Turning Points In Central Banking: A Retrospective Essay

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Turning Points In Central Banking

A Retrospective Essay

When the Central Bank of the Philippines first opened its doors for business on 3 January 1949, it faced an economy that had not fully recovered its sinews of production after their devastation in the course of the Japanese Occupation of the Philippines from early 1942 to practically the first quarter of 1945.[1] As the American soldiers were driving the Japanese out of the country through July 1945, they also kept disbursing huge amounts of money since February 1945 to the communities in every part of the archipelago that they were liberating.[2] Money supply by end-1945 had ballooned to four times its level in 1940.[3] This windfall of liquidity swelled even more as both U.S. military and civilian expenditures soared in 1946-1947 with the pace of reconstructing the Philippines quickly spreading across the countryside.

Together with the rapid pace of disbursements paid out by the U.S.-Philippine War Damage Commission in compensation to the local residents, schools and churches whose properties had been ravaged during World War II, an awful lot of liquidity was swirling all over the Philippine archipelago in three years' time. The Roxas Administration further added to this liquidity as it restored and expanded the bureaucracy, at both the national and local levels of government, across the country funded out of a budgetary loan worth $60 million from the U.S. Reconstruction Finance Corporation. The U.S. Congress had authorized this loan to the fledgling Republic of the Philippines in the course of the first visit of President Manuel A. Roxas to Washington, D.C. after narrowly winning over Sergio Osmeña, Sr. in the 23 April 1946 presidential and congressional elections.

At the pre-War parity of ₱2 to the US dollar, built into the 2 April 1946 Bell Trade Act of the U.S. Congress which President Roxas recognized in the June 1946 Executive Agreement he signed with Ambassador Paul V. McNutt of the United States,[4] it was easy in the foregoing conditions for anybody simply to import almost anything if he had so much liquidity in his hands. For one thing, many of the sinews of domestic production around this time had not yet recovered to their pre-War level, unable to meet the growing requirements of reconstruction. For another, following the War, a baby boom was swelling the population in the countryside.

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[1] Vicente B. Valdepeñas, Jr., *The Protection and Development of Philippine Manufacturing,* Ateneo de Manila University Press, 1970, pp. 3-4.

[2] Vicente B. Valdepeñas, Jr., "Central Banking in Historical Perspective," *Money and Banking in the Philippines*, Bangko Sentral ng Pilipinas, 3 July 2003, pp. 56, 57, 58.

[3] Central Bank of the Philippines, *Statistical Bulletin*, vol. X. no. 4, December 1958, p. 19. The last pre-War year, 1940, has complete data; 1941 has only six months data.

[4] Frank Hindman Golay, *Face of Empire,* Ateneo de Manila University Press, 1997, pp. 474, 482.

Consequently, importation surged by the year at horrendous rates.[5] Imports were 44.5 times greater than exports in 1945, 4.6 times greater in 1946, 1.9 times in 1947, 1.8 times in 1948, and 2.3 times greater by end-1949. In contrast, over the 5-year period to 1941, imports averaged just four-fifths of exports. While the decade before World War II broke out saw plenty of trade surplus, by 1946 trade deficits were soaring by 718.6% and kept piling up at the rate of 6.5% in 1947, 8.3% in 1948 and 24.4% by the end of 1949. It was a tough job for the Central Bank of the Philippines both to quell this soaring rate of importation and to keep the pre-War parity of ₱2 to the US dollar. Throughout 1949, the black market priced the US dollar at the premium rates ranging from ₱2.50 to ₱2.80.[6]

These massive rates of importation, though, aborted the hyperinflation in retail prices after 1945 when they soared 776% (1941=100). Since then, they kept falling by -42.1% in 1946, -39.6% in 1947, -4.6% in 1948, and -10.6% by 1949.[7] Emerging out of the War exhausted and deprived of their homes, livestock and farms as the fleeing Japanese Imperial Forces burned and pillaged their way out of the Philippines in the course of its relentless liberation island after island by the United States Army and Navy, the Filipinos welcomed the sustained deflation as part of the peace dividend. Heavy importation in the four years after their liberation spared them from more rounds of withering hyperinflation.

The thing to do in this circumstance would have been to devalue the peso. This would have both dampened importation as the peso prices of imports surged and stimulated exportation at the same time as peso earnings rose. As a matter of fact, the British Government facing a similar circumstance around this time devalued the pound sterling on 18 September 1949 for the Sterling Area, i.e., 14 countries including Thailand,[8] with the rest of the countries, i.e., another 14 countries, in the Sterling sphere of influence following suit. This way, together, they managed both to contain rapidly expanding importation and raised exportation at the same time.[9]

However, the Roxas Government took a different tack, getting the Congress of the Philippines to legislate on 15 July 1948 R.A. Act No. 330,[10] which installed quantitative restrictions (QRs) on the import trade with the establishment of the Import Control Board in the Office of the President. Its implementing secretariat, the Import Control Commission, tagged imports either essential or non-essential depending on their necessity in the reconstruction and development of the country, substituting its discretion for the market system in doing so. It controlled importation of what it perceived as non-essential or luxury good, i.e., for consumption. It eased up on the importation of what it thought essential, i.e., capital formation, for the reconstruction and development of the Philippine economy. This system of quantitative restrictions (QRs) went into effect on 1 January 1949 with the issuance of Executive Order

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[5] Central Bank of the Philippines, *First Annual Report 1949*, pp. 21, 24, 37; Statistical Bulletin, vol.V no.1 (March 1953), p. 51; Statistical Bulletin, vol. X. no. 4, December 1958, p. 89.

[6] Central Bank of the Philippines, *First Annual Report 1949,* pp. 25, 10.

[7] Ibid., pp. 21-22, 26.

