

THE PHILIPPINE CENTRAL BANK ACT<sup>1</sup>

by

DAVID L. GROVE AND JOHN EXTER

On June 15, 1948, a Bill creating a Central Bank of the Philippines and reorganizing the monetary system of the country was signed by President Quirino and became law. The legislation brings to an end the rigid 100 per cent reserve currency system which has been in effect in the Philippines, with only relatively minor changes, since 1903, and replaces it by a modern flexible currency system in which monetary authority and responsibility will rest in a central bank. The new legislation represents a consummation of Philippine aspirations for an independent currency system under which the peso will remain stable in relation to, and freely convertible into, the dollar, but under which the money supply will be more responsive to the domestic needs of the economy. The establishment of such a system was recommended by the Joint Philippine-American Finance Commission in June 1947.<sup>2</sup>

The Central Bank, which will be a Government institution, will have a monopoly of currency issue and will have broad regulatory authority over the credit and exchange operations of the banking system. It will have responsibility for developing and maintaining a market for Government securities and will, in addition, act as general fiscal agent of, and financial adviser to, the Government. The Central Bank will be a "bankers' bank" and will not deal directly with the public, except in the course of its open-market operations. The Bank will commence business as soon as its governing board has been appointed and its capital paid in.

The new legislation should be viewed against the background of the 100 per cent reserve currency system which it supersedes and of the financial environment in which the Central Bank will operate.

## THE 100 PER CENT CURRENCY RESERVE SYSTEM

The Philippines has never before had a central bank. Except for limited issue of notes by two commercial banks, the power of issue has for

<sup>1</sup> At the request of the Philippine Government, the Board of Governors of the Federal Reserve System made the services of Mr. Grove and Mr. Exter available to assist the Philippine authorities in the formulation of this Act. Mr. Grove and Mr. Exter are economists in the Board's Division of Research and Statistics.

<sup>2</sup> *Report and Recommendations of the Joint Philippine-American Finance Commission, June 7, 1947* (H. Doc. No. 390, 80th Cong., 1st sess.).

years been vested in the Philippine Treasury, which has had authority to issue Treasury certificates backed 100 per cent by silver coins and United States dollars. In practice these certificates have for some time been issued almost exclusively against dollars. The Treasury has been obliged to buy and sell dollars on demand at exchange rates based on the par value of the peso, which was fixed by law at 50 United States cents. Thus, in effect, the Philippines has been on a dollar exchange standard with a 100 per cent dollar reserve requirement against its note issue. The supply of currency has responded almost automatically to the dollar surpluses and deficits in the international balance of payments of the Philippines, irrespective of whether the response had a beneficial or harmful effect on the domestic economy. Moreover, the 100 per cent reserve system has tended to immobilize needlessly a part of the official international reserves of the country. Dollar reserves have had to be maintained even against the hard core of notes that was always needed to finance domestic transactions and that would never be presented for conversion into dollars to finance remittances or payments abroad.

Whatever flexibility has existed in the Philippine monetary system has been provided by the credit operations of the commercial banks. Although the banks have been required by law to maintain a cash reserve "in lawful money of the Philippines or of the United States" equal to only 18 per cent of their demand deposits and 5 per cent of their savings deposits,<sup>3</sup> the volume of their credit operations has been narrowly restricted by the following two factors.

First, unlike the practice in the United States, the bulk of monetary payments in the Philippines is made in cash rather than by check. As a result, whenever the banking system expands credit, the loss of cash reserves to the public is much heavier than in countries where checks are more commonly used.

Second, the Philippines has such a high propensity to import that a large percentage of any

<sup>3</sup> The reserve against savings deposits could be held in Philippine or United States Government Bonds, as well as in cash.

## THE PHILIPPINE CENTRAL BANK ACT

expansion of the money supply is likely to be used for additional importation from abroad, principally from the United States. To the extent that importers draw down their deposit balances in order to buy dollars from the banks, the banks lose reserves and the capacity of the banking system to extend credit is reduced.

The restrictive effects of these factors on bank credit expansion have been intensified by the absence of a central bank. The Philippine branches of foreign banks have needed central bank credit facilities less than the other banks, because they could ordinarily seek accommodation from their head offices when in need of funds. For the domestic banks, however, the absence of a central bank has meant that each bank has had, in effect, to rely exclusively on its own resources. In these circumstances, reasonable standards of precaution have required Philippine banks to maintain larger excess reserves and more liquid portfolios than would have been necessary had central bank credit been available. For these reasons, Philippine banks, in the aggregate, ordinarily have held reserves which were two to three times the legally required minimum.

No agency has had responsibility for seeing to it that the supply of money responded to the needs of the economy. The Philippine National Bank, which is a Government-owned commercial bank, has had inadequate resources and powers to undertake the responsibility, even if it had been so charged. The Government itself might have endeavored to regulate the money supply by the exercise of its fiscal powers, but has not done so; in any event, fiscal measures would have been difficult to employ in a country without a well developed tax system and a well organized government securities market. Thus, movements in the money supply of the Philippines have been the uncoordinated product of the country's international balance of payments and of the diverse credit activities of the banking system.

Another disadvantage of the system, given the limited ability of the Government to borrow domestically, was that it tended to obscure the distinction between domestic currency requirements and foreign currency requirements. This became particularly apparent when the Government was faced with a budgetary deficit last year; it was unable to sell its securities because of the absence of a securities market, and was unable to get

adequate accommodation from the banks because of their limited credit potential. As a result, the Government had to borrow dollars in order to obtain pesos with which to finance local expenditures.

