Central Bank of the Philippines

MANILA

OFFICE OF THE GOVERNOR

February 22, 1951

VIA AIRMAIL

Honorable Mariner Eccles
c/o Board of Governors
Federal Reserve System
Washington, D. C.

Dear friend:

I am glad to read in your note that you are back in Washington after a short vacation in the West. I have been following with much interest your continued fight for sound monetary policy. I have just read in the issue of TIME of February 19th that while you stood strongly for damming up the flow of money, the Federal Reserve Board itself "did nothing decisive." It might have been different if you were still Chairman. It seems that central banks will always find it a difficult job to get fiscal policy in tune with central bank policy.

Just to show you what I myself am up against here, I am enclosing herewith copy of my speech before the Chamber of Commerce of the Philippines.

In the opinion of the Bell Mission which was sent out here by President Truman last year, the Central Bank has been doing rather well. I am glad we were able to implement properly our exchange control since we put it into effect in December, 1949. Last year, we had for the first time a favorable balance of payments of a little more than $100 million. I am telling you all these because you did so much in 1947 to help dispel the misapprehension of certain people in the United States about the wisdom of our establishing a central bank. Our problem is not how to run an institution of this kind, but how to make the Government adopt a sound fiscal policy. This, of course, is a problem which exists in many countries.

With kindest regards,

Sincerely yours,

M. CUADERNO, Sr.

Encl.:
As stated

Central Bank of the Philippines

COMPLIMENTS

of

Governor M. CUADERNO, Sr.

Speech delivered by

GOVERNOR M. CUADERNO, Sr.

of the Central Bank of the Philippines

before the Chamber of Commerce of the Philippines

January 26, 1951

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I consider this a propitious moment and an appropriate forum for summarizing as comprehensively as possible and clarifying further the position that the Central Bank has taken at various times with regard to the different branches of the national economic policy. This economic policy is like a tree with commercial, monetary, fiscal, credit, investment and employment branches. All these branches sprout from the same trunk and are supposed to yield the common fruit of a higher domestic production and a more equitable distribution of the benefits of productive effort. The growth of these branches should be even and synchronized in order that the whole tree may be beautifully proportioned. It is regrettable that their unity of purpose and motivation and need for synchronization is often lost sight of whenever each one is appraised and debated upon individually. As a consequence, our efforts as gardeners are often rewarded with a distorted growth and a sour fruit.

The crop of financial problems that we are reaping today is wholly traceable to our failure in the past to appreciate this need of balance. We have failed, for instance, to give full and concrete implementation to the urgent and farsighted plea of the late President Roxas in his inaugural address of May 28, 1946. At that time, he said, and I quote:

"The coincidence of easy money and high prices gives to some of our people the false illusion of national prosperity and the mad notion that we have time to dally and debate. The prosperity of money and prices is a hallucination, a nightmarish dream resulting from the scarcity of commodities and the influx of a half billion dollars of troop money. We will find that mere money, bloated with inflation and circulating in narrow channels, does not bring about prosperity and national well-being. Every day, that money is being siphoned from our land by more and more imports - not productive imports, but imports of consumption. The well-being of the tradesmen alone is not the well-being of our people. Disaster awaits us tomorrow if we do not rouse ourselves and get back to work, to productive work."

In another message on June 3, 1946, he followed up this plea with the suggestion that "taxes must be realistically readjusted to the inflation which holds us in its grip." The measures subsequently recommended by the Tax Commission which he formed were inadequate and so also are the measures that have been taken in pursuance of the recommendations of the Joint Philippine-American Finance Commission in 1947 in the field of fiscal policy and economic development. You will all remember that the months and early years following liberation were years of commodity shortages, high prices and high money incomes. The money income stream was fed by the swollen tributaries of U. S. government expenditures, government spending and an extraordinarily prosperous copra trade. It is true that prices were subsequently brought down by the tremendous influx into the economy of imported merchandise. But had vigorous taxation and tax collection been instituted then, a goodly portion of the large money incomes and high profits being made during those years could have been siphoned off from the hands of the public, thus reducing the volume and pressure of effective demand and precipitating a further fall in prices at least down to the point where the internal price level would be in a more appropriate relation with the price level prevailing in the United States market. This also would have discouraged to a substantial degree the inordinate investment made by both private and government enterprises in commercial pursuits and real estate and would have prevented the expenditure of large amounts of foreign exchange in non-essential and luxury imports. The large revenue that might have accrued from the higher taxes could have saved the government from the necessity of continuing to pursue a policy of deficit spending and of relying primarily on bank credit for its financial requirements.