[8] Besides the United Kingdom (U.K.), Sterling Area countries at the time included Australia, Burma, Ceylon, Egypt, Iceland, India, Iraq, Ireland, Israel, Jordan, New Zealand, Thailand and the Union of South Africa. The Sterling-influenced countries included Argentina, Belgium, Denmark, Finland, France, Western Germany, Greece, Italy, Luxembourg, The Netherlands, Norway, Portugal, Sweden and Uruguay.

[9] Central Bank of the Philippines, *First Annual Report 1949*, p. 44.

[10] Ibid., pp. 45-48.

No. 193, which had to be amended along the way as often as the market for imports evolved in the following months.

The problem with QRs, though, is that they instantly create artificial shortages[11] of the goods that are controlled, suddenly sending their domestic prices soaring well above their world market prices before the QRs are imposed[12] and driving domestic producers chasing windfall profits to promptly get into the production of the very goods whose importation is being cut back. At the end of the day, the entire community consumes less of the goods under QRs and does so at their shortage prices in the domestic market. With shrunken imports, the government loses revenue at the customs border unless the import licenses are bid out in a public auction for a fee, which was not done.

The lucky domestic producer who goes into local production of the goods under control also incurs resource costs as he shifts resources away from their more efficient use to turning out import substitutes whose prices have likewise surged in parallel fashion with the imports subject to QRs. He also enjoys the prospect and high probability of becoming a monopolist, driven not so much by efficiency as in a competitive production regime and simply piling up windfall profits. An industry spawned and built this way could not stand the scrutiny of international competition. It would not survive in the larger world market. It is good only for the domestic market as long as this keeps growing, which is uncertain at best and limited at worst.

As it turned out, by 28 December 1948, the system of QRs implemented by the Import Control Commission of the Import Control Board was falling apart, failing to cut back on the level of importation which had to be increasingly financed by dipping into the country's international reserves[13] as U.S. Government expenditures in the rehabilitation of the Philippines kept declining. Overall imports kept surging through the first half of 1949.[14] QRs were the wrong policy instrument to address the swelling liquidity that was driving overall importation in the last three years. The burden of adjustment now fell on the shoulders of the nascent Central Bank of the Philippines, although it took a while for it to get its program of adjustment in place.

By 17 November 1949, though, the Central Bank of the Philippines was resorting to selective credit control. It was requiring 80% cash margin on all letters of credit (L/Cs) for imports the Central Bank deemed luxury and non-essential. This measure directly complemented what the Import Control Commission had been doing. However, it was far more effective because it raised the peso outlays for these imports by four-fifths. Furthermore, it disallowed the banking system from lending simply to cover these margins or finance imports.

On 9 December 1949, the Central Bank went into comprehensive foreign exchange controls,[15] operating a foreign exchange budget for the entire Philippines and allocating foreign exchange to imports it deemed priority, using for this purpose an elaborate classification of imports based on their

[11] Central Bank of the Philippines, *First Annual Report 1949,* pp. 9-10.

[12] Central Bank of the Philippines, *Third Annual Report 1951,* pp. 9-10, 15.

[13] Central Bank of the Philippines, *First Annual Report 1949,* pp. 28, 34.

[14] Ibid., p. 46.

[15] Ibid., p. 24; see also Central Bank of the Philippines, *First Annual Report 1949,* p. 9.

essentiality as this was perceived by the Central Bank. Partly in response to the International Monetary Fund's (IMF) drive against selling gold at premium prices, the Central Bank of the Philippines also licensed all transactions in gold, whether for export or import. By 16 December 1949, after the Supreme Court of the Philippines had outlawed the 24 December 1948 Executive Order No. 192 issued by President Roxas controlling exports of construction materials, farm implements, vital foodstuffs and critical industrial goods, the Central Bank of the Philippines also required all exports to be denominated in the U.S. dollar and their proceeds kept in banks domiciled in the Philippines to ensure their use in the domestic economy.

However, by end-1949, overall imports fell only by some 4% of their level in 1948.[16] The banks in town were still negotiating import bills at the rate of 2.2 times more than the rate at which export bills were being negotiated. In 1948, import bills were 1.15 times export bills, in 1947 they were 1.68 times export bills, while in 1946 they were 4.6 times export bills as the country's export capacity was being rebuilt after its devastation during World War II. This was evidence suggesting that foreign exchange licensing was not getting its job done. It did not seem like the policy instrument to do the job of quelling imports by making them more expensive in peso terms.

Although it was mandated to stabilize the peso,[17] the Central Bank of the Philippines was hampered at the job by the Philippine Government Executive Agreement with the United States implementing the Bell Trade Act,[18] which President Roxas had signed shortly after his inauguration mid-day on 4 July 1946 in compliance with Section 601 of the 5 December 1945 Tydings Rehabilitation bill.[19] In the course of the House deliberations on this bill at the U.S. Congress, Congressman Charles Jasper Bell had insisted on the pre-War parity of ₱2 to the U.S. dollar to help American investors in the Philippines avoid foreign exchange risk as they remit the returns on their investments in the country or repatriate them as the case may be. In effect, he had preempted a sovereign right of the independent Republic of the Philippines to be installed on 4 July 1946 of determining foreign exchange policy in its own national interest.

Until this preemption was lifted, there was no way for the Central Bank of the Philippines to use the market system in quelling the terrible rates of importation. Neither did President Roxas have the heart to ask the Congress of the Philippines at the time to tax away in some form the excess liquidity swirling all over the archipelago and dam the floodgates of importation. People simply needed all the cash they can lay their hands on to rebuild their homes and the lives[20] they had seen so horribly shattered in the course of three and a half years of occupation of the Philippines by the invading Japanese Imperial Forces.

