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ON Monday, January 22, 1962, the Central Bank's Circular No. 133 went into effect. This marked the end of a system of allocating foreign exchange that had been in operation from December 9, 1949, a period of over twelve years. It also marked the beginning of a new system of exchange operations with which this country has as yet had no experience, a system of floating exchange rates. On the same day that decontrol went into operation, the Fifth Congress commenced its session and the newly elected President Diosdado Macapagal delivered his address on the state of the nation. He announced to Congress and to the people the decision arrived at by the Monetary Board over the week-end and explained the rationale of the new policy. It was, he said, the fulfillment of an election promise to remove from government one of the principal sources of corrupting power and to restore a climate of free and private enterprise within the country. It was also an essential first step in the implementation of a new Five-Year Integrated Socio-Economic Program which was submitted by the President to Congress together with his state of the nation message.

This article examines the essential character of the decontrol program, first analysing it in terms of the decontrol program launched on April 25, 1960; next the new policy will be examined from the point of view of the economic theory of balance of payments adjustment; the specific form that decontrol took will then be analysed against the framework of the provisions of the Central Bank Charter. Finally, the country's experience with the system of fluctuating rates thus far will be examined.

I.

On December 9, 1949 when import controls on luxury goods failed to stop the rapid drain on the country's international reserves, the Central Bank of the Philippines issued Circular No. 20. This Circular invoked Section 74 of the Central Bank Act and subjected all transactions in gold and foreign exchange to licensing.

Licensing was established to achieve three principal ends. First, to make the Central Bank the sole legal holder of all foreign exchange assets in the country; second, to make the Central Bank the sole legal source of foreign exchange and third, to establish a system of rationing foreign exchange in order that the exchange resources of the country would be used in accordance with priorities established by the Central Bank of the Philippines. Thus was established the system of exchange controls.

This system had two essential features. It involved a Central Bank decision to maintain the exchange rate between the peso and the dollar at the parity of ₱2.00 per US $1.00. Since at this rate the demand for foreign exchange far exceeded its supply, the balance between supply and demand had to be achieved through some other means than an adjustment in the exchange rate. The second feature of the system was exchange rationing by the Central Bank. Having become the sole legal repository of foreign exchange, the Central Bank became the sole legal source of exchange. It was thus able to determine how much exchange the country should spend over given periods, what these amounts should be spent for and who should spend them. This was the essential characteristic of exchange controls.

Up to June 30, 1953 the Central Bank did not need to provide specific allocations for imports. Up until then direct controls on the importation of commodities were in effect under special legislation. The Central Bank merely certified global amounts for commodity imports which were then distributed among specific items and specific importers by a separate body. On June 30, 1953, however, Congress permitted Republic Act No. 426 to expire and left the country without a specific import control law. The Central Bank decided to assume the functions of the former Import Control Commission by carrying exchange licensing down to specific commodity items and specific individual users. From then on the Central Bank assumed the sole responsibility for the rationing of foreign exchange.

In the meantime, some modifications in the exchange rate were accepted by the Philippine Government. There were some indications that the prewar parity of ₱2.00 per $1.00 had become unrealistic for the postwar Philippines. Even before the imposition of exchange controls, as early as August of 1949, after the passage of the Import Control Law, the peso-dollar rate quotations in New York gave increasing discounts to the peso: 2-1/2% discount in August and increasing to a discount of over 12% by December (₱2.28 per US $1.00).

After the imposition of controls in December of 1949 a black market developed which gave increasing discounts to the peso. In January of 1950, for example, the free market peso-dollar exchange rate in New York reached ₱2.45 per $1.00 rising to a peak of ₱4.00 per $1.00 in February of 1951, and then declining gradually to an average of ₱2.91 in December of 1951.

Following a recommendation of the Bell Mission, an excise tax of 17 per cent was imposed on the sale of foreign exchange. This had the effect of raising the effective selling price of foreign exchange for most transactions up to 2.358 per US $1.00. What was established in effect was a multiple rate system in which the Central Bank purchased foreign exchange at ₱2.00 per $1.00, and sold at ₱2.358, the exchange profit being considered an excise tax.

It might be said as a matter of fact that all the succeeding changes in Central Bank policy before January 21, 1962 with respect to exchange transactions were more in the nature of additional exchange rate adjustments than steps towards the liberalization of exchange controls proper. This was true of the so called decontrol program launched by the Central Bank on April 25, 1960 in Circulars Nos. 105 and 106. They represented further adjustments in exchange rates and established multiple buying and selling rates. They did not effect any genuine decontrol in the sense of transferring the allocation of foreign exchange to a free market.