When a system requiring a 100 per cent reserve against the note issue is applied to a growing economy, it may logically be expected to impart to it a consistent deflationary bias. In order to create the larger money supply required for an increasing population and an ever-expanding domestic trade, it would be necessary for the country to have a persistently active balance of payments, which in itself would be a costly luxury for an underdeveloped economy. It would be difficult to demonstrate conclusively, however, that the operation of the system in the Philippines was a major deterrent to the full development of the country's economic potentialities in the prewar period. Except for the exchange crisis of 1920 and 1921, which can be blamed on a violation of the system rather than on the system itself, there was never any real threat of a breakdown of the Philippine monetary system. On the other hand, some of the more serious depressing effects of the system were undoubtedly obscured by such favorable factors as the free access of Philippine products to the protected American market, the continuous expenditures of United States Government agencies in the Islands, and the remission to the Philippines by the United States Government of taxes paid by American manufacturers on the processing of sugar and coconut oil of Philippine origin.

Now that the Philippines is independent many of the economic benefits resulting from the association with the United States will gradually disappear. United States Government payments in the Islands are scheduled to decline after 1950. After 1974 Philippine products will be subject to the full American tariff. These factors alone may subject the economy to pressures which will severely test its inherent strength. Moreover, the greater part of the task of reconstructing and developing the Philippine economy lies ahead. In these circumstances it could hardly be expected that the Philippine Government would retain a monetary system whose excessive rigidity might delay its program of reconstruction and development or might deprive it of any effective defense against the domestic consequences of world economic fluctuations.

There are many who point out that the 100 per cent reserve system guarantees the international

## THE PHILIPPINE CENTRAL BANK ACT

stability and convertibility of the peso and serves to attract foreign capital. The new monetary system recognizes the value of these objectives but is designed to achieve them without needlessly sacrificing domestic monetary stability and orderly economic development.

## THE NEW MONETARY SYSTEM

The Central Bank Act is an integrated body of provisions defining the monetary system of the Philippines and establishing the Central Bank to administer it. It declares the principal objectives of the Bank to be to maintain monetary stability within the Philippines, to preserve the international stability and convertibility of the peso, and to promote orderly growth in production, employment, and real income.

Since monetary authority in most countries is divided between the Treasury and the central bank, it has been customary to have currency legislation distinct from central bank legislation. This is unnecessary in the Philippines because all monetary authority and responsibility are to be vested in the Central Bank; consequently, all necessary legal provisions concerning the currency have been incorporated in the Central Bank Act.

The Act provides that the Philippine peso shall continue to be equal by law to 50 United States cents, but it goes further than former legislation by also defining the peso in terms of gold. It provides that the Central Bank shall have a monopoly of the issue of currency and may issue notes and coins in exchange for any assets which it is legally authorized to acquire.<sup>4</sup>

The Central Bank will not be required, as the Treasury has been, to hold the official international reserve exclusively in dollars; gold and foreign currencies other than dollars may also be included. Nevertheless, the Act will not in practice take the Philippines off the dollar exchange standard. Practically all Philippine trade and other international transactions have long been conducted on a dollar basis and are expected to continue to be so conducted in the future.

The legislation explicitly recognizes the validity of all international agreements entered into by the Philippines which affect its currency. Under the

<sup>4</sup> All Philippine notes and coins now in circulation will become a liability of the Central Bank. In return for assuming this liability the Central Bank will acquire the bulk of the assets of the Treasury Certificate Fund and the Exchange Standard Fund, which are the two Funds in which the Philippine Treasury has kept the monetary reserves. These Funds will be liquidated.

terms of the Executive Agreement between the United States and the Philippines, pursuant to the Philippine Trade Act of 1946, the Philippine Government has agreed that, until July 3, 1974, "the value of Philippine currency in relation to the United States dollar shall not be changed, the convertibility of Philippine pesos into United States dollars shall not be suspended, and no restrictions shall be imposed on the transfer of funds from the Philippines to the United States except by agreement with the President of the United States." In effect, this means that, for the life of this Agreement, the Philippines cannot change the dollar value of its currency nor adopt exchange controls without the approval of the President of the United States. The legislation is also in complete harmony with the Articles of Agreement of the International Monetary Fund, of which the Philippines is a charter member.

## ORGANIZATION OF THE CENTRAL BANK

The Central Bank will be a Government-owned institution with a capital of 10 million pesos.<sup>5</sup> The Bank will be headed by a "Monetary Board" consisting of seven members, one of whom will be the chief executive of the Bank and will bear the title of "Governor." The Secretary of Finance, the President of the Philippine National Bank, and the Chairman of the Board of Governors of the Rehabilitation Finance Corporation will be ex-officio members of the Monetary Board. The other four members, including the Governor, will be appointed for six-year terms by the President of the Republic. The Governor of the Bank must be of recognized competence in the field of banking, and the other three appointive members must be of recognized competence in the economics of banking, finance, commerce, agriculture, or industry. It should be noted that none of the appointive members will be chosen on a regional or functional basis, as is provided in many central bank laws. The members are to represent the public interest in the broadest sense of the term and are not to be spokesmen for special groups.