With its hands tied from exercising a market-oriented foreign exchange policy, the Central Bank of the Philippines initially tried to manage the overall level of bank credit funding imports by imposing reserve requirements on both peso and foreign currency deposits. On 10 January 1949, it required banks to keep 18% cash reserve on peso demand deposits, 5% reserve on time and

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[16] Central Bank of the Philippines, *First Annual Report 1949*, p. 13.

[17] Republic Act. No. 265, Article I, Section 2, sub-clause (b).

[18] Enabled in Philippine Commonwealth Act No. 733 and Public Law 317 U.S. 79th Congress.

[19] Philippine Congressional Record, 3rd Session, 925.

[20] Central Bank of the Philippines, *First Annual Report 1949,* p. 13.

savings deposits, and 10% reserve on foreign currency deposits. While these measures were meant to shrink the excess liquidity in the financial system, by 4 February 1949 the Central Bank was pumping out more liquidity[21] into the same system as it extended under Section 137 of its charter, R.A. No. 265, extraordinary advances worth ₱115 million to the Government. Though legislated on 15 June 1948, the Central Bank had three years to 30 June 1951 to complete making these advances to the Government for its use only for income-producing projects and servicing its external debt. The law required that these advances be made consistent with domestic monetary stability.

For its part, the Government issued to the Central Bank as collateral 5-year Treasury bonds at 2% interest p.a. for ₱50 million it was borrowing to amortize its debt to the U.S. Reconstruction Finance Corporation, and 10-year Treasury bonds at 4% interest p.a. for the other ₱65 million it borrowed for development and rehabilitation projects. It turned over ₱30 million of the latter amount as advances to the Rehabilitation Finance Corporation (RFC), whose chairman Delfin Buencamino also happened concurrently to be a member of the Monetary Board at the time, and the rest worth ₱35 million to its different agencies and private enterprises that were not eligible for RFC loans though, in the view of the Government, they were sound and merited support. By end-1949, the Government had drawn 90%[22] of the foregoing extraordinary advances made available by the Central Bank of the Philippines. It used two-fifths of it to amortize its debt, i.e., part of the original principal and accruing interest, to the U.S. Reconstruction Finance Corporation.

In addition, exercising Section 95 of its charter, the Central Bank of the Philippines extended to the Government a short-term loan worth P44 million. By end-1949, the Roxas Government, which was spending at the rate of 1.69 times its income,[23] had withdrawn as much as ₱37 million of this short-term credit line from the Central Bank of the Philippines. Moreover, the charter of the Central Bank of the Philippines also enabled it to extend advances to banks against eligible collaterals. On this basis, the Central Bank of the Philippines extended ₱87 million worth of advances to the Philippine National Bank, a government-owned and -controlled corporation at the time,[24] whose president Vicente Carmona was also serving concurrently in the Monetary Board at the time.

Altogether, as much as P246 million worth of resources of the Central Bank of the Philippines were exposed to the public sector during its first year of operation. The accessibility of the public sector to its resources was assured by the membership in the Monetary Board of the Secretary of Finance who was serving at the time as its chairman, the chairman of the Rehabilitation Finance Corporation and the president of the Philippine National Bank who both served as members of the Monetary Board, all in concurrent capacity. Before becoming governor of the Central Bank of the Philippines, Governor Miguel Cuaderno, Sr. himself had served as Secretary of Finance. He also served as member of the Monetary Board on a concurrent basis. Among the

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[21] Central Bank of the Philippines, *Third Annual Report 1951,* pp. 15, 19.

[22] Central Bank of the Philippines, *First Annual Report 1949,* p. 86.

[23] Ibid., pp. 27, 87.

[24] Ibid., p. 87.

four of them, they had the majority in the Monetary Board which had seven members altogether.

The overall situation that was emerging as early as the first year of central banking in the Philippines 60 years ago was of a central bank trying, on the one hand, to contain the excess liquidity in the financial system driving importation to perilous levels through a mix of foreign exchange controls, selective credit operations and prohibitive reserve requirements on banks; and, on the other hand, turning around at the same time to pump more liquidity into the public sector which had no intention of keeping the money in its vaults. At the end of the day, these contradictory motions simply offset one another. The management of overall liquidity still remained the problem to efforts at keeping importation to a manageable level.

The Central Bank of the Philippines from its birth seemed caught in some fundamental tension between getting monetary policy right and helping nurture a permissive fiscal policy. It appeared like a banker for the public sector bankrolling its rehabilitation and development projects, paying up its foreign debt as well as its expanding bureaucracy. In effect, through its budgetary and developmental loans[25] to the Government, it was monetizing the public sector deficits. While it was a byproduct of a central bank facing multiple objectives, it betrayed a lack of coherence in what it was doing.

In its incipient efforts at open market operations, the Central Bank of the Philippines turned around to sell the 10-year Treasury bonds paying 4% interest p.a., i.e., the so-called Rehabilitation and Development (R&D) bonds, to the banks in town. With bank credit fetching anywhere between 5% and 7% for production and import trade loans,[26] the banks generally had no appetite for these R&D bonds, which were designed and structured in such a way as to enable the Rehabilitation Finance Corporation to make a margin when it sold them in the domestic securities market. Central Bank advances, i.e., loans, to the Philippine National Bank were similarly configured.[27] Only 10.8% of the entire lot, though, got sold by the end of 1949 to the Philippine Bank of Commerce, Philippine Trust Company and China Banking Corporation, with the rest of the R&D bonds ending up in the vaults of the Central Bank of the Philippines. It was more successful as fiscal agent of the Government when it tendered, as accepted by the Secretary of Finance, ₱1 million worth of Treasury bills which the Bank of Philippine Islands won and bought at a 1.5% discount.