The terminology of these circulars and those that introduced the successive phases of the program gave the impression that the Central Bank was, as a matter of fact, relinquishing some of its allocating powers. Reference was made to a "free market rate" to which percentages of expenditures and imports as well as invisibles would become subject. In fact, no free market for foreign exchange was created.

What the Central Bank launched on April 25, 1960 was a new control system embodying two essential features: First, a multiple rate system with dual buying rates and multiple selling rates all of which rates were set by decree of the Central Bank. The amounts of exchange that could be transacted at each of these rates were also determined by Central Bank dictation. Second, a delegation of some of the regulatory functions of the Central Bank to the Commercianl banking system for an increasing proportion of foreign exchange transactions. For all foreign exchange the Central Bank continued to determine the purposes for which exchange could be used and the individual users who could purchase exchange.

Circular 105 established two buying rates of the Central Bank: a rate of ₱2.30 per $1.00 for recipients of export proceeds and for the U.S. Government, and ₱3.20 for foreign exchange from all sources. It established a number of selling rates depending on the category of the foreign exchange requirement. Thus for commodity imports that were exempt from the margin fee the selling rate of the Central Bank came to either ₱2.015 per $1.00 or ₱3.20 depending on the category of the commodity. For all other expenditures subject to the margin fee the selling rate of the Central Bank came to ₱2.519 or ₱4.00 per $1.00 depending on the category. The circulars that introduced the succeeding phases of the program such as Circular 117 of November 28, 1960 and Circular 121 of March 1, 1961 merely increased the buying rate of the Central Bank for export proceeds and for U.S. government dollars successively to ₱2.50 and ₱2.75 per U.S. $1.00. They also increased the volume of transactions that were subject to the so-called "free market rate."

Circular 133 of January 22, 1962 did two things: First, it established a genuine free market for foreign exchange, based furthermore on a system of fluctuating rates. Second, it transferred the function of allocating exchange for most categories of payments from the administrative machinery of the Central Bank to the free market.

Only two elements of controls were retained by the Central Bank: First, the compulsion on exporters to surrender 20 per cent of their exchange receipts to the Central Bank at the official parity of ₱2.00 per $1.00 and, second, the requirement that imports of commodities should be covered by letters of credit and advance time deposits running from 25 per cent to 150 per cent of the import values depending on the categories would have to be placed with commercial banks upon the opening of import letters of credit for a period of 120 days.

The first element took the place of an export tax. By requiring the surrender of 20 per cent of their export proceeds at the official rate of ₱2.00 per $1.00 the Central Bank in effect compelled the exporter to pay a tax that varied depending on the difference between the free market rate and the official rate of ₱2.00 per $1.00. (At a free market rate of ₱4.00 to $1.00 the tax was equivalent to ₱0.40 or 10 per cent since the exporter was permitted to sell only 80 per cent of his proceeds at ₱4.00 to $1.00 and 20 percent had to be sold at ₱2.00 to $1.00).

The principal reason for the advance time deposits was to retain some sort of regulation on the commodity pattern of imports. Thus by imposing a larger advance deposit requirement on non-essential consumer items and a smaller advance deposit on essential consumer and producer items, it was hoped that the removal of direct rationing would not be followed by an immediate deterioration in the commodity distribution of the importation of the Philippines.

II.

In order to appreciate more fully the significance of the Central Bank's new policy, it its necessary to see it against the background of the economic theory of exchange adjustment. The theory has to do with the mechanism whereby a country is kept internationally solvent. An individual business firm is considered insolvent when it can no longer pay its bills as they are presented for collection. In the same manner a country must be able to pay its bills to other countries as they are presented for collection. Its ability to do so depends on the rate at which it receives and disburses internationally acceptable currencies and gold. This balance between a country's receipt of foreign exchange and its disbursements is what is meant by the balance of a country's international payments.

Thus the Philippines regularly receives foreign exchange from a number of sources: the sale of exports abroad, the production of gold, receipts from incoming travellers, expenditures of foreign governments here, various invisible sources such as revenues from domestic companies and from foreign investments of Philippine residents, and incoming capital and loans. The country must make payments periodically for a number of items: imports, shipping and insurance, travel expenses of Philippine residents abroad, expenses of the Philippine government in foreign countries, payment of interest on foreign loans and dividends on foreign investments, repayment of principal on foreign loans and repatriation of capital. Of these the chief source of supply of foreign exchange and the chief requirement for disbursements arise from the foreign trade items, exports and imports.