The Secretary of Finance will preside at the meetings of the Board, but will have no special powers in the determination of policy or in the administration of the Bank. The principal reason for placing the Secretary of Finance on the Mone-

<sup>5</sup> To be obtained from the Exchange Standard Fund when it is liquidated.

## THE PHILIPPINE CENTRAL BANK ACT

tary Board is to promote an effective coordination of monetary and fiscal policies. As a member of the Monetary Board, the Secretary of Finance will share responsibility for central bank policy. Conflict with the Government is one of the obstacles over which central banks have stumbled and come to grief in many countries. The origin of much of the trouble frequently has been in central bank legislation which endeavored to make central bank policy completely independent of the national economic policies of the Government. The Philippines hopes to avoid such conflict by making all of the members of the Monetary Board subject to governmental appointment and by having the Secretary of Finance participate in, but not dominate, the formulation and execution of monetary policy.

The Governor is the only member of the Board who is required to devote all of his time to the Bank. The Law provides that he shall formulate the policies of the Bank for the approval of the Monetary Board, shall direct the operations and internal administration of the Bank, and shall represent the Board and the Central Bank in dealings with third parties. In emergencies, the Governor, with the concurrence of the Secretary of Finance or in the absence of the Secretary with the concurrence of any two other members of the Monetary Board, may decide any matter or take any action within the authority of the Board itself. The Governor will be assisted in the performance of his duties by a Deputy-Governor, appointed by him with the approval of the Board.

In recognition of the discretionary judgment which must be exercised by the Monetary Board, the Act provides for the establishment of a Department of Economic Research which will play an important role in the formulation of monetary and banking policy. The chief of the research department will attend meetings of the Board, with the right to be heard but without the right to vote.

All functions of bank examination and supervision will be placed under a department of the Bank to be called the "Department of Supervision and Examination," which will be headed by a "Superintendent of Banks." These functions were formerly exercised by the Bureau of Banking in the Department of Finance. Assigning the functions of bank examination and supervision to the Central Bank represents a departure from the practice of many countries, in which bank examination is

placed in the Treasury or in some other Government agency. The principle behind such separation has generally been that central banks should be subject to the same sort of scrutiny and examination as commercial banks and that, accordingly, a separate agency should be given responsibility for examining all banks, including the central bank. In practice, the application of this principle has frequently led to conflict between the central bank and the superintendent of banks over their respective roles in regulating the activities of commercial and savings banks and over the central bank's right of access to data obtained by the superintendent. As a result of such conflicts and, perhaps even more important, as a result of the general trend toward greater central bank control over the credit and exchange operations of the banking system, there has been a growing recognition that the character and scope of commercial and savings bank examination should be distinct from those of central bank examination. The Philippine legislation is in keeping with this trend. Inspection of the Central Bank itself is to be made by a special auditor appointed by the Auditor General of the Philippine Government.

## GUIDING PRINCIPLES OF CENTRAL BANK ACTION

In order to make possible the effective execution of appropriate monetary policies, the instruments of action given to the Central Bank under its charter are both large in number and flexible in design. The Law recognizes, however, that in a country without a well-established body of tradition in the field of central banking, there is a danger that the use of such instruments will be ill-timed and contrary to the intent which prompted their inclusion in the law.

As a partial safeguard against this danger, the third chapter of the Act prescribes the basic guiding principles of monetary management which the Central Bank is expected to follow. Similarly, the sections in Chapter IV, which define the individual instruments of Central Bank action, in most cases include an introductory comment on the general circumstances under which the particular instrument or authority is, or is not, to be used. These guiding principles are not intended to provide a ready answer to the problems which will confront the Bank. Their purpose is the modest one of providing some sort of orientation to clarify the intent of the Law with respect to the use of the powers

## THE PHILIPPINE CENTRAL BANK ACT

contained therein. The statements of principle should be especially useful in strengthening the position of Board members in carrying out anti-inflationary policies over the protests of groups pressing for easy money policies.

The guiding principles are divided into two parts. The first is concerned with the Central Bank's responsibility for maintaining domestic monetary stability, the second with its responsibility for maintaining the international stability of the peso. While the Law treats the problems of domestic and international monetary stabilization separately, it recognizes their close interrelation.

**Domestic monetary stabilization.** It has already been observed that the fundamental weakness of the former monetary system was that it did not respond effectively to the domestic needs of the Philippine economy. The Central Bank Act, on the other hand, is particularly concerned with this problem, but at the same time recognizes that a flexible domestic monetary policy must take into consideration possible repercussions on the international economic position of the country. The Central Bank's responsibilities with respect to this problem are as follows (Section 64):

"The Monetary Board shall endeavor to control any expansion or contraction in the money supply, or any rise or fall in prices, which in the opinion of the Board is prejudicial to the attainment or maintenance of a high level of production, employment, and real income. In adopting policies and measures in accordance with this principle the Monetary Board shall have due regard for their effects on the availability and cost of money to particular sectors of the economy as well as to the economy as a whole, and their effects on the relationship of domestic prices and costs to world prices and costs."