The Central Bank of the Philippines adhered to this pattern of central banking the rest of the 1950s as the Government, including its menagerie of government-owned and -controlled corporations, persisted in spending beyond its means and kept its senior officials in the Monetary Board, making it convenient for the public sector to have ready access to the resources of the Central Bank. The parallel program of the Government promoting tax-exempt new and necessary industries since 1946 kept chipping away at its tax base by the year even as they have been making profits from 20% to more than 100% on their capital.[28]

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[25] Central Bank of the Philippines, *Seventh Annual Report 1955,* p. 107-108.

[26] Central Bank of the Philippines, *Fourth Annual Report 1952,* p. 42.

[27] Central Bank of the Philippines, *Fifth Annual Report 1953,* p. 150.

[28] Central Bank of the Philippines, *Sixth Annual Report 1954,* p. 7.

Together, spending beyond its means and waiving its taxes drove the Government to a chronic condition of deficits and indebtedness to finance these deficits. Government spending since 1949 through 1956 was outpacing government revenue by 1.4 times annually, increasing at the rate of ₱59.1 million every year. At this level of expenditure, the average revenue kept lagging behind even as it rose annually by ₱64.1 million. A surplus in 1952 quickly vaporized by 1953 and reverted to a deficit in 1954 through 1958.

Public debt since 1949 was averaging ₱440.4 million annually, and was increasing by ₱135.9 million every year through 1958 and sharply for the last two years. Over this span of time, four-fifths of the public debt was long term, i.e., longer than 3 years, another one-tenth medium term,[29] i.e., 1 to 3 years, and about one-twelfth short term, i.e., 1 year or less. Averaging ₱550.5 million annually, long-term debt was increasing by ₱69.2 million every year. By 1957, however, the share of long-term debt dramatically shrank and by 1958, it was just a little over one-half of the debt stock.

Meanwhile, medium-term debt, which has averaged ₱61.5 million annually, was rising by ₱37.4 million by the year. As early as 1956, the share of medium–term debt notably surged and by 1958, it counted for close to one-fourth of the debt stock. Si milarly, short term debt, which since 1949 trended downwards at the rate of ₱48.6 million annually, more than quadrupled between 1956 and 1957. By end-1958, it further doubled its level in 1957. Accordingly, the share of short-term debt rapidly rose in 1957 and was almost one-fourth of the entire debt stock by end-1958. By the end of 1953, after five years into central banking, the Central Bank of the Philippines had not collected interest worth ₱1.1 million on its loans to the Government and its instrumentalities and on the domestic securities it had acquired from them.[30]

The Central Bank of the Philippines had also been issuing no-dollar import allocation licenses that ran afoul of the Philippine Anti-Dumping Act, prompting President Ramon Magsaysay to rectify the confusion by issuing Administrative Order No. 120 of 22 June 1955.[31] By 10 September 1955, the Congress of the Philippines generally proscribed no-dollar and barter imports in R.A. No. 1410, allowing them only under certain conditions as authorized by the Secretary of Commerce and Industry.[32] In 1957 and 1958, imports on barter and no-dollar basis were outpacing exports by 1.2 times.[33] There were leakages in the overall control system. By this time, the efforts of the Central Bank of the Philippines at foreign exchange controls and budgeting were wilting in the face of quite contrary efforts by the Government and the Congress of the Philippines. Coherence in public policy has apparently vanished after 10 years of QRs and foreign exchange controls.

The preoccupation of the Central Bank of the Philippines with foreign exchange licensing absorbed most of its energy as it took over by 30 June 1953 the job of the Import Control Commission from the Government.[34] By this time, too,

[29] Central Bank of the Philippines, *Tenth Annual Report 1958,* p. 135; they are called today as medium-term.

[30] Central Bank of the Philippines, *Fifth Annual Report 1953,* p. 153.

[31] Central Bank of the Philippines, *Seventh Annual Report 1955,* p. 533.

[32] Central Bank of the Philippines, *Eighth Annual Report 1956,* p. 91.

[33] Central Bank of the Philippines, *Tenth Annual Report 1958,* p. 67.

[34] Ibid., p. 106.

it was denying new foreign exchange quotas to non-Filipino import traders, limiting these allocations only to Filipino citizens or Filipino-owned or -controlled businesses to encourage them into the import trade. For all the growing intensification of foreign exchange controls, however, merchandise imports kept outpacing merchandise exports since 1950 when the outbreak of the Korean War sent export commodity prices soaring worldwide including those of the Philippines.[35]

Taking the whole stretch of time since 1946 through 1958, the average level of imports exceeded exports by 2.4 times, increasing annually by ₱21 million pesos.[36] This disproportion persisted even as exports over this period were growing by more than twice as fast as imports. Trade deficits were averaging at ₱483.6 million annually and were increasing by nearly ₱29 million every year. Since 1950, as a matter of fact, while the average level of imports kept exceeding exports by 1.1 times, these imports were increasing annually at the rate of 1.7 times the growth in exports. Consequently, the trade deficits kept widening by the year at the rate of ₱21.4 million through 1958. The current QRs were not working and by themselves they were thoroughly helpless at driving exportation more rapidly.

Obviously, these chronically widening trade gaps required another policy instrument to get sorted out. The alternative policy ought to be symmetrical in its operation, i.e., it must both drive down incremental importation at the same time that it drives up incremental exportation. Imports must be made more expensive in peso terms at the same time that exports are made more lucrative in peso terms. This required a devaluation of the peso. Over time, procrastination on this alternative policy instrument was to doom the Philippines in the future to persistent balance of payments difficulties. It was also eroding its international reserves which had been trending downwards since 1949 at the annual rate of -19.72 million US dollars,[37] as it got drawn down whenever export receipts lagged behind import payments. Averaging $359.8 million since 1949, by end-1957 the international reserves had perilously plunged down to $140 million. It rose marginally to $145.3 million by end-1958.

