*Southeast Asian Studies*, Vol. 28, No. 4, March 1991

# Financial Development in the Philippines in the 1980s*

Akira KOHSAKA**

## Introduction

In retrospect the 1980s may be regarded as a decade of financial liberalization in many developing countries, especially in East and Southeast Asian economies such as Indonesia, South Korea, the Philippines, Thailand and Taiwan.[1] Though these financial liberalization processes are still far from complete, some economies seem to have been successful while others continue to face a number of obstacles. The Philippines is without doubt among the latter.

The Philippines was a typical economy under "financial repression" in the 1960s and 1970s, where the financial sector suffered from excessive regulations and macroeconomic instability.[2] Then, in the beginning of the 1980s it introduced financial reforms following recommendations made by the IMF/World Bank joint mission.

The purpose of the present paper is to analyze the financial development of the Philippines during the reform of the 1980s and to discuss the main issues to be resolved. Pascual [1984] provided a comprehensive overview on the financial market in the Philippines and the World Bank [1988] shed light on recent policy problems in Philippines' commercial banking, while Cole and Patrick [1986] discussed Asian countries' experiences of financial development from a broad comparative perspective. The interaction between financial development and macroeconomic constraints, however, has not necessarily been paid enough attention nor articulated clearly enough in those studies. As will be shown below it is this interaction which appears to be most crucial in understanding how these constraints have prevented financial development and discussing how the government can manage them in the Philippines.

The first half of the 1980s was full of turmoil in the international economic environment. The Philippines was one of the developing countries most seriously affected by this turmoil, which had a significant impact on the process of its financial development.[3] It will be argued here that what matters in the case of the Philippines

* An earlier version of this paper in Japanese will be published by the Institute of Developing Economies, Tokyo, as part of its research project on "Ruiseki Saimu to Zaisei Kinyu (The Debt Problem and Financial Policies)."

** 高阪　章, The Center for Southeast Asian Studies, Kyoto University

1) For more detailed analysis in the cases of Korea and Taiwan, see Kohsaka [1987].

2) "Financial repression" was originally used in McKinnon [1973] to depict a typical situation in developing economies in which the government distorts the domestic capital market by imposing too many and too complicated regulations and taxes on the financial sector and thus hinders its development.

3) At the same time the Phillippines was one of the most erroneously managed economies during the period (See Kohsaka [1990]).

is macroeconomic rather than microeconomic. In particular, the "debt problem," both domestic and external, has much to do with its prospect of financial development.

This paper consists of 5 sections. Section 1 presents a general conceptual framework within which to analyze financial development in the Philippines. The degree of financial intermediation is given a key role. In this respect, comparison with other Asian economies would help highlight the case of the Philippines. With Section 2 briefly summarizing its financial history, Section 3 analyzes changes in the macroeconomic balance and the characteristics of the sectoral financial transactions. It is pointed out that the financing behavior of the public sector is crucial to understand the role of the financial sector. Section 4 examines the interrelationship between macroeconomic policies and the capital market. Monetary policy is emphasized as being closely linked to other macroeconomic policies such as fiscal management and exchange rate policy in the context of the Philippines. Finally, Section 5 summarized the issues and the prospects for financial development in the Philippines.

## I Comparative Financial Development

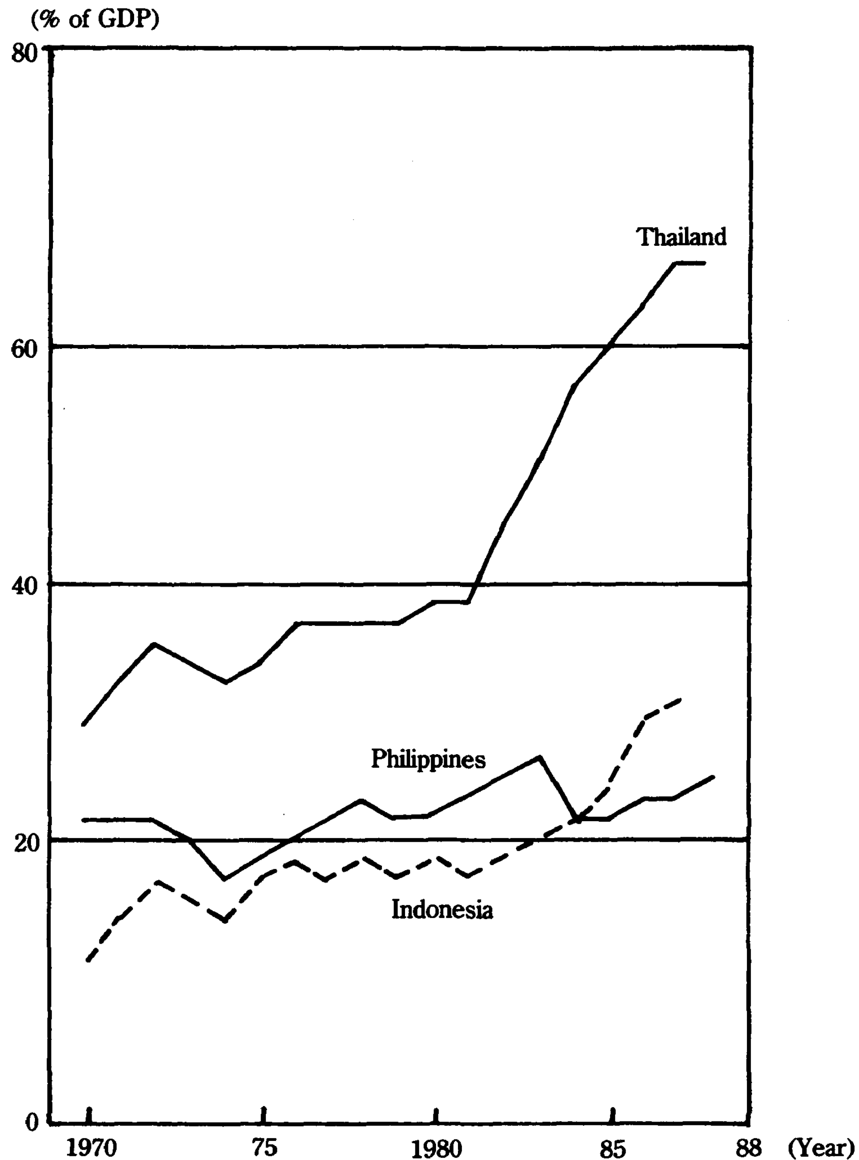
The role of the financial sector is not only to provide means of payments. It is to accept savings of the surplus sector in the form of such financial assets as bank deposits and to channel them to the deficit sector for investment. In the process of economic development, such financial intermediation would constitute the central role of the financial sector. Generally, financial intermediaries are supposed to be able to make use of an economy of scale in collecting information on creditworthiness of the deficit sector, examining the profitability of their investment opportunities, and reducing the risk of such investment by diversification. Accordingly, if the saving of the surplus sector is concentrated in financial intermediaries and efficiently allocated to investment opportunities with higher rates of return, this would enhance the overall efficiency of investment and lead to accelerated growth of an economy.[4)]