Like any individual business firm the Philippines must maintain liquid reserves of gold and foreign exchange to cover periodic deficiencies originating from lags between the receipt of exchange and its disbursement. When persistent deficits in the foreign exchange account of the country threaten to wipe out the liquid reserves some means of adjustment must be set in operation.

The alternative methods of adjustment are determined by the elements that affect a country's balance of international payments. These elements are three: First, the level of domestic income and expenditures, second, the relationship between domestic price levels and those in the countries with which the Philippines trades, and third, the level of the exchange rate. These three elements, national expenditures, domestic price levels and exchange rates are inter-related the way the pressure, temperature and volume of a body of gas are inter-related. A high level of domestic expenditures tends to increase the demand for foreign exchange. When the average level of domestic prices is high in relation to outside prices there is a resultant increase in local demand for imported products which generates an increased requirement for foreign exchange. Finally when the rate of exchange of the local currency for foreign currency gives the domestic currencies a higher purchasing power abroad than locally there is a tendency to spend more funds abroad and as a result there is a high level of demand for foreign exchange.

When an imbalance exists between the exchange receipts and disbursements of a country, there are four alternative systems of adjustment. First, the entire burden of adjustment may be placed on changes in incomes, expenditures and prices. The value of the domestic currency is fixed in terms either of gold or some key international currency like the United States dollar. When foreign exchange disbursements run ahead of foreign exchange receipts, balance is restored by reducing incomes and expenditures and deflating the economy. In the reverse situation when receipts are running ahead of disbursements, balance is restored by inflating the economy, increasing incomes, prices and raising the demand for foreign exchange.

A second alternative places the entire burden of adjustment on changes in the exchange rate. In this case exchange rates are permitted to fluctuate freely. Any excess demand for foreign exchange is adjusted by an increase in the exchange rate and any excess supply by a drop. In this case domestic incomes, expenditures and price levels are determined more or less independently of the balance of payments situation of the country. The third alternative is something of a combination of the first two. Exchange rates are fixed and *temporary* imbalances are adjusted in two ways: First, by limited fluctuations in the rate within a range say of 1 per cent above and below the fixed parity. Second, by deliberate contraction or expansion of credit to deflate or inflate the economy. A tendency towards longer range, *persistent* deficits or surpluses is adjusted by periodic changes in the fixed parity. This system might be called a managed flexibility.

A fourth and final alternative is the imposition of controls on foreign exchange. Exchange rates remain fixed. Domestic incomes, expenditures and prices are permitted to follow their own independent course. The imbalance in the exchange situation is cured by direct controls over foreign exchange transactions.

Over the last nearly six decades, the Philippines has tried all four of these systems.

With the passage by the United States Congress of the Philippine Coinage Act in the later part of February 1903 and subsequently the enactment by the Philippine Commission of the Philippine Gold Standard Act of October 10 of the same year, the gold exchange standard was established in the Philippines. This legislation did several things: First, it defined the Philippine peso in terms of a theoretical gold peso consisting of 12.9 grains of gold .900 fine as the unit of value. This unit was equivalent at the time to exactly 50 cents United States currency. Second, it authorized the coinage of a silver peso to represent the theoretical gold unit as defined. Third, against 100 per cent reserve of the silver peso the Insular Treasury was authorized to issue silver certificates in denominations of ₱2, ₱5 and ₱10. The silver peso became unlimited legal tender for all obligations in the Philippines. Fourth, a gold standard fund was set up in the Insular Treasury. This was financed initially out of the proceeds of a

$10,000,000 loan from the United States at 4% interest. This fund was to be used for maintaining the parity of the silver peso with the theoretical gold peso. Part of the fund was held in the Insular Treasury in Manila and part in the United States. Fifth, for the purpose of maintaining the parity of the Philippine silver peso with the theoretical gold peso, and of keeping the currency equal in volume to the demands of trade, the Insular Treasurer was directed "to exchange on demand at the Insular Treasury in Manila for Philippine currency offered in sums of not less than ₱10,000 or United States currency offered in sums of not less than $5,000 drafts on the gold standard fund deposited in the United States or elsewhere to the credit of the Insular Treasury, charging for the same a premium of three quarters of 1 per cent for demand drafts and of 1-1/8 per cent for telegraphic transfers...." Finally, it was provided that all money paid into the Insular Treasury for redemption or for the purchase of exchange in the United States should be withdrawn from circulation immediately and not paid out except in response to similar counter demands or to purchase bullion for an increase in coinage.

