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THE ROLE AND STRUCTURE OF THE CENTRAL BANK OF THE PHILIPPINES\*

by

Sue Van Atta and Edita A. Tan

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\*This paper will be a part of a monograph on Central Banking and Monetary Policy in the Philippines.

## Part I, Chapter 1

### THE ROLE OF CENTRAL BANKING IN AN UNDERDEVELOPED ECONOMY

The overwhelmingly important goal of public policy in the underdeveloped economy is rapid economic development. Since societies build institutions in order to further social goals, the major purpose of the Central Bank in an underdeveloped economy should be to promote economic development. The Central Bank can promote development through its control over the monetary system and by its policies directed toward the expansion of the economy's financial infrastructure.

This view, that the Central Bank should be a promoter of growth and development, is in sharp contrast to the traditional or orthodox view of the role of the Central Bank. Traditionally, it has been thought that the Central Bank's role should be stabilization of the economy. This orthodox view of the role of the Central Bank is a consequence of the evolution of central banking in the advanced industrialized economies, especially the United Kingdom and the United States of America. In the advanced, industrialized economy, stabilization of the economy is the dominant economic goal, and most central bank policies are directed toward the attainment of stability. The existence of a satisfactory long-term rate of growth, the presence of a highly developed financial infrastructure, and the functioning of a well integrated money market are assumed.

The traditional general (or quantitative) tools of monetary policy -- discount rate changes, open market operations, and varying reserve ratios -- can be feasible and effective policy tools in highly developed economies, with the likely exceptions of extreme economic circumstances such as war and severe depression.

The discount rate (or Bank rate) is the interest rate that the central bank charges commercial banks for discounting their assets at the Central Bank. In order that the discount rate be effective in controlling the economy, it must affect first short-term rates of interest which are then followed by similar changes in all other interest rates. Furthermore, these changes in interest rates must affect the volume of credit outstanding in the economy and the level of economic activity. It is generally felt that for most countries, the discount rate alone is a very weak policy tool, so that changes in the discount rate will have negligible effects on the level of economic activity in an economy. However, the discount rate may be of some importance, since changes in the discount rate anticipate policies of the central bank in the near future. Increases or decreases in the discount rate anticipate stronger contractionary or expansionary policies in the near future.

Open market operations consist of purchases or sales by the central bank of its assets. These transactions change the volume of reserves in the economy and thereby usually lead to multiple changes in the supply of money. The size of this multiple depends upon the reserve requirement and the size of the leakages from bank reserves, such as cash drain. In order that open market operations be effective in an economy, it is necessary that banks keep a more or



or less fixed ratio between reserves and volume of demand deposits, and banks must not discount excessively with the central bank, nullifying the effect of open market operations. Open market operations are generally considered to be a fairly powerful tool of monetary policy in developed economies, and they have the added advantage that they can be applied in as small amounts as desired.

The reserve ratio (or reserve requirement) is the percentage of deposits which banks must by law keep on reserve with the Central Bank. Given the volume of reserves outstanding, the reserve requirement determines the maximum supply of money the banks can lawfully create. Increases in the reserve ratio decrease the maximum legal quantity of money and decreases in the reserve ratio increase the maximum legal quantity of money. In order that variable reserve requirements be an effective tool of monetary policy, reserve conditions must be the factor which determines the volume of deposit creation of banks and banks must not discount excessively with the central bank, nullifying the effects of reserve requirement changes. Varying the reserve ratio is thought to be a strong tool of monetary control in developed economies but it has the draw-back that reserve ratios cannot feasibly be varied in relatively small amounts, due to the impracticality of specifying a reserve requirement with many decimal places.

In less developed economies use of the traditional general tools of monetary policy may not be possible or effective. In order for discount operations to take place, suitable assets must exist which can be discounted

at the central bank, and banks must habitually use the discount facilities in order to link the discount rate to short-term rates of interest. In countries where the money market is highly underdeveloped, suitable assets for discounting may not exist, making discount operations impossible. Furthermore, if banks do not use the discount facilities of the central bank habitually, there will be no link between discount rates and short-term rates, and the discount rate will possess no practical significance.

The conduct of open market operations requires the existence of a broad and active market for government securities, which the central bank can buy or sell. In principle, the central bank could deal in various types of assets, but a strong often exclusive preference for dealing in government securities has evolved. Many less developed countries have no government bond market, making open market operations impossible, or the bond market is so shallow that even small transactions result in wide fluctuations of bond prices.

Due to limitations imposed upon the banking system, stemming from the undeveloped nature of the money and government bond markets, variable reserve requirements will probably become the most important quantitative tool of monetary control in most underdeveloped economies. The variable reserve requirement is the one general tool of monetary policy which does not require the presence of active security markets. As long as banks keep a rough adherence to legal reserve requirements and small, fine adjustments



are not attempted, variable reserve ratios can become a most feasible tool of over-all monetary policy. ✓

{In less developed economies, general over-all monetary policy will probably have very limited effects on the economy.} Much economic activity in such economies never passes through a market at all and hence is untouched by central bank policy. <sup>2</sup>Other activities, although monetized, depend upon the unorganized local money market for their finance and are likewise largely unaffected by general central bank policy. The relatively modern sector of the economy, which is highly monetized and serviced by the organized money market, is highly vulnerable to the vicissitudes of international trade, so that conditions outside the control of the country (export earnings) may dominate the domestic financial situation.