However, the biggest public policy discussion in town since 1949 was trying to get the 1946 Philippine Trade Agreement with the United States, i.e., the Bell Trade Act, revised.[38] It was largely driven by the yearning of a sovereign country to do tariff policy on its own. By 15 December 1954, Sen. Jose P. Laurel, Sr. for the Philippine Government and U.S. Ambassador James M. Langley for the U.S. Government were signing the final act of their negotiations at Washington, D.C. the Revised Philippine-United States Trade Agreement, i.e., the Laurel-Langley Agreement.[39] Signed on 6 September 1955 by Ambassador Carlos P. Romulo and Ambassador James M. Langley, the Revised Trade Agreement was enforced from 1 January 1956 to 3 July 1974.

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[35] Central Bank of the Philippines, *Seventh Annual Report 1955*, p. 19.

[36] Central Bank of the Philippines, *Statistical Bulletin,* vol. X no. 4, p. 89.

[37] Central Bank of the Philippines, *Statistical Bulletin,* vol. 10 no. 4, December 1958, p. 21.

[38] Central Bank of the Philippines, *Fifth Annual Report 1953*, p. 8.

[39] Vicente B. Valdepeñas, Jr., *The Protection and Development of Philippine Manufacturing*, Ateneo de Manila University Press, 1970, pp. 70-78.

Over this 8-year transition, besides decelerating the application of American tariffs on imports from the Philippines and accelerating the application of Philippine tariffs on imports from the United States as well as modifying U.S. import quotas of Philippine cigars, leaf tobacco, coconut oil, rice and sugar, the Revised Trade Agreement replaced the 17% tax on the sale of foreign exchange by a 17% temporary levy on imports which fell by 10% p.a. from 1956[40] and recognized the sovereign right of the Philippines to determine unilaterally the peso-dollar rate in its own national interest. In time, the latter recognition would turn out to be far more important for central banking and the entire Philippine economy at addressing the chronic trade gap which had been threatening the country's balance of payments and the adequacy of its international reserves in the face of vaporizing United States expenditures in the Philippines, both military and civilian.

However, the exit program out of the regime of foreign exchange controls and licensing turned out to be a long drawn-out process. So much inertia had built up in the social system since 1946 when QRs and import licensing took over from the market the job of determining for the country how much and what to import. This inertia carried over into the Central Bank of the Philippines which practiced foreign exchange controls and licensing over a 10-year period to a fine art. However, by 25 April 1960, the Central Bank of the Philippines was shedding part of this policy inertia as it launched a 4-stage program of foreign exchange decontrol.[41]

Although somewhat tardy considering that the Laurel-Langley Agreement had been in effect since January 1956 enabling the Philippine Government to determine its foreign exchange policy as it saw fit in its own national interest, the first stage of the decontrol program was to gradually open to the free market 25% of all the foreign exchange transactions. The response of the export sector to this regime shift was immediate and widespread,[42] with export volume surging 7.3% as the peso proceeds of every dollar it earned rose even as export prices throughout 1960 were dropping by 1.6%. The country's international reserves increased nearly 18% to $192 million.

Imports, which now cost more in pesos, retarded. They also turned out to be the right sort of imports, i.e., capital goods and working materials for further domestic manufacture, the very items that the QRs and foreign exchange licensing had fondly aimed at encouraging. This salubrious outcome from even a fractional relaxation of foreign exchange controls was to motivate a widening relaxation by 28 November 1960 when the second stage of decontrol opened up as much as one-half of all the foreign exchange transactions to the free market.

However, the so-called *free market* lasted for about four months. By 12 September 1960, the Monetary Board at the Central Bank of the Philippines set the peso-dollar exchange rate at ₱3.00 to the dollar in this market for 25% of all its foreign exchange transactions while keeping the par value and official rate at ₱2.00 to the dollar in the other 75% of the market.[43] In addition, it still

[40] Section 7, Republic Act No. 1355, (18 June 1955).

[41] Central Bank of the Philippines, *Twelfth Annual Report 1960*, pp. 1, 121.

[42] Ibid., p. 10.

[43] Central Bank of the Philippines, *Thirteenth Annual Report 1961*, p. 108.

had to comply at the same time with R.A. No. 2609 of 16 July 1959 which had authorized the Central Bank of the Philippines to levy a margin fee of as much as 40% on the sale of foreign exchange although the going rate around this time was 20%, which by 15 March 1961 was brought down to 15%.

Parallel action was also taken on the marginal cash deposits which the Central Bank of the Philippines had been imposing since 1957 on certain imports it wanted to inhibit under its Circular No. 79. On 27 May 1960, it cut back on the marginal deposits it required against letters of credit (L/Cs) for eligible imports. By 7 September 1960, they were scrapped altogether as the higher peso costs of imports were doing the job of bringing down the overall level of importation with half of all foreign exchange transactions now being traded in the free market. Eliminating marginal cash deposits on imports apparently released as much as ₱46 million in additional liquidity across the entire country. This was equivalent to the average rate of sterilization achieved in 1959.

What was emerging in the overall market was a system of multiple exchange rates,[44] i.e., quoting several peso prices for the same dollar depending on its use or the type of transaction it pays for or how it has been earned or gained. Multiple exchange rates frustrate the job of the price system at allocating scarce resources, i.e., the U.S. dollar in this case, efficiently as they discriminate between export and import of different types of goods, i.e., distorting international trade, between current and capital account payments. They encourage parallel, i.e., secondary or black, markets in foreign exchange, export misinvoicing,[45] i.e., variances between exporting and importing countries' trade reports, and capital flight.[46]

They are also a nightmare to implement, and vulnerable to a lot of discretion teetering on the fringes of corruption. They are avoided by the world's key economies which operate unified foreign exchange markets, i.e., quoting one price for the foreign currency without regard to its use or the type of transaction.