The gold exchange standard thus established an automatic system of adjustment based on a fixed exchange rate where an automatic deflation of the currency adjusted an excessive demand for foreign exchange and an automatic inflation of the currency adjusted an excessive surplus. The Insular Treasurer was obliged by law to sell drafts on the gold standard fund in New York in exchange for sums not less than ₱10,000 delivered in Manila or drafts on the gold standard fund in Manila for funds not less than $5,000 delivered in New York provided he charged a premium of three quarters of 1 per cent for demand drafts and 1-1/8 per cent for telegraphic transfers. Pesos received in Manila had to be withdrawn from circulation. Dollars delivered in New York for the account of the Insular Treasury automatically went into the gold standard fund against which an equivalent amount of pesos would eventually be issued in circulation in Manila. Thus when an excessive demand for foreign exchange developed, the equivalent peso price of dollars would increase and when it reached a point where the premium threatened to exceed three quarters of 1 per cent for demand drafts, pesos would be presented to the Insular Treasury in Manila for drafts on the gold standard fund in New York. An amount of pesos equivalent to the dollars to be delivered in New York was then neutralized and taken out of circulation and money in circulation deflated by that amount. In the reverse situation, when a surplus on the balance of payments developed, pesos began to command a premium. As soon as the premium reached three quarters of 1 per cent, dollars were delivered in New York in exchange for drafts on the gold standard fund in Manila. The gold standard fund in New York was augmented by the amount of dollars presented, and drafts on the Insular Treasurer in Manila were redeemed in pesos thus increasing the amount of currency in circulation and inflating the economy.

After the devaluation of the dollar on January 31, 1934, the Insular government maintained the peso at a parity with the dollar rather than at a parity with the theoretical gold peso originally provided for in the Philippine Gold Standard Act. The parity was maintained at ₱2.00 per $1.00 which was carried over into the Central Bank Act of 1948. Up to the establishment of the Central Bank, adjustments in the Philippine balance of payments were effected entirely through adjustments in domestic incomes and prices.

The passage of Republic Act No. 265 in June of 1948 established in this country a system of "managed flexibility." The international value of the peso was defined on the basis of a fixed parity equivalent to the gold content of half a U.S. dollar as of July 1, 1944. The Monetary Board of the Central Bank was compelled by law to fix the buying and selling rates of the Central Bank within a range of no more than 1/2 per cent above and below parity. The buying and selling rates of commercial banks had to be fixed by the Monetary Board within a range no more than 1 per cent above and below parity. The Central Bank had to maintain international reserves composed of freely convertible currencies in an aggregate amount sufficient to defend the legal parity of the peso. In the event, however, that the parity could not be defended without sacrificing a rising level of production and incomes or causing a dissipation of the country's international reserves or without the chronic use of controls on exchange transactions, the fixed parity could be adjusted to a new level.

With the establishment of the Central Bank, therefore, a new system of adjustment replaced the dollar exchange standard. Under this a fixed parity was maintained for as long as it was possible to do so without dissipating the international reserves of the country and while maintaining a rising level of incomes, production and employment in the country. The moment it was no longer possible to maintain the parity without sacrificing the international reserves and/or economic growth then parity was adjusted to a new level.

This system was actually put into effect for only a few months because on December 9, 1949 the Central Bank established a third system of adjustment. This was direct controls on foreign exchange transactions.

With Circular No. 133 of January 22, 1962, the Central Bank has introduced a fourth system which imposes the entire burden of adjustment on day to day movements in the exchange rate.

The floating or flexible exchange rate system enjoys theoretical support from many respectable economists. As a permanent system exchange controls are considered neither desirable nor effective. The return to an automatic arrangement such as the gold exchange standard is no longer feasible in a world where the maintenance of a rising level of incomes, production and employment is the principal objective of economic policy. The choice of systems narrows down to fixed parities that are occasionally adjusted and flexible exchange rates.

Flexible exchange rates may be advocated at two levels. First, as a transition measure between exchange controls and a restoration of free convertibility based on fixed parities. The theory is that a country which has had a regime of controls has had no real basis for determining a new parity. The only feasible manner for discovering a rate that can maintain an approximate balance between foreign exchange receipts and disbursements is to allow free market forces to set the rate for a period. Only after a rate has been determined in this manner is it feasible to set a new parity for the local currency. On this there is little disagreement among economists.