Due to the relative ineffectiveness of general monetary policy in less developed economies and the importance attached to promoting growth and development, selective credit controls, rather than general credit controls, become very important. Since the money market is highly imperfect, chosen sectors of the economy can be expanded or contracted as a consequence of deliberate, selective credit policy. Selective credit policy tools are numerous, and various types of selective tools have been devised to meet selective credit needs in different economies. Multiple exchange rates, differential rediscount rates, varying margin requirements for loans or letters of credit, and direct credit rationing are examples of selective policy tools. Low exchange rates, low discount rates, low margin requirements and large rations of credit will tend to favor expansion of an industry and the

converse of these policies will disfavor the expansion of an industry. Therefore, selective credit policy can be a powerful tool for implementing specific policy goals, such as industrialization or rice self-sufficiency.

The largest barrier of all to effective monetary policy in the underdeveloped economy is the undeveloped condition of the country's financial infrastructure.<sup>1</sup> Banks tend to be concentrated in principal cities, leaving the towns and countryside unserved by banking facilities. Stock markets and private securities markets are non-existent or small and highly speculative. Government bond markets are either totally lacking or too small for effective policy purposes. Financial intermediaries of all types are inadequate to transfer funds from savers to investors. Retardation in the growth of the financial infrastructure will cause retardation in the rate of economic development as savings will not be transferred efficiently to investors. Therefore, it is argued here that the most important task of the central bank in the less developed economy is the conscious, deliberate development of the country's financial infrastructure. Control of the monetary system is of secondary importance. Where specific facilities are lacking, the central bank should take an active role in developing them. If banking facilities are unavailable outside of the major cities, the central bank can promote

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<sup>1</sup>The financial infrastructure includes (a) the currency system, (b) the central bank, (c) the commercial banking system, (d) other financial intermediaries, such as savings banks, development banks and insurance companies and (e) the direct securities market, which includes the stock exchange and a government bond market.



their extension to the outlying areas. If credit facilities are lacking for certain sectors of the economy, the central bank can foster the establishment of specialized banks to service these sectors. If a government bond market is small or non-existent, again the central bank can foster its setting-up or expansion. Central bank policy should be designed to meet the financial needs and requirements of the particular economy in which it operates. Since economic and financial conditions of less developed economies are most "unorthodox" viewed from the standpoint of the developed economies, appropriate central bank policy in less developed economies will also appear "unorthodox".



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## Part I, Chapter 2

### THE STRUCTURE, OBJECTIVES AND POWERS OF THE CENTRAL BANK OF THE PHILIPPINES

The Central Bank of the Philippines was created on June 15, 1948 by the passage of Republic Act 265, the Central Bank Act, and the Central Bank began operations on January 3, 1949. The Philippine Central Bank from its very inception was a most unorthodox type of central bank, if compared to the more traditional type. It was especially designed to deal with the economic conditions of the Philippines, a relatively small, underdeveloped, export-oriented economy.

The founders of the Philippine Central Bank clearly recognized the need for a central bank which departed significantly from the traditional model, and they recognized that a traditional type of central bank in the Philippines was likely to be very ineffectual. A keen understanding of the need for an unusual type of central bank is evident in the many writings of Miguel Cuaderno, principal founder of the Philippine Central Bank and its first Governor (from 1949-1960).

"Being thoroughly convinced of the need for a central bank in our country... I had been making a study of the best type of central bank which will be suited to the Philippine economy... in this study I found that we in the Philippines would do well to draw from the experiences of small underdeveloped countries whose economies are just like our own. I found that in countries in Latin America and even in the countries within the orbit of the British Commonwealth of Nations, a considerable



departure from traditional patterns based on British and American experience has had to be made in order that the central banks could function properly and effectually."<sup>1</sup>

The Philippine Central Bank was patterned after the central banks of Paraguay and Guatemala, particularly Guatemala.<sup>2</sup> The Central Bank Act vested the Central Bank with the usual traditional functions of a central bank: (a) it has sole responsibility for currency issue, (b) it holds and manages the reserves of the banking system, (c) it provides facilities as a lender of last resort in order to maintain the liquidity of the financial system, (d) it discharges banking services for the governments and for the commercial banks, and (e) it manages the country's international reserves.

Three broad policy objectives are contained in the Central Bank Act.

- (a) To maintain monetary stability in the Philippines;
- (b) To preserve the international value of the peso and the convertibility of the peso into other freely convertible currencies; and
- (c) To promote a rising level of production, employment, and real income in the Philippines." [Sec. 2, Article

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<sup>1</sup>Cuaderno, Miguel: Guideposts to Economic Stability and Progress, Central Bank of the Philippines, 1955, p. 168.