The broad directive just quoted is followed, in Section 66, by an outline of the procedures which the Monetary Board shall take "whenever abnormal movements in the money supply or in prices endanger the stability of the Philippine economy or important sectors thereof." In such circumstances, the Board shall:

"(a) Take such remedial measures as are appropriate and within the powers granted to the Monetary Board and the Central Bank under the provisions of this Act; and

"(b) Submit to the President of the Philippines, and make public, a detailed report which shall include, as a minimum, a description and analysis of:

"(1) The causes of the rise or fall of the money supply or of prices;

"(2) The extent to which the changes in the money supply or in prices have been reflected in changes in the level of domestic output, employment, wages and economic activity in general, and the nature and significance of any such changes; and

"(3) The measures which the Monetary Board has taken and the other monetary, fiscal or administrative measures which it recommends be adopted."

The Board is required to prepare such a report, moreover, whenever the money supply increases or decreases by more than 15 per cent, or whenever the cost of living index increases by more than 10 per cent, in relation to the level existing at the end of the corresponding month of the preceding year, and in the report the Board must state whether, in its opinion, the changes in the money supply or in the cost of living represent a threat to the stability of the Philippine economy or of important sectors thereof.

**International monetary stabilization.** The Central Bank Act recognizes the importance to the Philippines of continuing to maintain an internationally stable and convertible peso, and states explicitly in Section 67 that:

"The Central Bank of the Philippines shall exercise its powers under this Act to maintain the par value of the peso and the convertibility of the peso into other freely convertible currencies."

Toward this end, the Act provides, in Section 68, that:

"the Central Bank shall maintain an international reserve adequate to meet any foreseeable net demands on the Bank for foreign currencies. In judging the adequacy of the international reserve, the Monetary Board shall be guided by the prospective receipts and payments of foreign exchange by the Philippines. The Board shall give special attention to the volume and maturity of the Central Bank's own liabilities in foreign currencies, to the volume and maturity of the foreign exchange assets and liabilities of other banks operating in the Philippines and, insofar as they are known or can

## THE PHILIPPINE CENTRAL BANK ACT

be estimated, the volume and maturity of the foreign exchange assets and liabilities of all other persons and entities in the Philippines.”

The international reserve may consist of gold, foreign exchange, and foreign government securities having maturities of not more than five years. The Board is instructed to “endeavor to hold the foreign exchange resources of the Central Bank in freely convertible currencies” and to “give particular consideration to the prospects of continued strength and convertibility of the currencies in which the reserve is maintained, as well as to the anticipated demand for such currencies.” The special conditions under which inconvertible currencies may be acquired by the Central Bank are discussed later in this article.

The Act does not establish any required ratio between the Bank’s international reserve and its note and deposit liabilities. The usual purpose behind such reserve requirements in the legislation of other countries has been to place a limit on central bank credit expansion. The strict observance of these requirements in periods of crisis, however, would frequently defeat the purpose of central bank reserves, which is to provide resources for financing temporary deficits in the country’s international balance of payments, and might obstruct the bank in the discharge of its responsibility as “lender of last resort.” In practice, therefore, the requirements have usually either been lowered or suspended whenever they blocked, or threatened to block, central bank action.<sup>9</sup> Experience has also demonstrated that movements in the traditional reserve ratio cannot serve as a sound guide to central bank policy. Attempts have been made in recent Latin American legislation to provide mechanical reserve ratios of a different sort, relating the international reserve to sales of exchange during some preceding period or to movements in the money supply, or to some combination of the two, but, unfortunately, even such refined ratios are unlikely to serve as an adequate guide to appropriate central bank policy. In recognition of the foregoing, the Philippine Central Bank Act leaves the question of the adequacy of the international reserve of the Bank to the judgment of the Monetary Board and merely lays down broad guiding principles to be followed in the exercise of that judgment.

<sup>9</sup> See “Gold and Foreign Exchange Reserve Requirements of Foreign Central Banks,” Federal Reserve BULLETIN, JANUARY 1948, pp. 33-38.

The procedures to be followed whenever the international stability of the peso is threatened are provided in Section 70 of the Act:

“Whenever the international reserve of the Central Bank falls to an amount which the Monetary Board considers inadequate to meet the prospective net demands on the Central Bank for foreign currencies, or whenever the international reserve appears to be in imminent danger of falling to such a level, or whenever the international reserve is falling as a result of payments or remittances abroad which, in the opinion of the Monetary Board, are contrary to the national welfare, the Monetary Board shall:

“(a) Take such remedial measures as are appropriate and within the powers granted to the Monetary Board and the Central Bank under the provisions of this Act; and

“(b) Submit to the President of the Philippines a detailed report which shall include, as a minimum, a description and analysis of:

- “(1) The nature and causes of the existing or imminent decline;
- “(2) The remedial measures already taken or to be taken by the Monetary Board;
- “(3) The further monetary, fiscal or administrative measures proposed; and
- “(4) The character and extent of the co-operation required from other Government agencies for the successful execution of the policies of the Monetary Board.

“If the resultant actions fail to check the deterioration of the reserve position of the Central Bank, or if the deterioration cannot be checked except by chronic restrictions on exchange and trade transactions or by sacrifice of the domestic objectives of a high level of production, employment and real income, the Monetary Board shall propose to the President such additional action as it deems necessary to restore equilibrium in the international balance of payments of the Philippines.

“The Monetary Board shall submit periodic reports to the President until the threat to the international monetary stability of the Philippines has disappeared.”