From this point of view, the ratio of money supply to economic activity level, i.e., the degree of financial intermediation gives a good measure of financial development. Since money supply is the liabilities of the monetary system, the ratio represents the relative size of financial savings which can be transferred to the deficit sector through financial intermediaries out of the savings of the surplus sector. The transfer to the deficit sector takes the form of either loans or security investment by the intermediaries.

The relative size of financial intermediation in the Philippines, Thailand and Indonesia during 1970–88 is presented for comparison in Fig. 1 using the ratio of broad money to nominal GDP as a measure. Thailand has attained a significant degree of financial intermediation since the

4) A reasonable means alternative to transfer funds from the surplus to the deficit sector may seem to be "direct finance," by which the surplus sector obtains such primary securities as corporate stocks and debentures issued by the deficit sector. This, however, would never be a feasible choice for developing countries, because open markets for such primary securities are generally underdeveloped in developing countries. This is due to the low level of income, the resulting small scale of domestic savings and investment, and the lack of a network system of accounting information.

**Fig. 1** Degree of Financial Intermediation: Indonesia, Philippines and Thailand, 1970–88




Note : Total liquid liabilities of the whole financial system or IFS code 55l.
Source: IMF, *International Financial Statistics,* various issues.

early 1980s. Indonesia also has realized a certain degree of financial intermediation if we take account of its initial low level, and its pace surpasses that of the Philippines. By contrast the ratio of the Philippines has shown no significant upward trend, but remained at the same level of around 20% for the last 20 years, which implies almost complete stagnation in terms of financial intermediation.

There are two main reasons why the financial intermediaries in the Philippines remained stagnant. First, financial regulations such as regulated interest rates and reserve requirements repressed financial intermediation. Second, but not less importantly, the Philippines lacked macroeconomic stability, particularly inflation

control. Before examining these issues let us briefly outline the country's financial history.

## II Financial Market in Review

### (1) *Early Development of the Financial Market*

The Philippines' financial market consists of the (short-term) money market, the (long-term) capital market and the foreign exchange market. Although the money market was said to be the most developed in the Southeast Asia, the capital market was underdeveloped for bank loans, corporate debentures and stocks [Pascual 1984].

The money market consists of the interbank call market, the bills market and the government securities market. Transaction figures in these markets are shown in Table 1. The call market, officially established in 1963, has mediated demand and supply of short term funds among banks and nonbank financial institutions.

The bills market started in 1965 as an interfirm market with newly-established investment companies as intermediaries for transactions of promissory notes, bills with repurchase agreements and deposit substitutes outside the interest rate regulations. With participation by banks from the late 1960s, the market made steady growth in the 1970s despite temporary stagnation due to regulations imposed on deposit substitutes in 1976–77. The financial crisis in the beginning of the 1980s due to a notorious financial scandal, however, seriously affected the market, which became dwarfed. This was reinforced by regulations imposing a lower ceiling and a higher minimum amount with respect to note issuance in order to prevent the repetition of such scandals.

**Table 1** Money Market Transactions, Philippines, 1977–85

(billion pesos)

| | 1977 | 1980 | 1985 |
|---|---|---|---|
| Volume of Transactions<br>(% of GNP) | 190.4<br>(124.1) | 303.7<br>(114.8) | 505.8<br>(84.6) |
| Call money | 17.8 | 50.5 | 226.4 |
| Promissory notes | 119.5 | 144.5 | 156.8 |
| Repurchase agreements | 41.0 | 95.7 | 27.6 |
| Commercial papers | 10.3 | 10.5 | 20.2 |
| Government securities | 1.5 | 0.7 | 74.8 |

Source: Central Bank of the Philippines, *Statistical Bulletin*, 1986.

