because of the prevalence of sharecropping and the concentration of growth in export agriculture. The average income per household in rural areas is only about two-fifths of that in urban areas. Many urban workers also are badly off, however. The real wages of urban workers have declined sharply since 1955, by about 20 percent for

skilled laborers and by about 15 percent for unskilled laborers. Nevertheless, some poor Filipinos have attained rising levels of consumption by moving from agriculture into more productive urban employment. The city unemployment level is high, however -- in May 1967 it was nearly 14 percent of the urban labor force. In addition, substandard and over-crowded housing is the pattern throughout the Philippines but is particularly acute in the urban areas, where the squatter population grows by an estimated 12 percent a year. According to a 1965 report, the country needs to build 470,000 dwellings a year, but only 50,000 dwellings were constructed in 1965.

Problems in Agriculture

5. Agriculture, which accounts for nearly three-fifths of total employment, has undergone little modernization. There are only about 11,000 tractors for more than 2 million farms, and many peasants do not use chemical fertilizers or pesticides. Output has increased substantially since 1951 -- chiefly because the crop area has been expanded -- but most of the better land is already in use, and the prospect for sustained increases in agricultural output through further expansion of cultivated areas is not bright.

Cultivating the Land in the Philippines

Threshing Rice by Foot on a Road

6. Rice is the most important crop and the principal staple of the majority of Filipinos. Production increased about 53 percent, from about 2.6 million tons in CY 1950* to nearly 4 million tons in CY 1965, but population increased at a faster rate and imports remained substantial, averaging 441,000 tons during 1965-67. Most of the increase in rice production through 1965 can be attributed to the 45-percent increase in the area planted to rice (see Table 1). Despite this increase, the share of rice acreage in the total cultivated area has remained at about 40 percent. Rice yields declined during the 1950's as rice acreage was expanded rapidly and larger amounts of less fertile land were used, but then recovered during the early 1960's as some of this less fertile land was taken out of production. An even greater increase in rice yields has occurred since CY 1966, when the program to disseminate new high-yielding seed began -- although this improvement has been overstated (see paragraph 24). In CY 1968 an estimated 740,000 acres, or about 10 percent of the total area in rice, was planted with high-yielding seed. Nevertheless, rice yields for the country as a whole are among the lowest in the world, amounting to only one-third of those in South Korea and two-fifths of those in Taiwan.

* *The crop year (CY), ending 30 June, corresponds to the official fiscal year (FY).*

Table 1

Philippines: Production, Area, and Yields of the Principal Agricultural Crops
Crop Years 1950,1960, and 1963-68 a/

	Unit	1950	1960	1963	1964	1965	1966	1967	1968 b/
Rice									
Production	Thousand tons	2,613	3,740	3,967	3,843	3,993	4,073	4,159	4,330
Area	Thousand acres	5,469	8,172	7,811	7,631	7,907	7,683	7,613	7,725
Yield	Tons per acre	0.478	0.458	0.508	0.504	0.505	0.530	0.546	0.561
Copra									
Production	Thousand tons	850 c/	1,075	1,489	1,487	1,471	1,485	1,418	1,203
Area	Thousand acres	2,413 c/	2,616	3,440	3,662	3,966	3,981	4,026	4,076
Yield	Tons per acre	0.352 c/	0.411	0.433	0.406	0.371	0.373	0.352	0.295
Sugar									
Production	Thousand tons d/	710 c/	1,387	1,555	1,684	1,557	1,402	1,560	1,618
Area	Thousand acres	353 c/	598	640	667	867	778	706	756
Yield	Tons per acre	2.011 c/	2.319	2.430	2.525	1.796	1.802	2.210	2.140

a. Ending on 30 June unless otherwise indicated.
b. Preliminary estimates.
c. Annual average for the three-year period, crop years 1949-51.
d. Centrifugal sugar only. The crop year for sugar ends on 30 September.

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7. Output of export crops, the most important of which are copra and sugarcane, has increased rapidly in recent years, largely because the 1962 devaluation resulted in substantially increased earnings from agricultural exports. The growth of agricultural exports had been held down in earlier years by maintenance of a highly overvalued exchange rate. In the case of sugar, a large part of the increase in exports stemmed from reallocation to the Philippines of part of the Cuban sugar quota in the US market after 1963.