The measures taken in accordance with the provisions of subsection (a) above to check the deterioration in the reserve position of the Central

## THE PHILIPPINE CENTRAL BANK ACT

Bank may consist of direct restrictions on exchange operations or of indirect measures designed to contract the money supply, in order thereby to reduce the demand for foreign currencies. The choice between exchange restrictions and a deflationary monetary policy, and among various combinations of the two, will depend on the circumstances prevailing at the time. The Law does not give domestic monetary stability priority over international stability, nor vice versa. In some circumstances the Monetary Board might consider the hardships of a temporary deflation to be more than counterbalanced by the undeniable long-run advantages of free convertibility; at other times, deflation might be too bitter a medicine.

The situation envisaged in the next to the last paragraph of Section 70 is that of a fundamental conflict between the objectives of domestic and international monetary stability which would require consideration of revaluation. The conditions under which a change in the par value of the peso is authorized under the Act are stated in detail in Section 49, as follows:

"The par value of the peso shall not be altered except when such action is made necessary by the following circumstances:

"(a) When the existing par value would make impossible the achievement and maintenance of a high level of production, employment and real income without:

"(1) The depletion of the international reserve of the Central Bank; or

"(2) The chronic use of restrictions on the convertibility of the peso into foreign currencies or on the transferability abroad of funds from the Philippines; or

"(3) Undue Government intervention in, or restriction of, the international flow of goods and services; or

"(b) When uniform proportionate changes in par values are made by the countries which are members of the International Monetary Fund; or

"(c) When the operation of any executive or international agreement to which the Republic of the Philippines is a party requires an alteration in the gold value of the peso."

It should be noted that the existence of any of the conditions enumerated does not make a modification of the par value obligatory, under the terms of this Act, but merely permissible.

The administrative procedure for changing the par value of the peso is as follows: The Monetary Board, with the concurrence of at least five of its seven members, must first propose such action to the President, who may, if he deems it advisable, take such action after having obtained the approval of Congress (except in grave and urgent circumstances, in which case the President may act without such approval but must then report on his action to Congress at the earliest opportunity).

Any action to change the par value of the peso (or to apply exchange controls) would also be subject, of course, to the conditions imposed by the Executive Agreement pursuant to the Philippine Trade Act and by membership in the International Monetary Fund.

## INSTRUMENTS OF CENTRAL BANK ACTION

The specific instruments of action available to the Central Bank include operations in gold and foreign exchange, lending to banks and the Government, open-market operations, control of bank reserve requirements, and selective regulation of bank credit operations. These powers, as will be apparent from the following discussion, are flexible in design. This seems particularly desirable in an economy in which Government fiscal operations are unlikely to exert appropriate countercyclical influences, at least for some time to come, and which, because of its extreme dependence on the exportation of a few basic products, is sensitive to changing business conditions abroad, especially in the United States.

During the first few years of the Central Bank's existence, large export proceeds and large United States Government payments to the Philippines will probably prevent the money supply from falling, and may even increase it. In such a period the Bank may wish not only to restrict its own credit operations quite narrowly but also to limit the expansion of credit by the commercial banks through the use of its powers over their credit operations. At a later time, these powers could be used in a different direction to counteract depressive forces.

**Operations in gold and foreign exchange.** The Central Bank may buy and sell gold, regulate all dealings in gold, and require at any time that gold holdings of all persons or entities be delivered to the Bank. The Bank may engage in foreign exchange transactions with Philippine banks, Philip-

## THE PHILIPPINE CENTRAL BANK ACT

pine Government agencies, foreign and international financial institutions, and foreign governments, but not with the general public. In order to maintain the convertibility of the peso, the Central Bank is *required*, however, to buy any quantity of foreign exchange offered to it, and sell any quantity demanded from it, by any bank operating in the Philippines, provided that the currency offered or demanded is freely convertible into gold or United States dollars.

Notwithstanding the obligation just described, in order to protect the international reserve of the Central Bank during an exchange crisis and to give the Monetary Board and the Government time in which to take constructive measures to combat such a crisis, the Board, with the concurrence of at least five of its seven members and with the approval of the President of the Republic, may temporarily suspend or restrict sales of exchange by the Central Bank and may subject all transactions in gold and foreign exchange to license by the Bank. It is unlikely that this authority will be exercised within the foreseeable future because of the presently favorable balance of payments and the extraordinarily high level of the international reserve. The Philippine financial position is sound and the Philippine economy should be able to adapt itself to the tapering off of the currently large United States Government payments without the imposition of exchange controls.

The question of inconvertible currencies poses no immediate problem for the Philippines because Philippine trade is at present conducted almost exclusively in dollars. As long as the maintenance of a high level of exports is not dependent upon the acceptance of currencies which are not freely convertible into gold or United States dollars, it is to the interest of the Philippines that the Bank not accumulate such currencies. Nevertheless, the day may come when the Central Bank must choose between accumulating inconvertible currencies and suffering a curtailment of exports which would seriously reduce income and employment. The Bank might well decide that the former would be the lesser evil, particularly in view of the difficulties and hardships that would be involved in shifting factors of production from the export industries into other productive activities. This decision would be especially defensible in cases where the period of inconvertibility of a foreign currency was expected to be rather short. In view of the

foregoing considerations, the Central Bank Act states (Section 75) that:

"The Central Bank shall avoid the acquisition and holding of currencies which are not freely convertible, and may acquire such currencies in an amount exceeding the minimum balance necessary to cover current demands for said currencies only when, and to the extent that, such acquisition is considered by the Monetary Board to be in the national interest. The Monetary Board shall determine the procedures which shall apply to the acquisition and disposition by the Central Bank of foreign exchange which is not freely utilizable in the international market."