It is at the second stage that there is a substantial controversy. As a long term adjustment machinery is it preferable to have a system of fixed parities which are occasionally adjusted or a freely fluctuating exchange rate that adjusts to market forces from day to day? It is not our intention to go into the details of this controversy. It is important, however, to dispose of one objection to which at first glance flexible rates seem obviously subject and from which fixed parities seen exempt, namely, instability and uncertainty. The contention is that flexible rates are necessarily unstable and therefore introduce an element of uncertainty which disorganizes trades and discourages investment. The fact is a fluctuating rate system is not necessarily an unstable system. It is essential, however, in a fluctuating rate system that a satisfactory market for forward exchange should develop. Through this market an importer who foresees requirements for exchange in, say, 60 days is able to contract for the purchase of exchange at a given rate with, say, an exporter who foresees a receipt of foreign exchange of the same amount at about the same time. The existence of such a market stabilizes the rates. Without the opportunity for undertaking a forward purchase the importer would have to go into the spot-market to buy his requirements. When spot rates are rising, importers who need future exchange get panicky and enter as buyers in the spot market. This causes the spot rate to rise even more by swelling the demand. A well developed forward market by distributing supply and demand over time introduces stability into a free market.

On purely theoretical grounds, a floating rate system can provide as stable an exchange market as one with fixed parities established and supported by the Central Bank. The former, however, is somewhat more sensitive to Central Bank action and requires knowledgeable and dexterous monetary management. Every error in judgment or precipitous action by the Central Bank can cause abrupt fluctuations in exchange rates.

III.

One other question remains. What is the legal basis for Circular No. 133? Is the establishment of a floating rate system contemplated in any of our monetary and banking legislation?

The only pertinent law that needs to be examined is Republic Act No. 265, the Central Bank's Charter.[1]

Among the systems of adjustment, the Charter of the Central Bank clearly embodied one based on a fixed parity that could be changed as specifically defined conditions warranted the change.

A par value was established for the peso in terms of a specific content of gold equivalent to .50¢ U.S. under Section 48. The Central Bank was permitted to engage in foreign exchange transactions only with commercial banks, the Philippine government, foreign or international financial institutions and foreign governments and their instrumentalities. It was not permitted to engage in exchange transactions directly with the general public. The Monetary Board was compelled by law to set the rates at which the Central Bank would buy and sell spot exchange but these rates should not deviate from the legal parities by more than 1/2 of 1 per cent. Similarly, the Monetary Board was compelled by law to set the minimum and maximum rates at which the commercial banks should buy and sell spot

[1] A provision in Republic Act No. 2609 (an Act to authorize the Central Bank of the Philippines to establish a Margin over Banks Selling Rates of Foreign Exchange) has been invoked as providing a basis for Circular No. 133. Thi.s provision reads:

> "In implementing the provisions of this Act, along with other monetary credit and fiscal measures to stabilize the economy, the monetary authorities shall take steps for the adoption of a four-year program of gradual decontrol." (Section 2.)

It is clear that this provision does not specify the form of the decontrol program and leaves intact and in effect the more specific provisions of the Central Bank Charter.

exchange and these rates should not differ from the legal parity by more than 1 per cent. (Sections 76 and 79 of Republic Act No. 265).

The Sections which define the obligation of the Monetary Board to set the buying and selling rates have an identical qualification that has been taken to mean that the Central Bank may deviate from the maximum range of 1/2 per cent and 1 per cent above and below the legal parity set in Section 48. In the provision defining the Central Bank's own buying and selling rates, it is stipulated that "...said rates shall not differ by more than 1/2 of 1 per cent from the legal parities established in Section 50, unless in any given case a greater divergence from the legal parity exists in foreign markets." (Section 76). In Section 79 which covers the setting of commercial bank buying and selling rates, a similar provision reads as follows: "...but the rates thus established for each currency shall not differ from the respective legal parity by more than 1 per cent, unless in any given case a greater divergence from parity exists in foreign markets."