8. The obstacles to agricultural progress are many. Most farmland in the Philippines is capable of being cultivated the year round if irrigation water is used to compensate for the seasonal variations in rainfall, but only 10 percent of the cultivated area is irrigated. A very poor road network hampers the distribution of agricultural products. The prevalence of sharecropping on large landholdings, particularly in rice areas, reinforces the peasant's usual reluctance to innovate. In most instances the costs of innovation are borne entirely by the sharecropper, and he has no assurance that his share of the crop will remain constant from year to year.

9. Government investment in agriculture is small and private investment is almost nonexistent. The income of most farm families is so low that they are not able to save. The relatively prosperous large landowners tend to invest in real estate or manufacturing rather than agriculture. Government spending is allocated among a multiplicity of inefficient, overlapping agricultural agencies. The inadequacy of the administrative apparatus is evident, for example, in the poor maintenance of existing irrigation works, which now are only 30 to 40 percent effective.

Manufacturing -- the Leading Sector

10. Between 1951 and 1966, manufacturing output increased at an average annual rate of nearly 8 percent. Expansion was most rapid during the 1950's, when the principal stimulus was the operation of the system of exchange control. The government promoted new industries by selectively allocating foreign exchange and restricting imports that could

compete with domestically produced goods. Among the most important of these new industries were those producing transport equipment, electrical machinery and appliances, rubber products, and paper products.

11. Exchange controls, however, did not result in well-integrated and sustainable industrial development. The stimulation of industry was uncoordinated and poorly administered. Many of the new industries were essentially assembly operations, operating at high cost in a small market. They remained largely on the periphery of the domestic economy, unable to create a basis for further industrialization or strong links to other economic sectors. Erected under heavy protection, they were unable to compete abroad and thereby to provide new exports. By the end of the decade, shortages of imported materials and spare parts and, in some cases, overinvestment in relation to the size of the domestic market had given rise to widespread unused capacity.

12. One of the most negative effects of the protectionist policy was the construction of too many plants in some industries. For example, there are 40 motor vehicle assembly plants producing 80 to 100 different models for a market that only uses about 20,000 units a year. The burden of establishing and maintaining these inefficient industries has been borne almost entirely by two groups: exporters who were forced to swap their foreign exchange for pesos at an overvalued exchange rate, and consumers who have had to pay relatively high prices for locally produced goods. The long-run gains from this system lay principally in the creation of a Filipino entrepreneurial class.

Effects of the Financial Reforms

13. By the late 1950's, there was a growing recognition that the maintenance of an overvalued exchange rate had inhibited the growth of agricultural exports while the benefits of exchange controls for stimulating industrial growth were being exhausted. As a result, a program of decontrol was begun in 1959, culminating in 1962 with a devaluation of the peso

from 2 pesos per US dollar to 3.9 to the dollar.* In addition to removing most exchange controls, the government ended some tax exemptions for industry but also increased tariffs to high levels on imported manufactures to replace the protection previously afforded by quantitative restrictions on manufactured imports.

14. The foreign exchange reforms of the early 1960's have inhibited manufacturing growth. Manufacturing profits were squeezed by the increased cost of imported raw materials and capital goods at a time when domestic credit was being tightened to restrain the demand for imports and dampen inflationary pressures. In addition, increased smuggling in recent years has reduced the protection afforded some parts of industry. Although smuggling is a chronic problem, the financial reforms, by removing restrictions on capital outflows, have made it easier to finance illegal imports. As a result of these factors, annual manufacturing growth during the 1960's has averaged 6.5 percent compared with more than 10 percent during the 1950's.

15. The reduction in the degree of protection for some parts of industry, although largely unintended, was probably desirable. The government, however, has not created new stimuli for industrial growth. It has not encouraged foreign investment, developed infrastructure, or devised strong new investment incentives. Thus the opportunity to begin a more efficient and sustainable pattern of industrialization has not been grasped.