The Monetary Board will fix the rates at which the Central Bank will buy and sell foreign exchange, but the rates for spot exchange may not differ from the legal parities by more than one-half per cent, unless in any given case a greater divergence from the legal parity exists in foreign markets. The rates applicable to nonspot exchange transactions of the Central Bank may not differ from the spot rates by more than the additional costs or expenses involved in each type of transaction.

The Monetary Board will also determine the minimum and maximum rates within which the other banks may buy and sell spot exchange, but the limits fixed by the Board may not differ from the respective legal parity by more than one per cent, unless in any given case a greater divergence from parity exists in foreign markets. The rates fixed by the banks for their nonspot exchange transactions may not differ from their spot exchange rates by margins larger than those considered reasonable by the Monetary Board. The Board may at any time, however, specifically fix such margins.

Any revaluation profits or losses made by the Central Bank on its net international assets or liabilities, as a result of changes in the gold value of the peso or in the parities or exchange rates of foreign currencies with respect to the Philippine peso, are to be offset by any amounts which, as a consequence of such revaluations, are owed by the Philippines to the International Monetary Fund and the International Bank for Reconstruction and Development, or are owed by these institutions to the Philippines. The Central Bank will sterilize any remaining profit or loss by entering it in a special blocked account. The purpose



## THE PHILIPPINE CENTRAL BANK ACT

of such sterilization of revaluation profits and losses is to remove their potential influence on decisions to modify the value of the peso.

Similarly, any revaluation profits and losses made by the other banks on their net assets or liabilities in gold and freely convertible foreign currencies are to be for the account of the Central Bank and are to be distributed by the Bank in the same manner as those arising from its own holdings. The Monetary Board may, furthermore, at any time declare that revaluation profits or losses on banks' net holdings of any *inconvertible* foreign currency shall also be for the account of the Central Bank. The purpose of these provisions is principally to remove the speculative element of revaluation profits and losses from the normal exchange operations of the banking system.

In order that the Central Bank may at all times have foreign exchange resources sufficient to enable it to maintain the international stability and convertibility of the peso and in order to promote the domestic investment of bank resources, the Monetary Board is authorized, in Section 80, to require the banks to sell to the Central Bank all or part of their surplus holdings of foreign exchange. It should be noted that the exercise of this power is permissive, not obligatory. Such transfers may be required for surplus holdings of all foreign currencies or for only certain of such currencies, and are to be made at the regular buying rates of the Central Bank. Surplus holdings of any foreign currency are defined as the amount by which a bank's assets in the currency exceed the sum of: (a) the working balance which it needs to accommodate normal short-run fluctuations between the bank's sales and purchases of the currency and (b) the total liabilities of the bank in the currency. In calculating surplus holdings in any given currency, however, a bank may, with the permission of the Monetary Board, subtract from its net assets in that currency an amount equal to its net liabilities in other currencies into which the currency concerned is freely convertible.

**Loans to banking institutions.** The Central Bank is given wide latitude with respect to the volume, character, security, and maturity of its loans to banks, but its credit policy is subject to the following general principles, which are stated in Section 86 of the Law:

"The rediscounts, discounts, loans and advances which the Central Bank is authorized to extend to

banking institutions under the provisions of the present article of this Act shall be used to regulate the volume, cost, availability and character of bank credit and to provide the banking system with liquid funds in times of need.

"In periods of inflation, or as long as inflationary dangers exist, the Central Bank shall refrain from extending credit to banks and at such times shall grant credit only in exceptional cases where special circumstances justify a deviation from the principle stated herein.

"Conversely, whenever the national monetary policy requires an expansion of the money supply, the Central Bank shall make full use of the credit operations authorized under the present article of this Act."

Here again, it should be emphasized that the "guiding principle" is not intended to serve as a substitute for sound judgment but is designed rather to provide orientation and to place some impediment in the way of excessive or untimely credit expansion by the Central Bank.

The maximum permissible maturities for Central Bank loans and advances to banks are greater than those customarily permitted in the legislation of more highly industrialized countries. The Bank may grant loans with maturities up to 180 days against paper related to commercial loans and up to 270 days against paper related to production or processing loans. The Bank may in addition make advances up to 180 days against gold, against evidences of debt of domestic credit institutions, against utilized portions of bank advances on current account—provided they are covered by regular over-draft agreements between banks and their customers and were used to finance the production, processing, storage, or marketing of goods—and finally against obligations of the Government or of other official entities, provided that the obligation matures within 10 years from the date of the advance by the Central Bank.

The speed with which a central bank can contract the money supply is obviously conditioned by the maturity pattern of its portfolio. This is the real basis for the traditional principle that central bank loans should be "self-liquidating" and of short maturity. While the maximum maturities mentioned in the preceding paragraph may seem so long as to impair somewhat the speed with which the Central Bank could, in case of need, force a

## THE PHILIPPINE CENTRAL BANK ACT

drastic contraction of credit, their justification is to be found in certain characteristics of the Philippine economy. In the Philippines, as in other underdeveloped areas, productive and commercial processes are impeded by shortages of working capital as well as by lack of mechanization and limited transportation facilities. In order to meet the legitimate credit needs of business and agriculture in such communities, banks must adapt the character of their lending operations to the environment in which they operate. This requires that commercial banks at times grant loans of longer maturities than is the practice in the United States. The granting of such loans by the commercial banks will be facilitated if the Central Bank itself can make advances to the banks with similarly extended maturities, even though this may involve some sacrifice of the speed with which the Central Bank can contract the money supply.