These provisions should be interpreted in conjunction with Section 50 of the Central Bank Act which sets forth the basis on which legal parities of *foreign currencies* with respect to the Philippine peso are to be determined. The Philippines is a member of the International Monetary Fund whose charter provides that member countries shall define the legal parity of their respective currencies in terms of gold or the U.S. dollar of the weight and fineness in effect in 1944. However, some of the member countries have been excepted under special rules and do not have par values for their currency. (For example Argentina, Bolivia, Canada, Chile, Indonesia, Paraguay and Peru as of February 15, 1962 had no legal parities.) Also, in the case of some currencies, the par values do not necessarily govern the actual rates for transactions in exchange markets. The legal parity of the Philippine peso is defined in Section 48 of the Central Bank Act in terms of the gold content of 1/2 of a U.S. dollar with the weight and fineness in effect on July 1st, 1944. Section 50 sets forth the formula to be used in defining the legal parities of *other* foreign currencies with respect to the Philippine peso. Thus for countries which are members of the International Monetary Fund and which have established par values, the legal parity with the peso is calculated on the basis of those par values. For example, the United Kingdom's currency has a legal parity registered with the International Monetary Fund of U.S. $2.80 per pound sterling. Since the registered parity of the Philippine peso is .50¢ U.S. then the legal parity of the pound sterling in terms of peso is ₱5.60 per pound. Under the provisions of Section 76, the Monetary Board may set its own buying and selling rates for pound sterling at between ₱5.576 per pound and ₱5.628 representing the range of 1/2 per cent below and above the legal parity. It is possible, however, that some currencies with established legal parities may be transacted in the money markets at rates that deviate from their legal parities by a greater percentage. In such specific and exceptional cases, the Monetary Board may set buying and selling rates beyond the stipulated range of 1/2 per cent in the case of the Central Bank's own purchases and sales and 1 per cent in the case of commercial banks. It is important to note that this divergence is permissible for parities established under Section 50 and not under Section 48, that is to say, not for the parity of the peso in terms of the U.S. dollar which defines the basic par value of the peso.

For as long as the legal parity of the peso was set at ₱2 per U.S. $1.00, the Central Bank's buying and selling rates could not go beyond a minimum of ₱1.99 and a maximum of ₱2.01 per U.S. dollar and the commercial banks could not buy or sell beyond a minimum of ₱1.98 and a maximum of ₱2.02 per $1.

The commercial banks were perfectly happy to stay within this range for as long as they could go to the Central Bank to buy or sell foreign exchange at the maximum range prescribed by law. Thus any commercial bank was willing to buy foreign exchange at a minimum of ₱1.98 per $1.00 provided it could sell to the Central Bank at a minimum of ₱1.99 per $1.00. Likewise, there was no fear of selling foreign exchange to merchants and end-users at ₱2.02 per $1.00 as long as dollars could be gotten from the Central Bank at a maximum of ₱2.01 per $1.00.

The system worked for as long as the Central Bank could assure the commercial banks of a steady supply of foreign exchange at the maximum selling rate prescribed by law. On the Central Bank's part, it could maintain the required supply for as long as the legal parity maintained a rough balance between the supply of and the demand for foreign exchange in the country. The moment the legal parity no longer maintained such a balance, as was the case in the postwar Philippines, if the legal parity were such that the demand for foreign exchange far exceeded the incoming supply, then the Central Bank would be continually selling more dollars than it was buying. The exchange reserves would decline rapidly. When once the ability of the Central Bank to supply exchange at the maximum rate prescribed by law was impaired, then the system would no longer work. In this case, the Central Bank could:

1. Change the legal parity in accordance with Section 49 of the Central Bank Act; or
2. Suspend its own sales of exchange and subject all transactions in gold and foreign exchange to licensing as provided for in Section 74.

The Central Bank's power under Section 74 to suspend its own sales of foreign exchange or subject exchange transactions to licensing and restrictions was intended by the charter to be an emergency instrument to be used entirely for the purpose of giving the Central Bank time first to determine whether there were fundamental factors that no longer made the legal parity realistic in terms of the foreign exchange position of the country, and second, to take more permanent remedial action. The change in the legal parity was considered the normal way of remedying a fundamental foreign exchange disequilibrium.

Apart from the possibility that the 1949 factors responsible for the persistent balance of payment deficits of the country were such as to warrant a change in the legal parity, the rate at which the foreign exchange reserves of the country were being dissipated called for a measure that would be immediate in its effect. Besides, there were several features in the country's economic crisis which did not permit a determination of a new legal parity. For one thing the productive facilities of the country had not been fully restored as yet. While world prices for Philippine exports were fairly high, the volumes of exports had not reached prewar levels. For another, a considerable pent-up demand for imports had developed during the years of the war. On top of heavy consumption imports, the requirements of reconstruction were still fairly large. On the supply side of foreign exchange, furthermore, war damage payments to the Philippines and United States government expenditures here were still running at fairly high levels. All told, 1949 was not a particularly good year for determining what would be a normal foreign exchange rate that would suit the longer term economic situation of the Philippines. There were arguments, therefore, for imposing exchange controls at the time the Central Bank did.

Whether or not at the same time the Central Bank should have adjusted the exchange rate to some tentative level is a matter that must remain moot at the moment.