16. Meanwhile, the foreign exchange reforms have not improved the balance of payments. Exports, mainly agricultural products, have increased rapidly in recent years, but imports have grown just as rapidly. Moreover, there has also been a net outflow of both long-term and short-term private capital, partially in response to the hostile atmosphere for foreign

* *The new exchange rate was not immediately valid for all transactions. Exporters had to exchange 20 percent of their receipts at the old 2-to-1 rate and 80 percent at the new rate until November 1965, when the 3.9 rate was adopted as the par value and this exchange restriction was eliminated.*

investment that has been fostered by nationalistic elements throughout the Philippines. During 1964-67 the net outflow of largely speculative short-term capital amounted to $260 million, while that of direct investment totaled $42 million. These capital outflows have been offset to a large extent by increased utilization of Japanese reparations and by rapid increases in US military spending in association with the Vietnam conflict, both of which are of a temporary nature. Despite these temporary capital inflows and the rapid growth of merchandise exports during the first half of the 1960's, Philippine foreign exchange reserves have remained at extremely low levels. On 30 April 1968, net foreign exchange reserves amounted to only $2 million.

17. The poor atmosphere for foreign investment and the resulting outflows of long-run capital stem largely from the animosity of many Filipinos toward what they view as the privileged position of US business interests locally. A 1946 amendment to the Philippine constitution, which was restated in the Laurel-Langley Agreement of 1955, guarantees US investors equality with Filipino investors until 1974, including provisions for exploiting Philippine natural resources and operating public utilities. In recent discussions about replacing the Laurel-Langley Agreement when it expires in July 1974, Manila agreed to protect the rights of US investments made prior to independence in July 1946. The Filipinos, however, want the post-independence exploitation of natural resources and operation of public utilities by US nationals and by corporations less than 60 percent Philippine-owned to cease after July 1974. The United States indicated that it would not demand parity rights for investments made after 1974 but that it expected continued protection for investments made before that date. The resulting uncertainty surrounding the future of such investments has slowed reinvestment by existing US firms and has discouraged new US investment in the parity fields.

Government Economic Policy

18. The role of the government in the Philippine economy has traditionally been small by Asian standards and government economic policy has been

conservative. The government has concentrated on the stimulation of private enterprise and has done relatively little to support economic development through its own investments in infrastructure. The government's economic initiative is severely limited by the intense political rivalries that often impede its action on basic economic measures. There are only two major political parties in the Philippines, and both represent primarily upper income groups, making the passage of reforms and tax legislation more difficult.

19. As a result, all efforts to reform the tax structure have failed. The Philippine tax structure is both highly regressive and unnecessarily complex. As in most less developed countries, the greater part of the revenues are derived from indirect taxes, which fall largely on basic consumer goods. Revenues, however, are not adequate to finance the investment in infrastructure necessary to accelerate the growth process. Tax rates have not been raised since 1959, because of the general Filipino reluctance to expand government economic influence. Instead, there have been several changes that have reduced potential tax revenue, such as new exemptions for industry and the elimination in 1965 of the special tax on imports. As a result, the government's recurrent revenue (excluding borrowing), which was 11.1 percent of GNP in FY 1963, was only 10.0 percent of GNP in FY 1967 (see Table 2).

20. The relative shortage of government revenues, while important, is not the only obstacle to increased government investment in infrastructure. A very high proportion of existing public outlays are current expenditures, particularly for wages and salaries of political appointees. This proportion has remained stable despite fairly rapid growth of public expenditures and revenues during the 1960's. Thus it is clear that an inability to restrain current expenditures has been partly responsible for the failure to expand investment in infrastructure. The primary problem arises in the Filipino political system, in which government agencies are not developed as institutions to mobilize resources to achieve national objectives but exist to create sinecures with which political leaders reward their followers.

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Table 2

Philippines: National Government Revenues and Expenditures
Fiscal Years 1963-67 a/

Million Pesos

Fiscal Year	Recurrent Revenues	Percent of GNP	Borrowing	Total Revenue	Current Expenditures	Capital Expenditures	Total Expenditures
1963	1,778	11.1	131	1,909	1,493	359	1,852
1964	1,931	10.7	154	2,085	1,713	354	2,067
1965	1,865	9.5	210	2,075	1,779	298	2,077
1966	1,868	8.7	280	2,148	1,920	307	2,227
1967	2,339 b/	10.0	143	2,482	1,968	422	2,390

a. Ending on 30 June.
b. Preliminary estimate.