Around this time, too, the Central Bank of the Philippines was still practicing some residual foreign exchange control and licensing which diluted its implementation of the decontrol program. As a market maker, it was buying dollars at the free market rate of ₱3.00 to the dollar. However, as the Central Bank turned around to sell them at the official rate of ₱2.00 to the dollar in order to stabilize domestic prices and subsidize essential industries, it had been piling up losses since 25 April 1960 which by end-February 1961 had added up to ₱81 million altogether.

Realizing that there was no way of keeping up with this rate of losses, the Monetary Board dumped its initially gradual tack and hastened to implement the third phase of the decontrol program. Quickly, the peso-dollar rate adjusted upward. In the adjustment process, the spread between the buying and selling rates narrowed. At the same time, it accommodated a wider range of export

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[44] Brian Butler, David Butler, Alan Isaacs, eds., *Dictionary of Finance and Banking,* 2nd. ed., Oxford University PressOxford, 1997, p. 231.

[45] Miguel Kiguel, J. Saul Lizondo, and Stephen A. O'Connell, *Parallel Exchange Rates in Developing Countries,* St. Martin's Press, New York, 1997.

[46] Carmen M. Reinhart, A Modern History of Exchange Rate Arrangements: Parallel Markets and Dual and Multiple Exchange Rates, University of Munich Personal RePEc (Research Papers in Economics) Archive (MPRA) Paper No. 13194, 5 February 2009.

dollars and invisibles receipts to exchange at the free market rate of P3.00 to the dollar.

While it understandably sold dollars at ₱2.00 for existing foreign exchange obligations contracted before 25 April 1960, for decontrolled items and newsprint, dollars were sold for ₱2.50 to the dollar, and for the import requirements of dollar-earning industries, ₱2.75 to the dollar. For all other import payables, dollars were sold at ₱3.00 to the dollar. There were four different exchange rates at the same time on the selling side of the market.

On the buying side of the market, while nobody was transacting at the official rate of ₱2.00 to the dollar, exports other than gold and including U.S. government expenditures and walk-in foreign capital, i.e., without the prior approval of the Central Bank, were transacting at ₱2.75 to the dollar with 25% at the official rate and the rest, i.e., 75%, at the free market rate of ₱3.00 to the dollar which was also the going rate for foreign capital with the prior approval of the Central Bank, inward remittances, tourist receipts and proceeds from the sale of gold. This cumbersome system of multiple exchange rates operated throughout the Philippines from 3 March 1961 to 29 December 1961.

By 21 January 1962, the fourth phase of the decontrol program went into effect, with 80% of all export proceeds transacting in the free market, and the other 20% sold to the Central Bank of the Philippines at ₱2.00 to the dollar.[47] It dismantled the residual restrictions on foreign exchange transactions. By May and through December, the buying rate had stabilized at ₱3.87 to the dollar and the selling rate at ₱3.92 to the dollar. Export receipts soared by 22% while imports plunged 15%. The forward exchange market rocketed several hundredfold.

International reserves increased by 37%. The external commitments of the Philippines plummeted 59% by the end of the year. The short-term standby credit arrangements worth $170 million obtained by the Macapagal Administration to support the foregoing transition in the country's foreign exchange regime never got used. Private capital that had fled over the many years of QRs and foreign exchange controls had all returned.

The overall position of the foreign exchange receipts and disbursements at the Central Bank of the Philippines completely reversed from a deficit of $89 million in 1961 to a surplus of $40 million by end-1962. The market was doing its job of adjustment. It was a shame that its magic had been stifled from 1946 by QRs and foreign exchange controls.

The windfall from the foreign exchange reform persisted through 1963. Exports soared 28% in the year, driven both by rising world prices for them and by large gains in the volume of their production.[48] This expansion in exports more than offset the 14% surge in import payments, although their volume declined by 1% due to a prolonged strike at the Manila pier the first half of the year when import volume dropped 13%. It was big enough to offset a 10% increase in their volume the second half of the year when the Government has had to import a huge amount of rice to quell a surging price as drought parched the farmlands of the archipelago, foiling their typical output of paddy rice.

The huge response of exports to a more market-determined peso-dollar rate enabled the Central Bank of the Philippines to repay $32 million worth of

[47] Central Bank of the Philippines, Fourteenth Annual Report 1962, pp. 1-2.

[48] Central Bank of the Philippines, Fifteenth Annual Report 1963, p. 4.

stabilization loans it had borrowed in 1961 and 1962. It also made possible an increase in CBP's international reserves by $7 million even after the net repayment of its stabilization loans. The country's balance of payments ended the year with a surplus worth $13 million.[49]

However, well before the fifth stage of the decontrol program would unfold, clever market makers in the foreign exchange market began to wise up to the opportunities of speculating on the next phase of the stage-managed reform of the market. As things stood by end-1963, the Central Bank of the Philippines held on to 20% of the export receipts which were purchased at P2.00 to the dollar, while the other 80% was freely transacted in the foreign exchange market at whatever exchange rate the market will bear. By 1964, some four years into the fractional liberalization of the foreign exchange market, although exports rose 1.4% to $737 million, imports skyrocketed by 26% to $780 million.