But the opportunity had been lost and it is easy to see now that our present difficulties with regard to the international reserves, to the inflationary rise of prices, to the critical condition of the government finances and the increase of the unemployed in some sectors of the economy are all directly traceable to our failure to act in the past on the fiscal front. It is also easy to see that all these problems are inter-related and spring from some common roots and that the real basic remedy must be applied to those roots in order that a permanent solution may be achieved. The control devices that are now being employed may hold the tide of inflation momentarily but they would eventually be ineffective unless the forces that generate the pressures they are trying to repress are neutralized.

When the expenditures of United States government agencies in the Philippines started to decline after 1948, money incomes continued at a high level nevertheless partly because of improved export receipts but primarily because of government deficit spending on a larger scale. The excess of expenditures over income since liberation was financed with pre-war credit balances, foreign borrowings, borrowings from special funds, the sale of treasury notes and bills to financial institutions and by the dangerous practice of expanding bank credit through the Philippine National Bank and the Central Bank. These sources of funds can hardly be relied upon now to provide additional amounts for the urgent budgetary requirements of the government. Pre-war credits and the special funds have been exhausted. Further loans for budgetary purposes from the United States are now out of the question. Government securities will not receive a favorable reception in the money market for as long as government finances have not been placed on a sound basis. On the other hand, the international situation imposes upon the government the urgent necessity of providing for vital services to insure our continued political survival. The government must have an adequate source of revenue and if we should fail to provide it with the necessary amount of funds via the normal instrumentality of taxation, it will be forced to rely upon continued borrowing from the Central Bank and the Philippine National Bank. In the present economic state of the nation such borrowings and additions to the total money supply could only serve to reinforce the inflationary pressures already existing and precipitate a further spiralling of prices which no price control measure no matter how comprehensive and efficient could possibly stem. It can also create a tremendous pressure of demand for imports, considering our heavy dependence on foreign sources of supply even for some of the most elementary items of consumption, a pressure so strong that our import control and exchange control machinery may not be able to hold it for long. Should this happen the ultimate consequence should be obvious to you. We may have to resort to the age-old method of effecting an adjustment between the internal and international price levels with all the painful consequences and uncertainties that usually follow in its wake.

I have tried and I hope I have succeeded in outlining to you the vital connection of the tax measures that are now being considered by the Congress to the maintenance of monetary stability and the preservation of the value of our currency. Our long-run objective, however, does not consist in the mere maintenance of monetary stability but in stability at the highest level of production and employment consistent with the resources available to this economy. We are all agreed that for this purpose what is needed is to produce more not only of those products that earn foreign exchange for the economy but also of those commodities and services that are consumed primarily in the domestic market. Much public discussion has already taken place on the subject of economic development and in order to clarify whatever misunderstanding may have grown about the position of the Central Bank in this matter, I should like to state once more than the Bank is one of the most vigorous supporters of an economic development program for this country. The fact that the Bank counsels against deficit spending and against indiscriminate bank credit expansion for financing government development schemes should not be interpreted to mean that it is in favor of achieving monetary stability even at the cost of economic stagnation. But because monetary stability is its primary responsibility, the Bank is interested in ensuring the closest coordination between the investment policy of the government, its fiscal policy and monetary policy in general. It is anxious to prevent any form of development financing that would only intensify inflationary pressures in the present situation. It must be realized that for as long as government budgetary deficit spending continues supported primarily by bank credit for so long will the present pressures raising the level of prices grow unabated. If on top of these, additional money income is created via development financing supported primarily by bank credit, then a degree of inflation might develop which may jeopardize the effective implementation of the economic development program itself. It is commonly held that government investment even if supported by bank credit is a commendable thing provided expenditures are not for budgetary purposes but for development projects; that the effect of controls has been to increase unemployment in commercial establishments, in the construction trades and in other sectors of the economy and that this development would surely precipitate a decline in the level of money income and, therefore, a depression in the level of economic activity. It is said that because private capital in this country is timid in entering new investment outlets, the government should step in and deliberately increase the level of investment to stave off the dire consequences of a recession in the national income. Consequently, it is argued that the government should move rapidly to implement as many government development projects might have to be as is sufficiently planned and studied even if the financing of such projects be supported primarily by newly created bank credit.

