associations, branches and agencies in the Philippines of foreign banks and all other corporations, companies, partnerships, and associations performing banking functions in the Philippines."

"Insurance companies are exempted from the provisions of this Act but shall present to the Central Bank such information, data and report as the Monetary Board may require in order to ascertain the effects of the operations of the insurance companies on the monetary, credit and exchange situation in the Philippines. /Sec. 3 of the General Banking Act, R.A. No. 337/

The law provides for the creation of a department of supervision in the Central Bank, to supervise the operation of banking institutions. This Department is headed by the Bank Supervisor. No bank may be licensed to operate unless approved by the Monetary Board. The Central Bank has therefore both supervisory and policy power over all banking institutions. The policy powers of the Central Bank will be discussed in the next section of this Chapter.

In the course of its history in the Philippine government created by law several types of financial institutions aimed mostly at channelling savings to finance some priority projects or to service particular sectors. Foremost among these institutions are the Philippine National Bank, a public commercial bank, the Development Bank of the Philippines, an investment bank; two insurance companies: The Government Service Insurance System (GSIS) and the Social Security System (SSS); the rural banks, and the private development banks. The last two are quasi-public institutions which are partially capitalized by the government. With respect to these institutions, the law provides "government-owned corporations which perform banking or credit functions are hereby declared to be instruments of the national monetary policy and, accordingly, shall coordinate their general credit policies with those of the Monetary Board." /Art. X, Chapter IV, Central Bank Act/.

A more detailed discussion of the structure objectives of these institutions is given in Chapter III which covers the financial system of the country.

The Central Bank not only acts as the banker for the government but also as the Treasurer. Sec. 38, Article IV, Chapter VII provides that "all powers, duties, and functions vested in the Bureau of the Treasury and the Treasurer of the Philippines...shall be exercised by the Bank and are hereby transferred to the Central Bank." At the same time, the issue of securities representing obligations of the government and its political subdivision and instrumentalities, shall be made through the Central Bank, which shall act as agent of and for the account of the government...the servicing and redemption of the public debt shall also be effected through the Central Bank."

The power of the Central Bank to extend credit to the government is severely restricted to an unusual degree. The Central Bank Act stipulates that the Central Bank shall act as agent for the placing of government securities, but "the Bank shall not subscribe to the issue of said securities and shall not guarantee their placement." /Ch. V, Art. I, Sec. 122, Central Bank Act/. This means that the government of the Philippines cannot lawfully finance budgetary deficits by selling bonds to the central bank. This provision was included in the Central Bank Act to prevent the inflationary finance of government expenditures, which had occurred in some other countries. "Advances to the government can only be made to cover seasonal gaps in revenues and expenditures and must be repaid before the end of the first quarter following the termination of the fiscal year. Their total may not exceed 15 per cent of the average annual income of the borrower for the last three preceding years."[7]

This section may be concluded by stating that the Philippine Central Bank has the authority to influence the level and allocation of credit of all financial intermediaries, private or public. At the same time, it is responsible for the maintenance of international reserves and the issue, servicing and redemption of public debts. To a certain extent, it also has powers to influence the level of public expenditure in its decision to change the size of public debt.

C. Policy Tools of the Central Bank

The Central Bank is provided by law with two types of policy

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[7]Cuaderno, Central Bank of the Philippines, p. 76

instruments - (a) quantitative controls which are intended to affect the over-all monetary and credit climate of the economy by tightening or easing the availability of credit; and (b) selective controls which have a deliberate allocative (of investment) effect. Selective credit controls have direct impact on the sector that it aims to influence. However, they often have indirect effects on the over-all availability of credit also.

Quantitative controls are usually used to stabilize the general level of demand and the price level. In a managed monetary system based on the fractional reserve requirement, quantitative controls are exercised by the usual methods of influencing the level of reserves of the banking system and by levels of currency issue. The Central Bank is provided with quantitative instruments commonly used in other countries. These are changing the reserve requirement, changing the discount rate and tightening or easing the discount window, and open market operations, and of course, deciding on new currency issue.

The impact of monetary policy on the level of income depends on the state of development of the country, on the rate of unemployment and on the mobility of resources. At the same time, the effectiveness of each type of quantitative instrument is conditioned by the state of the financial market, by the country's banking practices, and on the population's banking habits as discussed in chapter 1. The impact of monetary policy and the effectiveness of the instruments used in the Philippines will be discussed more thoroughly in the following chapter. In the absence of a market for government securities in the Philippines, open market operations are not possible and have not been used. The effect on credit of changing the reserve requirement has been weak until recently because commercial banks tended to hold reserves far in excess of required reserves. Furthermore, the credit expansion multiplier tends to be relatively small for any given reserve requirement since demand deposits constitute a relatively small proportion of the total money supply and the cash-drain leakage is correspondingly large.