The government securities market was officially established in 1966 but long remained underdeveloped, partly due to its regulated low interest rates. This market took off virtually after the financial crisis in 1981. Aiming at developing relatively riskless assets in the money market and then controlling interest rates with the open market operation, the authorities decided to issue more government bills through financial institutions newly designated as government securities dealers. The more serious the economic crisis became in the 1980s, the more government securities, especially TBs, were issued at the market-determined interest rate to finance the increasing fiscal deficit. This brought about a major structural change in the money market which will be discussed later.

### (2) *Financial Reforms*

Under the financial reform of 1972, the monetary system was rearranged and unified with the revision of the Bank Law and the Central Bank Law. The main objective was to expand the scale of financial institutions and strengthen the control of the central bank over domestic credits. Developments in the 1970s,

particularly the development of the money market over commercial banking, urged the authorities to overhaul the entire system of financial regulations.

On the recommendation of the IMF/World Bank joint mission a further financial reform was implemented in 1980. This had three purposes, namely, to strengthen the savings mobilization to financial intermediaries, to devise provision of medium- and long-term industrial funds, and to enhance the productivity of the financial sector by expanding its scale. For these purposes a number of measures were implemented such as liberalizing interest rates, permitting selected financial institutions to operate universal banking, reducing reserve requirements, and revising the tax system on interest income.

As a consequence of the reform and with the help of the chaos in the rival money market in those days, the bank sector exhibited relatively steady growth until 1983. The general economic crisis during 1983–86, however, drove several banks to bankruptcy. The two major government financial institutions, the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP), were forced to seek rescue by the central bank from their burden of huge non-performed assets. Thus the recovery of the financial sector had to be postponed until 1987.

(3) *Present Situation*

Table 2 shows total assets in the financial sector excluding the central bank. The sector is divided into banks, which provide means of payments or demand deposits, and nonbank financial intermediaries. The former are further disaggregated according to their specialization into commercial banks, thrift banks, rural banks and government specialized banks. Nonbank financial intermediaries consist mainly of investment companies in the private sector and of public insurances in the public sector. Note that the share of banks, particularly that of commercial banks, was dominant and that the share of each category remained mostly unchanged except for the dwindling share of government specialized banks.

During 1983–87, the financial sector shrank remarkably in not only real but also nominal terms. Table 2 shows that the financial sector reduced relative to the real economic activity. One reason for this was undoubtedly the political-economic turmoil during the period. During the period 1980–86, the total assets of the banking system decreased by 44% and its private sector loans declined by as much as 63%, both in real terms. For the same period 147 local banks and 32 savings institutions went into bankruptcy, whose assets amounted to 14 billion pesos or 2% of the total assets of the sector. Furthermore, two government financial institutions, PNB, the largest commercial bank, and DBP, the largest development finance institution, went on the brink of bankruptcy so that they had to be rescued by tranferring their nonperformed assets to the Asset Privatization Trust (APT) in 1986. These nonperformed assets amounted to 67% and 84% of their total assets respectively [World Bank 1988]. The reduced share of government specialized banks in Table 2 reflects this. At the end of 1989, there were 29 commercial banks including 4 foreign banks and 1 government bank (PNB).

**Table 2** Assets of Financial Intermediaries, Philippines, 1980-88

(billion pesos, %)

| | 1980 | | 1985 | | 1988 | |
|---|---|---|---|---|---|---|
| | Assets | (Share) | Assets | (Share) | Assets | (Share) |
| (Banks) | 188.8 | (76.2) | 395.2 | (78.6) | 391.8 | (74.0) |
| Commercial banks | 138.4 | (55.9) | 283.3 | (56.4) | 328.9 | (62.1) |
| Thrift banks | 10.6 | (4.3) | 15.1 | (3.0) | 24.9 | (4.7) |
| Agricultural banks | 5.6 | (2.3) | 8.8 | (1.8) | 10.7 | (2.0) |
| Government banks | 34.2 | (13.8) | 88.0 | (17.5) | 27.3 | (5.2) |
| (Nonbank financial) | 58.9 | (23.8) | 107.3 | (21.4) | 137.7 | (26.0) |
| Total | 247.7 | (100.0) | 502.5 | (100.0) | 529.5 | (100.0) |
| (% of GNP) | (93.6) | | (84.1) | | (64.2) | |
| Central bank | 65.4 | | 251.6 | | | |

Note: Thrift banks = savings banks + private development banks + stock savings and loan associations.

Government banks = specialized government banks = Development Bank of the Philippines + Land Bank of the Philippines + Philippine Amanah Bank.

Nonbank finance = investment houses, financing companies, investment companies, security dealers, security brokers, pawn shops, fund managers, lending investors, nonstock savings and loan associations, mutual building and loan associations, private insurance companies, government nonbank financial institutions (Government Service Insurance System (GSIS), Social Security System (SSS), etc.), and venture capital corporations.

Source: Central Bank of the Philippines.