Much has been written in the course of the last twenty years about the benefits that deficit spending and a cheap money policy could bring to a country in a condition of underemployment. The experience, however, of countries that have tried this instrument has shown that it is not of proven efficacy in all environments. The peculiar conditions obtaining in a particular country determines in a large measure the degree of efficacy that could be achieved. In a country like the United States, for example, with a tremendous industrial potential and a rich domestic market, such a policy may be expected to result immediately in increasing effective demand, increasing employment and expanding production. During a depressed period when labor is unemployed, there also exists in the economy a substantial amount of unused plant facilities. A rise in effective demand stimulated by government deficit spending reacts immediately on these reservoir of unemployed resources which are harnessed back to production without too much delay. There is, thus, an immediate expansion of production and an inflationary increase in the domestic price level due to the injection of additional purchasing power via government deficit spending is avoided. In such an economy as the United States' government deficit spending becomes a dangerous expedient only after reaching a condition of full employment. In an underdeveloped country like the Philippines, however, the environment is totally different. It is true that we have vast potential resources but these are resources that can not be harnessed overnight to effective production without passing through a protracted period of conversion, construction, training and development. The present degree of immobility of these resources is such that they can not be expected to add effectively to the total volume of commodities available for consumption during the period of conversion. During that period, however, they will be already armed with purchasing power which would exert further pressure on the market for consumable goods and tend to raise domestic prices all the more. Because of our continued dependence on imports this would increase our balance of payments difficulties.

The Central Bank has always taken the position that sound economic development can only be successfully achieved if monetary stability is not impaired. The impairment of monetary stability can only discourage and inhibit any confidence that the public may have to invest. The Central Bank is in favor of the vigorous implementation of economic development provided that side by side with such a policy a vigorous fiscal policy is adopted whereby adequate government revenues could be raised to meet all the essential expenditures of government and the financial requirements of the government sector of the development program. It recognizes that the financing of this program may not be able to wait upon the full mobilization of private savings and their effective canalization into desirable investment outlets. Consequently, it urges that pending the development of desirable savings habits on the part of the people and the full development of financial institutions that could effectively harness these savings the government must move aggressively to effect a system of public savings via taxation and to use the proceeds therefrom in promoting its own development schemes as well as providing a framework of incentives for those that might be undertaken by private enterprises. The Central Bank's position in this respect finds support in the report of the Bell Mission. Allow me to quote a little bit from that report:

> "The present attitude of the Central Bank is not conducive to the excessive creation of bank credit for the business community. The practical danger of an excessive expansion of credit arises from the exigencies of Government. If the Government operates on a large current deficit which cannot be financed in other ways, it will in practice have to be financed by the Central Bank. The law may limit the amount of direct loans to the Government; and the Central Bank may resist making even these loans. In the end, however, the Central Bank will have to find the means to enable the Government to meet its obligations. The only practical and dependable safeguard is to avoid such an emergency by a strong fiscal policy.
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> "Perhaps even more dangerous, because it is likely to be defended with specious reasoning, is the creation of large amounts of Central Bank credit for the Government for investment purposes. The government has already invested excessively through the various government corporations. So long as they do business they will press for more funds to extend their activities. The emphasis on development will provide an atmosphere in which it will be easy to assume that somehow an expansion of credit for investment is not inflationary. And as this credit will not be available from the private banking system, there will be great pressure to secure it from the Central Bank either directly or through the Philippine National Bank."