This lopsided pace in the trade account drove market makers in the foreign exchange market to mount two virulent attacks during the year, speculating on the next adjustment in the exchange rate as and when the Central Bank proceeds to implement its fifth stage of the decontrol program. In the course of these speculative attacks, short-term capital fled in huge amounts ending the year with a net outflow of $56 million, reversing a net inflow of $9 million in 1963.

The outflows were fueled further by the servicing requirements of the country's external debt which soared by $52 million in 1964 reversing its cutback by $20 million in 1963.[50] Between them, the Central Bank of the Philippines and the Development Bank of the Philippines borrowed from foreign banks as much as $44 million of this net addition to Philippine external debt, with other government corporations like Philippine National Bank and National Power Corporation accounting for the rest of the increment. By end-1964, the country's balance of payments was in deficit by $26 million, reversing a surplus $13 million end-1963.

Despite these speculative attacks, however, and with the intervention of the Central Bank in the foreign exchange market, the buying rate was kept at ₱3.89 to the dollar while the selling rate held at ₱3.91 to the dollar. However, these episodes of speculation exposed the warts and moles in the overall decontrol program. They were warning signs pointing to the need to make a clean break of all the residual vestiges of foreign exchange controls.

The gradual process of unfolding stage by stage over intervals of several months the next configuration that the foreign exchange market decontrol will take simply whets the appetites of aggressive market makers to arbitrage in different markets or their segments as in a regime of multiple exchange rates and make an immediate profit without risk. It is stylized procrastination on a complete market adjustment of the exchange rate on the basis of the supply and demand for the foreign currency, i.e., the dollar in this case. The sooner this adjustment is made, the sooner the market surfaces with the true price, i.e., peso-dollar rate, which clears the market, signaling everyone, exporter or importer, creditor or borrower, in the market to respond and adjust its decision and behavior.

[49] Central Bank of the Philippines, *Sixteenth Annual Report 1964*, p. 6.

[50] Ibid., p. 38.

Eventually, this transition came in late 1965.[51] However, before it came, aggressive market makers mounted in June several rounds of speculative attacks on the peso-dollar rate and, on quite a sustained effort, in August through October. In defense of its increasingly untenable multiple exchange rates, the Central Bank of the Philippines has had to sell a large fraction of its store of dollars, which was not such a big store to begin with. The speculative attacks were quashed only in November as the Central Bank adopted a new par value of ₱3.90 to the dollar, unifying the exchange rate as it abandoned at the same time its claim to 20% of the export receipts that it had been purchasing at ₱2.00 to the dollar. With the foreign exchange unified at one price for the dollar, the buying rate averaged ₱3.89 to the dollar and the selling rate, ₱3.91 to the dollar.

While exports rose 3.4% during the year, imports increased slightly higher at 3.6%. The current account ended with a surplus worth $154 million. The country's overall balance of payments also ended with a surplus worth $80 million. With the supply of dollars aplenty, the Central Bank of the Philippines ended up buying a lot of them in the foreign exchange market. Its international reserves soared 1.9 times to $142 million by end-1965 from its pretty parlous amount of $74 million by end-1964.

It was a long journey of 20 years from 1946 for the foreign exchange market in the Philippines to get sorted out. Opportunities for more rapid economic growth and higher levels of employment were lost in the procrastination on unifying the exchange rate to its market value. This brief history shows that a colonial outreach was partly behind this procrastination. However, from 1956, policy inertia has built up over a decade of QRs while foreign exchange licensing held it back as well. The magic of the market was kept in check from invigorating the economy to its full potential.

[51] Central Bank of the Philippines, *Seventeenth Annual Report 1965*, pp. 1, 91-92.

Annexes

Chart 1

Imports, Exports and International Reserves

1945-1965, In Million US Dollars

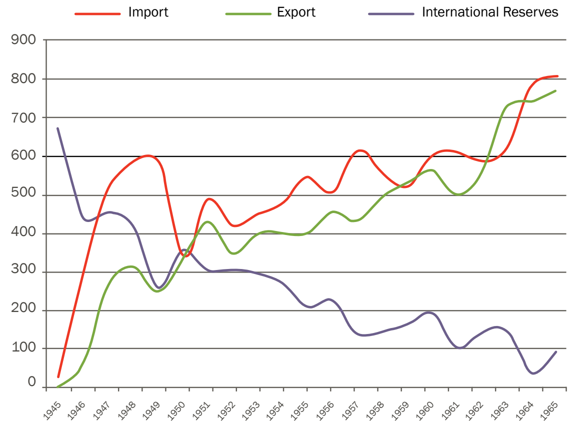

Table 1

Imports, Exports and International Reserves

Million U.S. dollars

Period	Imports	Exports	Int'l. Reserves
1945	28.9	0.6	669.1
1946	295.9	64.2	442.5
1947	511.1	263.4	453.5
1948	584.9	309.6	420.1
1949	585.9	247.9	260.1
1950	341.9	331	355.9
1951	489	427.4	303.9
1952	421.4	345.7	305.9
1953	452.4	398.3	296
1954	478.7	400.5	272.7
1955	547.7	400.6	209.1
1956	506.2	453.2	224.7
1957	613.2	431.1	140
1958	558.7	492.8	145.3
1959	523.6	529.5	162.9
1960	603.9	560.4	192.1
1961	611.3	499.5	103.3
1962	586.7	556	140.8
1963	618.2	727.1	147.5
1964	780.3	742	38.44
1965	807.6	768.5	91.62

Source: CBP, Statistical Bulletin, Dec. 1969; First Annual Report 1949, p. 30, for 1945 imports and exports.