## III Financing Macroeconomy

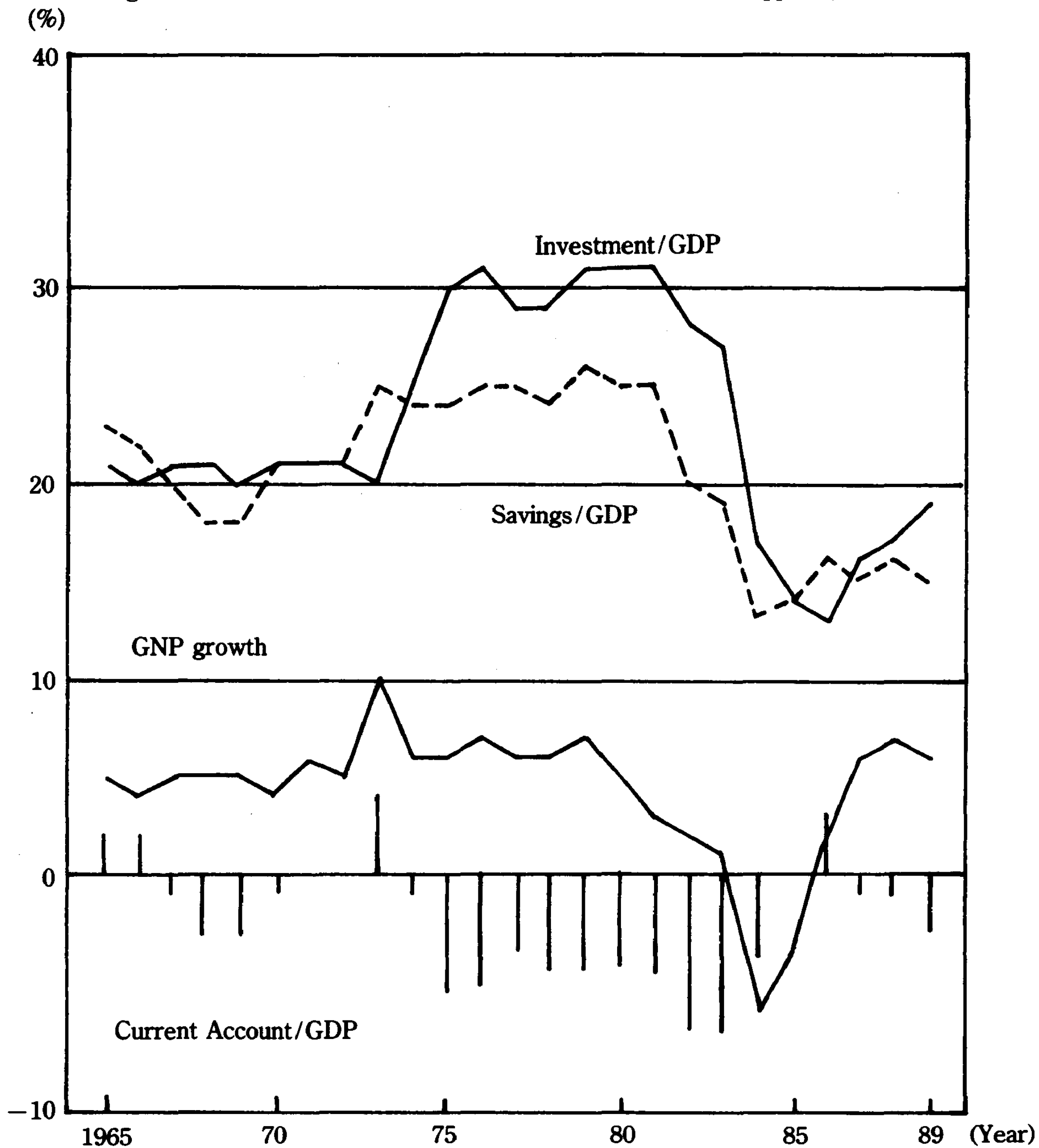
### (1) *Sectoral Investment-Savings Balances*

Fig. 2 shows investment, savings, current accounts of the balance of payments and the real GNP growth of the Philippines during the period 1965-89. As is clear from the Figure, the Philippines expanded investment and adopted an ambitious industrialization strategy after the first oil shock in the 1970s.[5] While the domestic saving ratio increased to some extent from that in the 1960s, there was no choice but to resort to foreign savings in order to sustain this high investment and growth.

The deteriorating international economic environment since the second oil shock in 1979 brought about an overall decline of nonoil developing economies, to which the Philippines was no exception. Although the saving ratio fell as expected, the Philippine government left domestic credit expansion to continue and stuck to their expansionary investment policy during the same period. The result is well known. The government was forced into default in external debt service in 1983, with both current account and fiscal deficits growing at an accelerating rate, as well as enormous capital

5) Note, however, that public investment by both the central government and public enterprises were the dominant source of an increase in domestic investment during the period. This is one example of "erroneous management" (See footnote 2).

Fig. 2 Macroeconomic Balance and Economic Growth: Philippines, 1965–89




Source: IMF, ***International Financial Statistics***, various issues.

flight due to the political and economic chaos of the time.