The Philippine Economic Survey Mission in its report on August 11, 1950, on the Revised Agricultural and Industrial Development Program called attention to the run-away inflation that could develop under present conditions if "substantial deficit spending and indiscriminate bank lending should continue concurrently with the implementation of the investment program." The Commission suggested that the inflationary risk "could be minimized and kept within manageable bounds by appropriate fiscal policies, administration and management that seeks to eliminate deficit spending and implements aggressively an adequate program of raising tax revenues." In its annual Report for 1949, the Central Bank called attention to the dangerous inflationary implications of bank credit expansion to support government budgetary deficits and government investments and suggested that aggressive steps be taken immediately to raise tax revenues to meet these requirements. If a further deterioration of the internal and external value of the currency is to be avoided, if the government is to be placed in a position to meet current and future budgetary requirements adequately, and if the vigorous implementation of the economic development program is not to be delayed on account of inflationary pressures generated by government deficit financing itself, fiscal measures capable of achieving a balance in the budget at a high level and of meeting a portion of the internal currency requirements of the development program should be adopted and implemented now. Decisive action in this respect is necessary whether or not the country receives economic aid from the United States. No amount of economic assistance from that country within the realm of present possibilities can prevent the deterioration of the domestic situation unless that aid is complemented by essential fiscal and investment reforms. That the United States has indicated its willingness to help is, of course, our good fortune but the institution of and the responsibility for domestic financial stabilization and social improvement is wholly our own. I am not lacking in the confidence that we shall prove equal to the demands of the critical present and that provided we act promptly enough, we may yet ensure for the next generation a regime that is less troubled, more stable, and more bountifully provided than our own.

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March 9, 1951

Governor M. Cuaderno, Sr.,
Central Bank of the Philippines,
Manila, Philippine Islands.

Dear Governor:

I have read your speech to the Chamber of Commerce of the Philippines with great interest. Your analysis of the economic forces operating in the Philippines during the past several years is most penetrating and illuminating. I am glad that you have emphasized the vital connection of the tax measures now under consideration by your Congress to the maintenance of monetary stability and the preservation of the value of your currency. At the same time, however, you have not overlooked the fact that the long-run objective of the Philippines is not the maintenance of monetary stability by itself. As you point out, what you are seeking is monetary stability of a sort which will promote the highest level of production and employment consistent with the resources available to the Philippine economy.

More than anything else, I was delighted to see how effectively you exploded the fallacious argument that deficit spending and cheap money policies can accelerate the rate of economic development of the Philippines. Yours is the most forceful statement of the differences between the environment of an underdeveloped country and that of a highly-developed country like the United States, and the significance of this difference for monetary and fiscal policy, that I have had the pleasure of reading anywhere. The point which is usually overlooked by advocates of deficit financing as an instrument of economic development in underdeveloped countries is that the vast potential resources of such countries cannot be harnessed over-night to effective production without passing through a protracted period of conversion, construction, training and development. As the experience of many Latin American countries demonstrates, attempts to force the rate of economic development by excessive expansion of credit produces inflation. Inflation, in turn, causes balance-of-payments difficulties, an inequitable distribution of the national income, and the making of investment decisions on the basis of criteria which are not in the long-run interest of the country.

I comment on these matters at such length because I understand that there are influential voices in the Philippines that advocate irresponsible financial policies and I wish to give you my strong moral

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support in combating and enlightening such advocates. May your program have the full measure of success which it deserves.

It was a great pleasure to hear from you and I hope that you shall continue to keep in touch with me. Because of the vital role which the Federal Reserve had in the establishment and organization of the Central Bank of the Philippines, I am particularly interested in following your progress.

You may be interested in the enclosed statement, which was prepared in connection with an address which I delivered recently before the Executives' Club in Chicago

With best wishes for the success of your program and kindest regards, I remain

Sincerely yours,

M. S. Eccles.

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