Chart 2

Growth of Money Supply

In Million Pesos, and Percent (1945-1965)

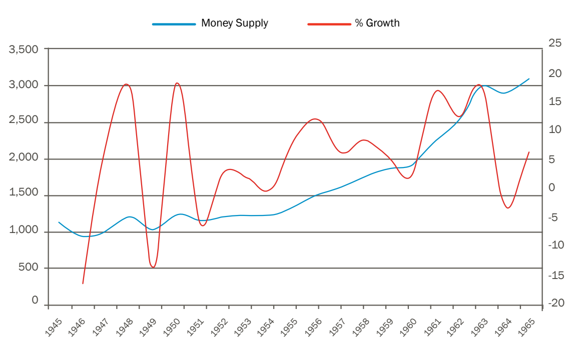

Table 2

Money Supply and its Growth

Million Pesos

Period	Money Supply	Growth %
1945	1,120	
1946	940	-16.1
1947	1,015	8.0
1948	1194	17.6
1949	1036	-13.2
1950	1229	18.6
1951	1161	-5.5
1952	1198	3.2
1953	1225	2.3
1954	1227	0.2
1955	1337	9.0
1956	1501	12.3
1957	1600	6.6
1958	1740	8.8
1959	1845	6.0
1960	1896	2.8
1961	2219	17.0
1962	2505	12.9
1963	2954	17.9
1964	2874	-2.7
1965	3067	6.7

Source: CBP, Statistical Bulletin, Dec. 1969; First Annual Report 1949, p. 30, for 1945 imports and exports.

Chart 3.1

Cost of Living Index, Manila

1945-1952 (1941=100)

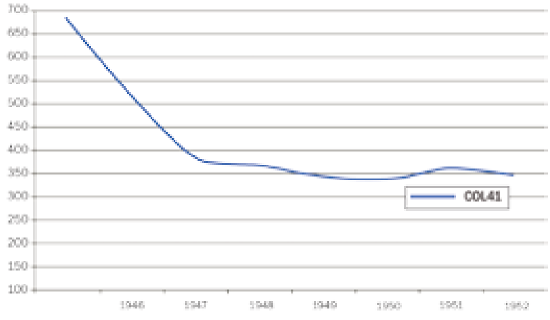

Chart 3.2

Consumer Price Index, Manila

1949-1967 (1955=100)

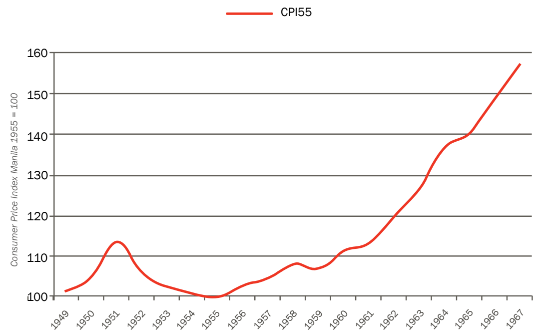

Chart 3.3

Consumer Price Index, Philippines

1957-1967 (1957=100)

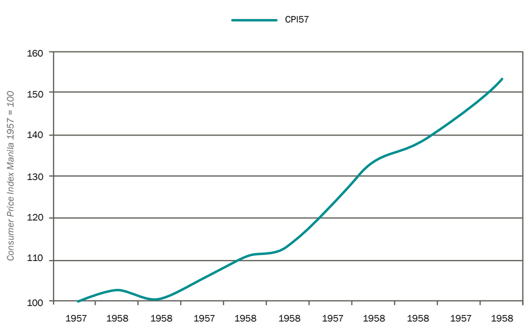

Chart 4

Growth of Output, 1946-1967

GDP in millions of 1955 pesos, Percent

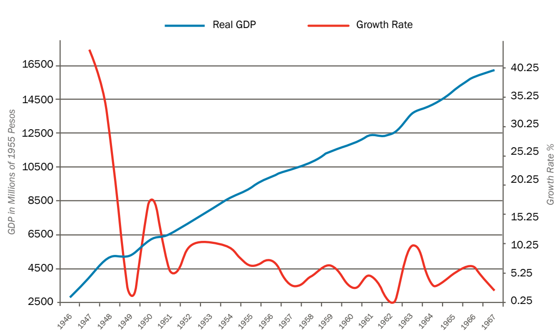

Table 3

Indicators of Price Pressures

1945-1967

Period	Cost of Living Index Manila, 1941=100	Consumer Price Index Manila, 1955=100	Consumer Price Index Philippines, 1957=100
1945	683.4		
1946	521.6		
1947	387.1		
1948	365.8		
1949	343.7	101.6	
1950	337.5	104.7	
1951	359.4	113.4	
1952	346.4	106.1	
1953		102.5	
1954		101	
1955		100	
1956		102.7	
1957		104.5	100
1958		108	102.5
1959		107	100.6
1960		111.5	105.6
1961		113.2	110.3
1962		119.8	113.6
1963		126.5	122.6
1964		136.9	133.5
1965		140.4	137.6
1966		149.1	144.5
1967		157.6	153

Note: Cost of Living for Wage Earner
Source: CBP, Statistical Bulletin, Dec., 1953, 1969.

Table 4

Growth of Input

1946-1967

Period	GDP In million 1955 Pesos	Growth in Percent
1946	2842.5	
1947	4074.5	43.3
1948	5236.4	28.5
1949	5307.1	1.4
1950	6260.1	18.0
1951	6586.5	5.2
1952	7248.8	10.1
1953	8005.7	10.4
1954	8744.1	9.2
1955	9307	6.4
1956	10009.7	7.6
1957	10328.9	3.2
1958	10818.4	4.7
1959	11509.3	6.4
1960	11839.1	2.9
1961	12416.3	4.9
1962	12472	0.4
1963	13703.6	9.9
1964	14163	3.4
1965	14898.3	5.2
1966	15833	6.3
1967	16215.2	2.4

Source: NEC, Statistical Reporter, April-June 1969