As stated at the beginning of this Chapter, the Central Bank Act did not provide explicitly how the third basic goal of the Central Bank, that of promoting rising levels of employment and real income, may be achieved. But subsequent banking acts of Congress established banks for economic and financial market development.

Reference is made to the following banking laws establishing various types of banks.

1. Rural Banks Act, Rep. Act No. 720, approved June 6, 1952 provides for the creation, organization and operation of rural banks.

2. Development Bank of the Philippines (Rep. Act No. 2081, approved June 14, 1958) amending Rep. Act. No. 85 and other laws to provide facilities for intermediate and long-term credit by converting the Rehabilitation and Finance Corporation into the Development Bank of the Philippines, authorizing the said Bank to aid in the establishment of provincial and city private development banks...

3. Private Development Banks' Act (Rep. Act. No. 4093, approved June 19, 1964) aimed at encouraging "the establishment of more private development banks in order to meet the needs for capital

and to meet the demands for adequate credit or medium and long-term loans for Filipino entrepreneurs"

4. Republic Act, No. 2023 gives special provisions relating to cooperative banks.

5. Philippine Veterans Bank Rep. Act No. 3518, approved June 18, 1963. 51% of its capital is to be subscribed by the Philippine Government for and in behalf of the veterans, their widows, orphans and heirs. It may grant long and short-term loans.

Other banks such as cottage industries banks and land banks are permitted by law to operate.

The selective instruments of the Central Bank have been used extensively and imaginatively to influence the level and the allocation of funds of the banking institutions, especially those that were established to serve particular sectors such as the development banks and the rural banks.

Article IX - to provide for the other selective credit instruments. Among the more important provisions are those governing directly the cost and availability of credit.

1. "The Monetary Board may fix the maximum rates of interest which banks may charge for different types of loans and for any other credit operations... |Sec. 109, Article VIII |.

2. It may specify the maximum maturity of loans and investment the banks may make and the kind and amount of securities to be required against them.

3. It may place an upper limit on the amount or rate of increase of specific categories of loans

and investment which the banks may hold.

4. The Monetary Board may also prescribe minimum ratios of capital and surplus to the volume of assets of banks.

5. In addition, the discount window has been used extensively to influence the allocation of credit. The Central Bank gives differential discounting privilege and discount rates the various types of banking institutions.

6. The Rural Bank and the Private Development Bank Acts stipulate that the Development Bank of the Philippines, with prior approval of the Central Bank, capitalize the establishment of these banks; up to 50% of paid in capital in the case of rural banks, and without restriction in the case of private development banks.

D. Management of the Foreign Exchange Reserves

The responsibility of the Central Bank to maintain the international value of the peso and its international convertibility probably warrants a separate section. Various methods of controlling the flow of foreign exchange have been tried by the Bank. Articles II and III of Chapter IV of the Central Bank Act stipulate the powers of the Bank to achieve this objective by means of foreign exchange control, deposits on letters of credit, multiple exchange rates and spot purchases or sales of foreign exchange. It has broad powers over domestic holding, production and processing of gold. Most of the methods of controlling the flow of foreign exchange are selective in nature. The allocation of foreign exchange and the multiple exchange rates were used extensively to promote industrialization. A substantial literature has been written on the industrialization policy, in particular on the orientation of the past policy toward import-substitution.[8] On the other hand, some of the tools used to control foreign exchange have quantitative impact on the supply of money and credit. For instance, the deposit requirement and the dollar retention scheme directly reduce the money supply.

E. The Currency System

The Central Bank Act established for the Philippines a modern managed currency system and the Central Bank has sole authority for currency issue. The present currency system contrasts sharply to the previous currency system known as the "Dollar-Exchange Standard".