The continuation of exchange controls is something that was justified on other than the purely exchange and monetary considerations contemplated in the Central Bank's Charter. Exchange controls became an instrument not of monetary but of commercial policy. In the absence of complete tariff autonomy, controls were used as an instrument for giving protection to domestic industries. They were used to give competitive advantage in the domestic market to Filipinos over aliens. They were used to shift trade patterns from consumer goods to producers' goods and among consumers' goods from items of lower to items of higher essentiality.

For many of the purposes it was made to serve controls were effective. They determined the entire climate for investments and the whole character of investment behavior in the country during the decade of the 1950's; they stimulated investments and created a class of Philippine entrepreneurs. The point is, however, that this use of controls under Section 74 was not contemplated in the Charter.

Nor for that matter was the establishment of a floating rate.

IV.

At this writing the new decontrol policy has been in operation for three months. The period is perhaps too short for the proper evaluation of a measure that is entirely new in the experience of Philippine banking and business. There are reasons, however, that make an evaluation at this time useful.

In reporting the decontrol policy to Congress as a *fait accompli,* the President emphasized its urgency as a first step in establishing a new, more sound and stable base for future development. In the speculative atmosphere that had pervaded the country's economy since 1957, Philippine business had suspended long-term investment plans pending a change in governmental policy on the foreign exchanges. Even then business recognized that the unrealistic rate of ₱2.00 per $1.00, with all the indirect adjustments thereto could no longer be held and some drastic change in policy could be anticipated. Pending that change there seemed no point in planning new projects or expansion. Business calculations of future prospects were rendered indefinite and uncertain until it became clear first at what level the new exchange rate would settle, second, what form decontrol would take and, third, what inducements by way of protection and financial facilities the government would offer. Only one thing was certain, that any adjustment would mean a higher exchange rate than ₱2.00 or ₱2.50 per $1.00.

Speculation became the order of the day: exporters held on to their export bills as long as possible postponing the final sale of dollars to the banks. Importers were madly piling up inventory in anticipation of higher costs. The demand for short-term financing to sustain speculation reached such magnitudes that, in the face of credit restrictions, short-term interest rates rose to as high as 35 to 40 per cent per annum. All interest in long-term investments died out and even blue-chip stocks of commercial and industrial firms were going begging in the stock market.

The first order of business, the President pointed out in his message to Congress, was to stabilize the atmosphere and restore interest in long-term investments. Since the principal source of uncertainty was the exchange rate policy, an adjustment in the exchange rate became a pre-requisite first step.

Although the exchange rate could have been adjusted simply by resorting to a legal devaluation under Section 49 of the Central Bank Act without the removal of controls on foreign exchange, decontrol became an essential element in the adjustment by reason of the President's pledge that he would free exchange transactions from government restrictions. The choice of the floating rate system was the Central Bank's although shortly after Circular No. 133 was issued the Chairman of the Monetary Board was reported to have announced that the floating rate was temporary and had been adopted only for the purpose of discovering the level at which a new parity could be set. It was reported in the February 5 issue of a newsletter of limited circulation that Finance Secretary Fernando E. V. Sison had revealed the existence of a commitment with the International Monetary Fund that the floating rate would last "only until December 31, 1962."

The principal objectives then of exchange decontrol were first to stabilize the business atmosphere, second, to establish a new exchange rate that would provide a more realistic basis for comparing domestic with international values and restore equilibrium in the country's balance of payments and, third, remove a source of temptation to graft and corruption. It is against these objectives that the experience with decontrol so far should be evaluated although, for our purposes in this article, the third objective may be left out.

In the Manila Times of April 20, 1962, Dr. Andres V. Castillo, Governor of the Central Bank, published a statement on "the State of the Economy after Three Months of Decontrol." "The results of decontrol," he wrote, "have been better than anticipated." The exchange rates have not fluctuated violently nor have they exceeded ₱4.00 to $1.00. On its effectiveness in restoring equilibrium he said: "the international reserve has been maintained at approximately the same level as prior to decontrol. The reserve stock at ₱121.1 [read $] million last April 5 compared to ₱121.7 [read $] million last January 26 shortly after decontrol." The Central Bank governor was gratified also to note that prices have not skyrocketted as "had been expected." And he promised that "as the economy adjusts its operations to the new situation we may expect an easing of the credit restrictions."

Some bankers and many businessmen however, did not share the governor's impression that these first three months of decontrol were characterized by the absence of violent fluctuations in exchange rates. Recently the Executive Vice-President of one bank called on the Central Bank to return to a system of fixed parities in order to give stability to the exchange market. Speculation has not been removed. Exporters continue to hold on to their export bills as long as they can in anticipation of higher rates. Much of the purchases of exchange by merchants is not for immediate requirements but for future needs.