<sup>2</sup>Cuaderno, Sr. M.: Central Bank of the Philippines (A Monograph), Central Bank of the Philippines, Manila, June, 1949, p. 5-6.



1, R.A. No. 2657.

The central bank is committed to pursue the usual goals of maintaining a stable, fairly constant price level, promoting growth of output and employment, and maintaining equilibrium in the balance of payments at a fixed exchange rate. ✓

The Central Bank Act also has numerous unusual provisions, which are intended specifically to aid in the development of the Philippine economy and to protect it against adverse conditions in the international sector. The Act provides for a high degree of coordination between government policies and central bank policies by having membership on the Monetary Board overlap with government executive positions. Central Bank regulatory control is very extensive extending to "all banking institutions", instead of to commercial banks only. Therefore, essentially all institutional financial intermediaries come under central bank control, with the exception of insurance companies, which are explicitly exempted from the Act but over which the Bank exercises persuasive influence. The Bank has extensive powers to use selective credit controls to pursue specific economic objectives. The Bank is given the responsibility of developing a government securities market though its lending power to the government is severely curtailed. The Bank is empowered to create specialized lending institutions and to control the level and allocation of their credit. It has extensive powers to deal with a foreign exchange crisis. The bank can impose exchange

controls and margin requirements on letters of credit, and it can alter the exchange rate with the approval of the President.

At the time when the Central Bank was established, its immediate and most pressing tasks were to assume the responsibilities of (political) independence and to assist in post-war reconstruction of the economy. There was a need to develop a new currency system, to serve the banking needs of the government, to provide liquidity to the banking system, and to manage the international reserves. Since the most immediate problem at the time was the balance of payments, the attention of the Central Bank was concentrated on controlling the flow of foreign exchange. With the passage of time, the Central Bank assume other responsibilities, such as promoting industrialization, financing economic development, and encouraging the growth of capital and money markets. The Central Bank Act did not explicitly envision these latter responsibilities; however, the law provides the Central Bank with very broad powers which could be utilized to promote development objectives. Furthermore, the Bank is so organized as to have extensive influence on the allocation of funds of public and private financial institutions.

#### A. The Structure of the Philippine Central Bank

Monetary and credit authority is vested in the Monetary Board of the Central Bank. The Board is composed of seven members. The chief executive of the Bank bears the title of Governor of the Central Bank, He is appointed by the President of the Philippine Republic to serve a term of six years. The Secretary of Finance, Governor of the Development Bank



of the Philippines, and President of the Philippine National Bank also serve on the Board. The other three members are appointed by the President of the Republic to serve six-year terms. The principal reason for placing the Secretary of Finance on the Monetary Board is to promote an effective coordination of monetary and fiscal policies.<sup>3</sup> The drafters of the Central Bank Act were quite concerned about conflicts of policy arising between the government and the Central Bank, and they wanted to minimize the possibilities of these two institutions working at cross purposes.<sup>4</sup> Therefore, the Monetary Board is not as independent of the Executive Branch of the government as in the United States of America.

The question of independence of the Central Bank is a controversial subject. There is what Nevin calls the right-wing and the left-wing view of the issue.<sup>5</sup> The right wing central bankers lay heavy stress on the virtues of the independent authority of the Central Bank, while those of the left-wing view emphasize the inevitability of a high degree of "integration between monetary measures applied by the Central Bank and the levels of income and employment for which ultimate responsibility must clearly rest with the government and cannot be devolved on any independent agency."<sup>6</sup>

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<sup>3</sup>Grove, David L. and Exter, John: "The Philippine Central Bank Act," Federal Reserve Bulletin, Vol. 34, (August 1948), p. 940-941.

<sup>4</sup>Cuaderno, Sr., Miguel: Problems of Economic Development (The Philippines - A Case Study), 1960, p. 11-12.

<sup>5</sup>Nevin, Edward: Capital Funds in Underdeveloped Countries, Macmillan and Co., Ltd., London, 1961, p. 36.

<sup>6</sup>op. cit. p. 36



According to Nevin the balance of advantage would seem to be somewhere between the two extremes, although probably closer to the official-agency position than the independent-body position. Nevin explains the rationale for many central bankers gravitating towards the middle as arising from the increasing degree of responsibility of the government for the level of income and employment. One can extend the reasoning to development objectives. The overriding goal by a developing country is to raise its productive capacity and national income. Monetary stabilization is a secondary objective in many of these countries. One can probably argue that central banks in developing countries would tend to be less independent and assume a more active participation with other government agencies in promoting economic development. However, as will be seen in the chapter evaluating monetary policy and its impact, this lack of independence, especially from the Executive Branch, can be misused for political purposes.

#### B. Scope of Central Bank Control

The Monetary Board controls not only commercial banks but all "banking institutions" defined to be entities engaged in the lending of funds obtained from the public through receipt of deposits or sale of bonds, securities, or obligations of any kind. The term "banking institutions" include most of the financial intermediaries such as "commercial banks, savings banks, mortgage banks, trust companies, building and loan