The sectoral I–S balance since the crisis (Table 3) indicates that the private savings maintained a level of 17–18% of GNP during 1983–86 despite continued economic depression. Accordingly, the acute drop in private investment due to the economic crisis and the following tightening policy led to a significant degree of excess savings in the I–S balance of the private sector. On the other hand, the savings of the public sector as a whole remained negative between −2% and −4% of GNP, Naturally, in spite of restraint in public investment, the I–S balance in the public sector resulted in excess investment, which overwhelmed the private sector's excess savings, thereby continuing the current account deficit

**Table 3** Sectoral I–S Balance, Philippines, 1983–88

(% of GNP)

| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|---|
| *Private Sector* | | | | | | |
| 1. Savings (S) | 19.9 | 18.8 | 17.2 | 18.2 | 12.6 | 16.6 |
| 2. Investment (I) | 19.0 | 14.6 | 11.4 | 9.8 | 11.8 | 14.8 |
| S–I | 0.9 | 4.2 | 5.8 | 8.4 | 0.8 | 1.8 |
| *Public Sector* | | | | | | |
| 1. Savings | −2.8 | −3.7 | −2.2 | −2.5 | 1.5 | 0.6 |
| 2. Investment | 6.2 | 4.5 | 3.7 | 3.1 | 3.6 | 3.4 |
| S–I | −9.0 | −8.2 | −5.9 | −5.4 | −2.1 | −2.8 |
| (Central Government) | | | | | | |
| Savings | 0.5 | −0.8 | −0.3 | −3.2 | 1.1 | −0.0 |
| Investment | 2.5 | 1.1 | 1.5 | 1.9 | 2.0 | 2.0 |
| S–I | −2.0 | −1.9 | −1.9 | −5.1 | −0.9 | −2.0 |
| (Public Enterprises) | | | | | | |
| Savings | −0.9 | 0.9 | 0.6 | 0.0 | 0.7 | 1.4 |
| Investment | 3.3 | 3.0 | 1.9 | 1.1 | 1.4 | 1.2 |
| S–I | −4.2 | −2.1 | −1.3 | −1.1 | −0.7 | 0.2 |
| *Current Account* | −8.1 | −4.0 | −0.1 | 3.0 | −1.3 | −1.0 |

Source: National Economic and Development Agency.

until 1985. This situation implies that the public sector dominated the demand for funds in the financial market during the period.

In 1987, the savings of the central government turned positive mainly due to increased tax revenue that accompanied overall economic recovery, and the fiscal balance in public enterprises improved because of structural adjustments, which brought with it a slight decrease in the excess investment in the public sector as a whole. By contrast, however, a recovery in investment and a fall in savings took place simultaneously in the private sector, which caused abrupt shrinkage of its excess savings. Consequently, since the recovery of economic growth in the latter half of the 1980s, both the private and public sectors have competed for funds in the market. In particular, the I–S gap of the public sector has been large enough at 3% of GNP for its financing behavior to have a great impact on the domestic financial market. We will examine this more in detail below.

### (2) *Flow-of-Funds Structure within the Public Sector*

The public sector in the Philippines is divided into five subsectors: the central government, local governments, nonfinancial public enterprises (simply, 'public enterprises' below), public financial institutions, and the social security system. Table 4 illustrates the flow-of-funds structure among these subsectors, excluding financial institutions, in 1986, which represents a typical structure in the latter half of the 1980s.

The Table makes clear the transactions

**Table 4**　Flow of Funds within the Public Sector, Philippines, 1986

(billion pesos)

| | Central Gov't | Public Enterprise | Local Gov't | Social Security |
|---|---|---|---|---|
| a. Revenue | 79.2 | 38.7 | 8.9 | 13.8 |
| b. Current expenditure | 65.7 | 38.4 | 7.4 | 4.9 |
| c. Capital expenditure | 11.7 | 5.9 | 1.2 | |
| d. Capital transfer (net) | 1.2 | 1.2 | | |
| e. Net lending | 31.9 | | | 8.9 |
| to public enterprises | 10.5 | | | |
| government banks | 20.4 | | | |
| central government | | | | 5.6 |
| f. Savings (=a−b) | 13.5 | 0.3 | 1.5 | 8.9 |
| g. S–I gap (=f−c) | 1.8 | −5.6 | 0.3 | 8.9 |
| h. Finance gap (=g−d−e) | −31.3 | −6.8 | 0.3 | 0.0 |
| i. Net external borrowing (=j−k) | 3.6 | −5.3 | | |
| j. Gross borrowing | 9.8 | 18.1 | | |
| k. Amortization | 6.2 | 23.3 | | |
| l. Net domestic borrowing (=m−n) | 27.7 | 12.0 | | |
| from central government | | 8.9 | | |
| commercial banks | | 0.9 | | |
| m. Gross borrowing | 35.5 | | | |
| (TB issuance) | 24.6 | | | |
| n. Amortization and others | 7.8 | | | |

Source: Calculated from Central Bank of the Philippines' data.

among public subsectors as follows. In 1986, the central government saved 13.5 billion pesos out of a revenue of 79.2 billion pesos and spent 11.7 billion pesos on capital expenditure, 1.2 billion pesos on capital transfers to local governments and 31.9 billion pesos on net lending in the form of loans and security investments to public enterprises and public financial institutions. The resulting shortage of funds amounted to 31.3 billion pesos, which was financed by both external borrowing (3.6 billion pesos net) and domestic borrowing (27.7 billion pesos). This domestic borrowing was made mainly through bond issuance including Treasury Bills (TB).

In turn, the revenue, savings and investment of public enterprises were 38.7, 0.3 and 5.9 billion pesos respectively. The gap of 6.8 billion pesos was financed with 12 billion pesos of domestic borrowing mainly from the central government, of which the balance, i.e., 5.3 billion pesos, was used for repayment of external debt. The social security system or public insurances had a revenue of 13.8 billion pesos, which exceeded that of the local governments, spent 4.9 billion pesos on current expenditure and invested the remaining 8.9 billion pesos mostly in government securities.