Giving allowance for the uncertainty of the exchange market during the first few weeks after decontrol went into operation the following seem to be the principal observations that may be made on the market behavior so far: first, the Central Bank has had an unstabilizing influence on the exchange market, second, no forward exchange market has developed sufficiently to provide the required stability of expectations; third, the market operations have not yet provided a clear basis for establishing a new parity for the peso; fourth, the atmosphere after three months of decontrol remains speculative.

From the President's explanation of the decontrol program to Congress it appeared that the plan contemplated was to have the Central Bank free the exchanges and allow the exchange rate to "float". The Central Bank, however, was to maintain a sobering influence on the market in several ways: First, by holding over the market a stabilization fund of about

$300 million[2] the mere presence of which would exert a restraining influence. This influence relied primarily on the ability and the willingness of the Central Bank to use the stabilization fund and not necessarily on the Central Bank's actually entering the market as a seller. Second, the advance time deposit requirements for commodity imports were intended to retain restrictive effects on importation. Third, the increase in the legal reserve requirement on demand deposits from 15 to 19 per cent curtailed the credit potential of commercial banks and reduced the resources for speculating in foreign exchange.

From the outset, however, the Central Bank announced and its Governor repeated constantly before bankers that the Central Bank would not intervene in the market, in effect that the stabilization fund would not be used. This immediately removed any restraining influence that the mere existence of the stabilization fund might have exerted on the market. Furthermore, the rumor began to spread among banking and business circles that the Central Bank had substantial foreign exchange commitments that needed to be met and that sometime soon the Central Bank would have to enter the market not as a seller but as a *buyer* of exchange. The market thus watched the actions of the Central Bank very closely and, at every sign that the Central Bank had entered to buy, the exchange rate would firm up.

With the influence of the stabilization fund neutralized by the Central Bank's own assertions, the only restraints left were the credit restrictions and the time deposit requirements.

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[2] The following breakdown of the stabilization fund negotiated by the President's special mission to Washington was given in the Feb. 5th issue of the aforementioned confidential newsletter:

International Monetary Fund	$ 28.3	million
Federal Reserve loan against gold	23.250	"
Refinancing by private banks	84.80	"
Stand-by financing by private banks	82	"
Agency for International Dev. (AID)	50	"
Ex-Im Bank	30	"
Total	$298.35	"

On March 2 without any warning the Central Bank issued Circular No. 139 removing the requirement of a time deposit of 25 per cent on essential consumer and essential producer goods. This circular took effect on Monday, the 4th of March. Immediately thereafter the exchange rate shot up from an average of about ₱3.50 to ₱3.75 (merchant selling rate) over a period of three days. In the following week the rate dropped precipitously by 10 points to an average of ₱3.60 and immediately thereafter started to edge up more slowly but persistently. This upward trend has continued to the time of this writing.

One of the principal stabilizing influences on a free market is the development of a market for forward exchange. Although there are so-called forward exchange quotations up to about 60 days forward, the basis of the rates indicates the absence of a real market. A forward market does not exist in substance until enough recipients of foreign exchange are willing to sell at fixed rates for future delivery. At present, what usually happens is commercial banks sell forward and can only cover their commitment to deliver in the future by buying spot exchange and holding this to maturity. As a result the forward rate is calculated purely on the basis of the interest costs of holding spot exchange. Thus at present forward exchange is quoted at a premium of roughly .8 of 1 per cent or three points per month forward. Thus with a spot rate of ₱3.74 the quotation on exchange for delivery 30 days hence would be ₱3.77 and for 60 days hence ₱3.80. Exporters are reluctant to sell their future receipts forward at fixed rates because they anticipate a further increase in the rate.

It may be concluded that the first three months of decontrol have not stabilized the atmosphere as yet. To produce stability, action by the Central Bank is required. This may take either of two directions: first, the Central Bank may decide to continue the floating rate system (legal considerations apart) in which case it would have to take deliberate action to develop and stabilize the forward market in order to provide traders and banks with a mechanism for covering their future exchange risks. The Central Bank would have to decide on an experimental rate at which to try and stabilize the price of foreign exchange. This rate must necessarily be experimental because, if it turns out to be too low and it fails to achieve a balance between the country's exchange receipts and disbursements, the Central Bank will have to permit it to rise in an orderly fashion.

A second course of action is for the Central Bank to return to a fixed parity in accordance with its Charter. In this event the Central Bank would have to be certain that the new parity devalues the peso adequately so that no further adjustments will become necessary for sometime.