Whenever inflation looms on the horizon, the Central Bank should, of course, give careful attention to the liquidity of its portfolio. In times of deflation or depression, on the other hand, undue preoccupation with liquidity would defeat what should be a primary objective of central bank policy under such circumstances—namely, to prevent a serious fall in the money supply. In recognition of these considerations, the Philippine Central Bank Act permits the maximum maturities of new credit operations to be raised from the normal periods of 180 and 270 days to a year whenever, in the opinion of the Monetary Board, a deflationary situation exists which requires special expansionary measures. In similar circumstances, the Bank is also empowered (Section 89) to grant advances up to one year to mortgage institutions against their mortgage loans.

Just as the Act recognizes that normal maturity requirements should be liberalized in periods of emergency, it also recognizes that adherence to normal eligibility rules at such times might block the discharge of the Central Bank's responsibility as "lender of last resort" and, accordingly, provides, in Section 90, that:

"In periods of emergency or of imminent financial panic which directly threaten monetary and banking stability, the Central Bank may grant banking institutions extraordinary advances secured by any assets which are defined as acceptable security by a concurrent vote of at least five mem-

bers of the Monetary Board. While such advances are outstanding, the debtor institution may not expand the total volume of its loans or investments without the prior authorization of the Monetary Board."

The Philippine Central Bank Act does not prescribe the interest or rediscount rates to be charged on the Central Bank's loans. The Act merely provides that the rates are to be fixed by the Monetary Board in accordance with the character and terms of the credit operations, with due consideration being given to the credit needs of the market, the composition of the Central Bank's portfolio, and the general requirements of the national monetary policy.

**Advances to the Government.** Direct loans to the Government and to its political subdivisions are limited to short-term advances for the purpose of covering seasonal gaps between revenues and expenditures.<sup>7</sup> These advances have to be repaid before the end of the first quarter following the termination of the fiscal year and their total may not exceed 15 per cent of the estimated income of the borrower for the current year.

**Open-market operations.** For some time to come, open-market operations will not serve as a very effective instrument of Central Bank action in the Philippines. The Central Bank must first develop a market for Government securities. To this end, the Bank is given charge of the marketing of all Government obligations and will administer a special "Securities Stabilization Fund" for the account of the Government. The objective of this Fund is to promote private investment in Government obligations by increasing their liquidity and stabilizing their value. The Fund will have an initial capital of 2 million pesos, but provision is made to increase its resources by the allocation of part of the annual profits of the Bank. The Monetary Board is instructed to use the resources of the Fund to prevent or moderate sharp fluctuations in the quotations of Government obligations, but not for the purpose of altering movements resulting from

<sup>7</sup> As a special exception until June 30, 1951, however, the transitory provisions of the Act authorize direct advances to the Government up to an amount of 200 million pesos. Such advances may be made only when the Monetary Board considers the international reserve to be adequate to meet all foreseeable demands on it and when the advances are consistent with domestic monetary stability. Furthermore, these advances may be made only for productive and income-producing projects or for the repayment or servicing of external obligations of the Government. The advances are to be made against Government securities having denominations and interest rates which will make them attractive to the banks and the public. Their maturities may not exceed fifteen years.

## THE PHILIPPINE CENTRAL BANK ACT

basic changes in the pattern or level of interest rates.

In order to regulate bank reserves and the money supply, the Central Bank may engage in open-market operations for its own account. Whenever the Bank's total holdings of Government securities are so small as to prevent the Bank from engaging in selling operations on the scale desired, or, as is more likely in practice, whenever its holdings of such securities do not have maturities or other characteristics which would evoke favorable market response, the Bank may issue obligations of its own; these obligations may have such characteristics as the Monetary Board considers appropriate. This provision has the effect of providing the Bank with an unlimited and highly flexible portfolio for open-market sales.

The Act provides the same general type of policy directive for the open-market operations of the Central Bank as it does for the Bank's lending operations: in periods of inflation, or as long as inflationary dangers exist, the Bank is to refrain from security purchases and at such times must endeavor to sell securities. Whenever there is danger of deflation, on the other hand, the Bank may freely engage in open-market purchases.

**Bank reserve requirements.** The Central Bank has broad authority over the reserve requirements which the banks must observe. The Monetary Board may prescribe reserve ratios from 10 to 50 per cent against demand deposits and from 5 to 25 per cent against time and savings deposits. The ratios established are to apply to all banks uniformly, regardless of the size of the city in which they are located. Notwithstanding the upper limits just mentioned, the Board may, in periods of inflation, prescribe ratios up to 100 per cent against any future increase in the deposits of each bank. Whenever the use of such special authority results in required reserves in excess of 50 per cent of the total demand deposits of a bank or in excess of 25 per cent of its total time and savings deposits, the Central Bank may pay interest on the excess at a rate not higher than the Bank's lowest rediscount rate.