What we can learn from the above is this. Although the main subsectors in the public sec-

**Table 5** Financing of the Central Government, Philippines, 1983-89

(billion pesos)

| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|---|---|
| Finance gap | 7.4 | 10.1 | 11.1 | 31.3 | 16.7 | 20.3 | 15.3 |
| (% of GNP) | (1.9) | (1.9) | (1.8) | (5.0) | (2.4) | (2.5) | (1.6) |
| External borrowing (net) | 5.4 | 2.0 | −0.3 | 3.6 | 6.8 | 2.1 | −1.1 |
| Borrowing (gross) | 7.7 | 5.1 | 3.7 | 9.8 | 15.4 | 15.1 | 17.8 |
| Repayments | 2.2 | 3.1 | 4.0 | 6.2 | 8.6 | 13.0 | 18.8 |
| Domestic borrowing (net) | 2.3 | 8.1 | 11.5 | 27.7 | 9.9 | 18.3 | 16.4 |
| Borrowing (gross) | 8.1 | 35.9 | 15.8 | 35.5 | 58.6 | 47.3 | 47.4 |
| (TB issuance) | (1.4) | (32.0) | (11.8) | (24.6) | (51.6) | (35.3) | 33.8) |
| Repayments | 3.5 | 19.6 | 2.5 | 4.4 | 25.4 | 10.3 | 17.2 |

Source: Ministry of Finance.

**Table 6** Issuers and Owners of Government Securities, Philippines, 1980-86

(billion pesos)

| | 1980 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|
| By issuers: | | | | | |
| Central government | 18.3 | 35.7 | 49.7 | 61.8 | 91.4 |
| (Treasury Bills) | (3.0) | (6.1) | (19.4) | (31.2) | (55.4) |
| Public enterprises | 4.3 | 9.6 | 10.7 | 10.1 | 11.2 |
| Government banks | 11.7 | 5.5 | 11.7 | 25.4 | 23.7 |
| Total outstanding | 34.3 | 50.8 | 75.1 | 97.3 | 126.3 |
| By owners: | | | | | |
| Central bank | 6.1 | 7.8 | 13.2 | 12.2 | 11.9 |
| Deposit money banks | 13.0 | 18.3 | 24.1 | 21.1 | 22.5 |
| Nonbank finance | 4.3 | 5.7 | 6.6 | 7.3 | 12.6 |
| Social securities | 7.0 | 13.6 | 12.0 | 14.0 | 12.6 |
| Nonfinancial private | 3.6 | 4.8 | 15.0 | 41.6 | 43.3 |

Source: Central Bank of the Philippines, *Statistical Bulletin*, 1986.

tor which are net borrowers or in short of funds are the central government and public enterprises, it is only the central government which appears as a net borrower in the domestic financial market. Namely, the deficit in public enterprises was financed indirectly through the central government in the domestic market, while historically it was financed with external borrowing to a great extent.[6] To evaluate the impact of the public sector deficit on the domestic financial market, therefore, it would suffice

6) Until the first half of the 1980s the main source of external finance by public enterprises was external borrowing as well as borrowing from the central bank. Direct borrowing from the domestic market was not common. See, for instance, Manasan [1988].

to watch the financing behavior of the central government.

The composition of the central government's means of financing is shown in Table 5. The financing gap amounted to 2–5% of GNP, most of which had been financed by domestic borrowing (see the net borrowing figures), particularly by the issuance of TBs since 1983, when external borrowing became difficult. Table 6 depicts the composition of ownership of government securities by sectors. The shares of financial intermediaries and the nonfinancial private sector have been increasing rapidly, which could obviously hinder financial intermediation in the private sector.

## IV Macroeconomic Constraints

### (1) *Monetary Policy*

Monetary policy instruments in the Philippines consist of open market operation, reserve requirements and rediscounts. Since the financial reform of 1980, the basic policy stance has changed from selective controls to quantitative controls. Accordingly, the rediscount policy is used not as a means of credit rationing for industrial finance but as a tool for money supply control or interest rate management. Open market operation is the most important policy instrument of the three. It is the accumulation of government bond stocks due to fiscal deficits that enables open market operation to be a powerful and flexible policy instrument.

The annual rate of inflation of 50% in 1984 was obviously attributed to the loose monetary policy in the previous years. In fact, domestic credits had been maintained as high as 25% of annual growth and had risen further to 30% in 1983. In 1985–86, conversely, a very strict tightening policy was adopted, which was partly along the lines of the "IMF conditionality." This reduced inflation severely, as expected, with the help of reduced aggregate demand, which was brought about by the negative economic growth (See Table 7).