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21. Foreign economic aid, primarily from Japan and the United States, has not significantly augmented domestic investment in recent years. Between FY 1963 and FY 1967 the Philippines received an annual average of about $32 million of economic aid from Japan and an average of about $26 million from the United States compared with Manila's claimed annual average of more than $1,100 million of gross domestic capital formation. Japanese aid, entirely reparations grants, has been used primarily to purchase machinery and equipment, including ships, cement factories, textile mills, and construction equipment. About two-thirds of the reparations grants have been made available to the Philippine private sector on generous peso repayment terms by the Philippine government. The benefits to the Philippine economy from the use of Japanese reparations appear to have fallen short of the potential, primarily because of the dispersion in terms of use, the mismanagement at both the selection and the use stages, and corruption. Economic aid from the United States in recent years has consisted largely of PL 480 foodstuffs and a Peace Corps program.

Japanese-Reparations Supplied Trucks

22. President Marcos, who assumed office in January 1966, initiated an anticorruption program and formulated a four-year plan designed to accelerate development. Although tax evasion and smuggling have been curtailed somewhat, the four-year plan has been abandoned. Government development spending is now concentrated on increasing rice production and on road construction,

but press reports of substantial progress can be attributed more to Marcos' skill in public relations than to actual achievement.

23. The construction of infrastructure, particularly roads, has been one of the most publicized aspects of President Marcos' economic program, but actual progress belies published claims. The government's capital expenditures rose substantially in FY 1967 (the first full year of the Marcos administration) over the level of FY 1966 but probably only equalled those in FY 1963 in real terms. Moreover, the length of roads paved during FY 1967 was only slightly higher than the annual average attained during the previous 10 years.

24. The success of the Marcos government in stimulating rice production also has been overstated. Contrary to recent press reports, the Philippines did not achieve self-sufficiency in rice production in CY 1968, nor is it likely to do so in CY 1969. Substantial quantities of rice imports were reexported during CY 1968, and during the same year a small quantity of Philippine rice was exported. This, however, was permitted by a reduction of high local stocks rather than the achievement of actual self-sufficiency in rice production. The gap between production and consumption remained high in CY 1968, amounting to about 10 percent of production. The achievement of rice self-sufficiency in CY 1969 would require an increase in production of about 13 percent, an expansion which is not likely to be attained.

25. Rice production and rice yields have increased in recent years, primarily because of the dissemination of new seeds and modern inputs within selected areas, but it is far from certain that these successes can be easily duplicated throughout the country. Increases in per capita rice production may remain small and could easily be consumed by the peasants, so that imports would be required to feed the rapidly growing urban population. The availability and partial dissemination of new rice seeds is a substantial achievement in itself, representing remarkable technical achievements at the International Rice Institute at Los Banos as well as unusual government administrative proficiency. Nevertheless, the availability of new rice seeds is not a shortcut to modernization of the agricultural sector. Most of

the new seeds require rather precise amounts of such inputs as pesticides, fertilizer, and water. As a result, there is a greater need than ever for increased agricultural inputs and for well-administered government programs to promote improved agricultural techniques. At the same time, however, the prospects of obtaining substantially increased investment in agriculture are slight.

Prospects

26. Philippine economic prospects over the next few years are mediocre compared with other developing countries. GNP is likely to grow about 5 percent a year, but the population probably will grow about 3.5 percent annually, and as a result the average Filipino will be largely unaffected. Increases in industrial production are likely to be small, and expansion of agricultural production will be limited primarily to small gains in productivity.

27. Although President Marcos has proposed a tax legislation program for the fiscal year beginning 1 July 1968 that would increase government revenues by more than 50 percent, the Philippine Congress is unlikely to pass many of the tax increases. Thus government revenues, and hence investment, probably will remain at the present low level. And only slow progress can be expected in providing agriculture and industry with the infrastructure needed for expansion.

28. To overcome its balance of payments difficulties, the country needs a marked reduction in smuggling, a rapid growth in exports, and a more favorable climate for private foreign investment. But the chances are that smuggling will not be greatly reduced, that export earnings will increase no more than 3 to 4 percent a year, and that the inflow of foreign investment will be small. Consequently, continued balance of payments difficulties can be expected. Export growth and foreign investment are closely linked. Sustained rapid growth of merchandise exports is not likely unless the Philippines can exploit the market for manufactures in the developed countries. This would require an increasing flow of private foreign investment, particularly from the United States, to raise the level of efficiency in Philippine industry and increase the awareness of foreign markets. The paradox is that many Filipinos hope

to reduce the large US role in the economy rather than enlarge it, and they fear any new foreign investment, particularly from the United States. The recently approved Investment Incentives Act, which appears liberal enough to encourage local investment in manufacturing, is unlikely to attract large amounts of badly needed foreign capital.