The required reserves of each bank will ordinarily have to be held in the form of a noninterest-bearing deposit with the Central Bank; nevertheless, the Board may, whenever circumstances warrant, permit the maintenance of part of the required reserves in the form of assets other than peso deposits with the Central Bank. Thus, in periods of

inflation, the Monetary Board might raise requirements substantially,<sup>8</sup> but might permit all or part of the increase to be held in the form of Government securities, or of foreign exchange. The use of this authority could be of considerable value in accustoming banks to invest in Government obligations. It would have the further advantage of curbing bank credit expansion without necessarily forcing the banks to hold assets yielding no return and it should therefore be more acceptable to the banking community.

**Interbank clearing.** The Central Bank is to provide facilities for interbank clearing, and is to use the reserve deposits of the banks for this purpose.

**Selective regulation of bank credit operations.** In addition to the quantitative control which it may exercise over the volume of bank credit through the adjustment of reserve requirements and, at some later date, through open-market operations, the Central Bank is given several instruments of quantitative control which should enable it to curb credit expansion in certain directions, while at the same time permitting it in other directions. The selective controls include authority:

- 1) to regulate interest rates;
- 2) to establish maximum maturities for bank loans and investments, and to prescribe the kind and amount of security to be required against the various credit operations of the banks;
- 3) to place ceilings on the amount of bank loans and investments, or certain categories thereof, or to place a limit on the rate of increase of such assets over time. In no case may the Board establish limits which are below the value of the loans or investments of the banks on the date on which they are notified of such restrictions;
- 4) to prescribe minimum ratios which the capital and surplus of banks must bear to the volume of their assets or to specific categories thereof,<sup>9</sup> and
- 5) to prescribe minimum cash margins for the opening of letters of credit, and to relate the size of the required margin to the nature of the transactions to be financed. This last power is designed to give the Central Bank authority to restrict the abuse of bank credit for speculative or nonessential importation.

<sup>8</sup> But, insofar as reserve requirements against existing liabilities are concerned, at a rate not exceeding 4 per cent per month and only after giving the banks notice reasonably in advance of the date on which the increase is to become effective (Section 104).

<sup>9</sup> For a discussion of the use of capital-asset ratios, see David L. Grove, "New Guatemalan Bank Law," *Federal Reserve Bulletin*, April 1947, pp. 398-401.

## THE PHILIPPINE CENTRAL BANK ACT

The selective controls listed above can, if exercised in accordance with the spirit of the Law, be of great value at times when the use of other instruments of central bank action would be ineffectual or awkward.

### FUNCTIONS AS FISCAL AGENT, BANKER, AND FINANCIAL ADVISER OF THE GOVERNMENT

The Central Bank is to act as fiscal agent, banker, and financial adviser of the Government, its political subdivisions and instrumentalities. It will represent the Government in all dealings with the International Monetary Fund and may also represent it in its dealings with the International Bank for Reconstruction and Development. Before the Government may undertake any credit operation at home or abroad it must first consult with the Central Bank in order that the latter may render an opinion on the probable effects of the proposed operation on the money supply, the price level, and the balance of payments. Moreover, to assure the Central Bank of a voice in the formulation of national economic policies, the Act provides for the representation of the Governor of the Bank on the National Economic Council, which is the entity responsible for the coordination of such policies. Thus, the Law places great stress on an effective integration of monetary policy with the fiscal and general economic policies of the Government.

The Central Bank will be the depository of all official funds. An important element of flexibility is introduced, however, by the provision that the Monetary Board may from time to time authorize certain other banks to accept Government deposits. Thus, bank reserves can be increased and credit expansion encouraged at any time by the simple expedient of placing Government funds with the banks; similarly, bank credit can be tightened, with equal or greater effectiveness, by the withdrawal of these funds at times when credit stringency is in order.

### CONCLUDING COMMENTS

The Central Bank Act establishes an institution which, if prudently managed, should make a valuable contribution to the economic progress of the

Philippines. With the establishment of a Central Bank to which they can turn in times of need, the banks will be in a much better position to accommodate the credit needs of a vigorously growing economy. The banks should in particular be able to give more sympathetic consideration to the medium and long-term credit needs of agriculture and industry—needs which tended to suffer under the former system. With the development of a market for Government securities, the scope of fiscal policy will be broadened and a channel for safe investment of savings will be opened; both a greater volume and more effective utilization of savings should result.

It would be folly to believe that the Central Bank can fully insulate the Philippine economy from fluctuations in world demand for the raw material exports on which so large a part of the Philippine level of consumption depends. Nevertheless, the impact of world economic fluctuations, particularly those of brief duration, can be cushioned by appropriate central bank policy. The fulfillment of this compensating function will undoubtedly occupy a prominent place in the Bank's activities; but a major concern of the Bank should be to create and maintain a financial environment in which a fuller and more diversified utilization of the rich resources of the Philippine economy is encouraged and local and foreign capital are permitted to make the greatest contribution of which they are capable.

The Philippine Government has recognized the need for further reforms in other fields, two of the most important of which are taxation and agriculture. It is expected that the Central Bank's policies will be integrated with such reforms and will form a part of a unified program of reconstruction and development. If the new Bank, in the formulation of monetary policy, adopts a perspective which encompasses the entire economic environment in which it operates, it should be able to make an outstanding contribution to the effective conduct of Philippine economic affairs.

NOTE.—A pamphlet containing the text of the Philippine Central Bank Act and a reprint of this article, will be available in a few weeks upon request from the Division of Administrative Services, Board of Governors of the Federal Reserve System, Washington 25, D. C.