With the decline of inflation, nominal interest rates fell after 1985, though real interest rates rose actually. For instance, if we take the 90 days TB rate as a representative market rate, it fell from the peak of 41% in 1984 to 11% in 1987, while the real rate adjusted for actual inflation rates rose from −10% to +8% in the

**Table 7** Major Financial Indicators, Philippines, 1984–88

| | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|
| (billion pesos) | | | | | |
| M3 | 121.2 | 132.9 | 149.3 | 167.3 | 184.8 |
| (% change) | (7.3) | (9.7) | (12.3) | (9.8) | (10.5) |
| Domestic credits | 166.1 | 156.7 | 122.5 | 108.4 | 122.0 |
| (% change) | (−2.8) | (−5.7) | (−21.8) | (−11.5) | (12.5) |
| (%) | | | | | |
| Inflation | 50.3 | 23.1 | 0.8 | 3.8 | 8.8 |
| Interest rate | 40.9 | 26.2 | 16.3 | 11.4 | 15.7 |
| GNP growth | −7.1 | −4.1 | 2.0 | 5.9 | 6.7 |

Source: IMF, *International Financial Statistics*, various issues.

same period.

From 1984, the bulk of TBs were issued as a means to finance fiscal deficits. As a consequence, particularly since 1987 when the demand for funds recovered in the private sector, the "crowding-out" has become serious in the loanable fund market. This is one reason why nominal interest rates increased in 1988, another reason being higher inflation. Since TBs are close substitutes for time deposits in banks, the purchase of TBs both by the surplus sector and by financial intermediaries would diminish the availability of funds in the bank loan market, with financial intermediation by commercial banks declining inevitably.

As such there appears to be a trade-off between fiscal policy and financial development against a single monetary policy instrument. Note, however, that this is far from the end of the story about constraints on macroeconomic policies.

### (2) *Linkage among Fiscal, Monetary and Exchange Rate Policies*

Changes in interest rates, inflation rates and foreign exchanges rates are shown in Table 8. Interest rates on deposits and loans were fully deregulated during 1980–83. As a result, except for 1984–85, the real interest rate adjusted for inflation became positive. Comparing this with the pervasive negative real interest rates in the 1970s, it could be said that price distortion in the financial market was corrected to a great extent. This, of course, tends to promote mobilization of financial savings.

Moreover, since financial deregulation, interest rate arbitrage through speculative capital movements has tended to produce close movements among interest rates. This is especially explicit since 1986, when inflation and exchange rates have been comparatively stabilized.

In the present situation the TB rate is the most basic interest rate in the monetary system. Commercial banks have to offer interest rates on deposits competitive with those of TBs in order to mobilize savings. In this sense the TB rate plays the role of a link between the bank and the nonbank sectors.

On the other hand, the TB rate is affected by external factors. Foreign exchange controls have been deregulated since 1983 so that banks are not restricted in their foreign exchange holdings. With this enhanced capital mobility, domestic interest rates cannot be insulated from developments in external financial situations. In fact, while the differential between

**Table 8** Interest Rates, Inflation and Exchange Rates, Philippines, 1980–88

(%)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|---|---|---|---|
| Lending rates | 14.0 | 15.3 | 18.1 | 19.2 | 28.2 | 28.6 | 17.5 | 13.2 | 15.9 |
| Deposit rates | 12.3 | 13.7 | 13.7 | 13.6 | 21.2 | 18.9 | 11.3 | 8.2 | 11.3 |
| Inflation | 18.2 | 13.1 | 10.2 | 10.0 | 50.3 | 23.1 | 0.8 | 3.8 | 8.8 |
| TB rate | 12.1 | 12.5 | 13.8 | 14.2 | 28.5 | 26.7 | 16.1 | 11.5 | 14.7 |
| LIBOR | 14.2 | 16.9 | 13.3 | 9.7 | 10.9 | 8.4 | 6.9 | 7.2 | 8.0 |
| Devaluation | 1.8 | 5.2 | 8.1 | 30.1 | 50.3 | 22.1 | 9.6 | 0.9 | 2.6 |

Source: Central Bank of the Philippines and IMF, *International Financial Statistics*, various issues.

domestic and foreign short-term interest rates widened in 1984–86 when devaluation was widely expected, it dwindled again to 4–6% after a pair of large devaluations and under relatively stable prices.

In general, monetary policy is closely associated with exchange rate policy via the interest rate arbitrage between domestic and foreign assets. The monetary tightening during 1987–88 was not only to control inflation, but also to stabilize the exchange rate by preventing capital outflow with higher domestic interest rates. With the nominal exchange rate pegged to the U.S. dollar, devaluation has been maintained relatively small since the two "maxi-devaluations" during 1983–84. Though the peso depreciated against trade partners' currencies along with dollar depreciation, its international competitiveness did not improve very much against export competitors in the world market as shown in Table 9.

**Table 9** Real Effective Exchange Rates, Philippines, 1985–88

| | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|
| Nominal rates (pesos/$) | 18.6 | 20.4 | 20.6 | 21.2 |
| Real effective rates | | (1980=100) | | |
| w.r.t. trade partners | 81.48 | 69.37 | 64.80 | 68.71 |
| rival exporters | 99.43 | 94.67 | 89.26 | 89.75 |

Source: Central Bank of the Philippines.

It is generally hard to define an "appropriate" level of exchange rates. Real devaluation will improve international competitiveness, but devalue real income, thereby deteriorating national welfare. Furthermore, when a country carries over external debt, nominal devaluation will increase the debt service burden because of the increased domestic-currency value of debt. For example, it can be shown that, without devaluation, the domestic currency value of the Philippines' external debt should have been only 40% of the actual value in 1985 [Kohsaka 1990]. This generates two additional burdens. First, this valuation effect gives a sheer capital loss to the economy. Second, the increased debt burden tends to expand the fiscal deficit. This in turn will cause either inflation or crowding-out or both, depending on the way of deficit financing, which in any case lead to financial disintermediation.