The Dollar-Exchange Standard:

Previous to the establishment of the Central Bank in 1949, the Philippines was on a dollar-exchange standard. This system required that the Philippine currency be backed 100 per cent by foreign exchange reserves, namely United States dollars, and the exchange rate between U.S. dollars and Philippine pesos was fixed by law at ₱2 = $1. Currency, in the form of Treasury certificates, was issued by the Philippine Treasury. These certificates could be backed 100 per cent by silver coins and

[8] A.A. Castro, "Import Substitution and Export Promotion", IEDR Discussion Paper No. 69-10.
J. Power and G.P. Sicat, "Industrialization in the Philippines", IEDR Discussion Paper No. 70-11

United States dollars, but in practice they were issued against United States dollars only.[9]

The dollar-exchange system caused the volume of local currency outstanding to fluctuate in accordance with the surpluses or deficits of the international balance of payments - surpluses caused the volume of currency to expand, and deficits caused it to contract. When surpluses were present, foreign exchange would be sold to the Treasury for peso equivalents. Peso circulation would increase and the foreign exchange would be held by the Treasury as backing for the increased pesos in circulation. When deficits were present, pesos would be presented to the Treasury in order to purchase foreign exchange. Foreign exchange holdings of the Treasury would fall and the peso equivalents would be sterilized by the Treasury and would cease to circulate. The Philippine currency system was very rigid. Changes in the volume of currency outstanding was determined solely by conditions prevailing in the international balance of payments, and the total <u>stock</u> of currency outstanding at any moment of time represented the accumulated surplus in the country's balance of payments plus domestically produced gold and silver reserves. When monetary requirements of the domestic economy came into conflict with the requirements of the dollar-exchange standard domestic con-

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[9] Grove: <u>op. cit.</u>, p. 938.

siderations were sacrificed for international considerations.

How well the 100 per cent reserve system has served colonial territories is a subject of considerable debate. There are several advantages and disadvantages to the system. Among the advantages are the following considerations: (1) The likelihood of over-issue of currency leading to injurious inflation and dissipation of foreign reserves was highly unlikely, (2) The territory had a simple, inexpensive currency-issue mechanism, where opportunities for mismanagement due to incompetence or corruption were minimal (3) The system provided a complete and absolute guarantee of convertibility of the peso into U.S. dollars at a stable exchange rate, resulting in a maximum of incentive for foreign investment. The disadvantages included: (1) The monetary authorities were prevented from exercising any monetary policy with the aim of affecting the domestic economy, (2) The expansion of currency in circulation required that the country become a net exporter or international creditor. To the extent that the community wished to add to its stock of currency it had to lend to the colonizing country.

The required export surplus results in a loan or sacrifice of real resources from the colony to the colonizing country. This flow of real resources is matched by a financial flow. The colony acquires hoards of foreign exchanges (non-interest bearing securities) or when provided for, the foreign exchange is invested in interest-bearing securities of the colonizing country. A currency system which causes a poor country to become a net creditor is thought now to be inappropriate since international policy is oriented toward causing capital to move from rich countries to poor countries.

The general consensus on this subject is that the 100 per cent reserve standard was a fairly satisfactory monetary system in areas where it was used during the colonial period and there is no evidence that the system seriously impeded Philippine economic development. It's deflationary bias was probably offset by its attracting of foreign capital. However, it is generally agreed that this type of currency system is not appropriate for an independent country.[10]

The Managed Currency System

The currency system of the Philippines was totally reorganized with the passage of the Central Bank Act. The 100 per cent reserve currency system was replaced by a flexible, managed currency system. There is no required ratio between the volume of international reserves held by the Central Bank and the volume of currency outstanding or note and deposit liabilities. Therefore, all reserves of foreign exchange are

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[10] Nevin: op. cit., p. 8-13; Grove: op. cit., p. 938-940; Drake, P.J.: Financial Development in Malaya and Singapore, Australian National University Press, 1969, p. 54-63.

freed for use in settling international accounts and their adequacy is left to the discretion of the Monetary Board. The country no longer was forced into the position of international creditor in order to affect increases in the supply of currency and for the first time it was in a position to pursue discretionary monetary policy. The volume of local currency outstanding was to be determined by domestic and international considerations.

The international value of the peso was fixed at two pesos to one United States dollar as under the previous system. The value of the peso was also defined in terms of gold, unlike under the previous system, where the value of the peso was defined in terms of U.S. dollars only. Futhermore, the peso could be revalued in the event of a fundamental disequilibrium in the Philippine balance of payments. Also, a revaluation of the U.S. dollar no longer required a revaluation of the Philippine peso. Under the dollar-exchange standard, any revaluation of the dollar required a revaluation of the peso in order to maintain the ₱2 to $1 ratio. Under the managed currency system a revaluation of the dollar would change the peso-dollar exchange rate but not the value of the peso defined in terms of gold. In essence, then, the international value of the peso was defined in terms of gold independently of the value of the U.S. dollar, and the quoting of its value in terms of dollars served only for purposes of convenience. Since in the Philippines a large percentage of international trade is conducted on a dollar basis and the dollar is used so widely as a unit of international accounting, it serves as a more convenient "denominator" than gold.

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