## V Issues and Prospects for Financial Development

### (1) *Structural Adjustments*

As we have seen, financial reform in the Philippines was interrupted by macroeconomic turmoil. Accordingly, the main issues remain low productivity and high intermediation costs due to smalless of scale and lack of competition, and lack of specific finance fields such as medium- and long-term industrial finance and export finance. Thus the basic line of reform should be to promote competition among financial institutions by deregulating protectionistic financial restrictions, and at the same time to enhance the stability of the financial system by strengthening means and organizations for monitoring and supervising financial institutions.

The scale of commercial banks in the Philippines is small, even relative to other Southeast Asian countries. The largest commercial bank, PNB, is only 82nd in the asset ranking of Asian banks, and there are a number of far smaller banks than PNB [World Bank 1988]. It is not difficult to find higher management costs and lower productivity in smaller banks. Accord-

ingly, consolidation of small banks could be an urgent objective of the reform.

Despite the financial crisis, the profitability of the bank sector as a whole, except for PNB, improved until 1985. This is mainly because of increased bank margins as a share of the total intermediation fee. In particular, if we look at banks other than foreign and very small banks, their profit margin amounted to 2.4% of their total assets, in comparison with 0.7% for other Asian countries [World Bank 1988]. This high profit margin must be the result of protecting high-cost small-scale banks within the banking system, which would give room for making bad loans.

This relatively high level of profit margin was partly due to the tax system and reserve requirements. For example, the gross receipts tax was estimated to increase the intermediation fee by up to 1.0% [World Bank 1988], while the reserve requirement did so by up to 7.9% in 1985 [de Leon 1989].[7] The World Bank [1988] recommended that this requirement be reduced and TB holdings be regarded as reserves. Note here that it is reported that the intermediation cost net of reserve requirement, agrarian credit requirement and gross receipts tax has shown an explicit downward trend since 1987 [de Leon 1989].

### (2) *Macroeconomic Adjustments under the Debt Problem*

The financial reform mentioned above refers to a microeconomic approach to or structural adjustments of the financial sector. As discussed earlier, the stagnation of the sector in 1983-86 was not necessarily due to shortcomings intrinsic in the sector. In other words, the prospective financial reform should remain the same as was suggested in the early 1980s. The real problem lies rather in the macroeconomic context, which is implied by recent developments since 1987.

A number of experiences in developing countries have suggested that macroeconomic stability is a crucial requirement for financial development (see, for instance, Kohsaka [1986] and McKinnon [1986]). In fact, we can show that, in the Philippines, the degree of financial intermediation is significantly negatively correlated to the domestic price level, while positively correlated to the level of economic activity.[8] Macroeconomic stability can be thought to provide "infrastructure" not only by reducing uncertainties in order for market mechanisms to function fully, but also by demonstrating the government's managerial ability in order for the private sector to rely on it.

In the case of the Philippines, however, the external debt problem casts a shadow even in this respect. It is financial disintermediation due

7) Other examples are the 20% withholding tax imposed on interest income and agrarian credit requirements. Reserve requirement ratios are 21% on short-term deposits and 5% on long-term deposits. According to the World Bank [1989b], "the combined burden of the gross revenue tax and the implicit tax on reserve requirements in 1984 exceeded 150% of value added in the banking system."

8) Regressing the ratio of total financial assets to GDP, L/Y, on the CPI and the real GDP, y, we obtained the following result using iterative maximum likelihood estimation for the period of 1970-88:

$$\log(L/Y) = -6.33 - .189\log(CPI) + .753\log(y)$$
$$(3.64)\quad(2.35)\qquad\quad(2.82)$$

where estimated rho=0.619, S.E.=0.0697, adjusted R-square=0.810 and t-values are parenthesized.

to the larger fiscal deficit which could be the real obstacle to both revitalization of the financial sector and evolvement of financial intermediation. The outstanding amount of TBs reached 142.6 billion pesos at the end of 1988. It follows that, since M3 was 184.8 billion pesos, TBs amounted to as much as 77% of M3. It is evident that the large issuance of TBs and other government securities crowded out both bank deposits and bank loans, thereby preventing further expansion of financial intermediation.

A significant part of public enterprises' debt was assumed by the central government in 1986–87. This greatly increased the central government's debt service burden not only for amortization (quintuplicated in 1987), but also for interest payments (over 40% of total expenditure in 1988). Accordingly, the higher the domestic interest rate is, the stronger becomes the pressure for bond issuance on the government. Meanwhile, devaluation of the domestic currency would barely encourage the trade sector to improve the country's solvency in the long run, but would increase again the debt service burden, which would bring into effect the same argument as in the case of high interest rates.

The above discussion does not deny the importance of structural adjustments in the financial sector. But in the case of the Philippines it is macroeconomic constraints more than anything else which are the first hurdle to be overcome.

## References


Central Bank of the Philippines. *Report on the Economic and Financial Developments.* various issues.

Cole, David C.; and Hugh T. Patrick. 1986. Financial Development in the Pacific Basin Market Economies. In *Pacific Growth and Financial Interdependence,* edited by Tan and Kapur. Sydney: Allen and Unwin.

Kohsaka, Akira. 1986. Role of Finance in Economic Development: A Survey (in Japanese). *Ajia Keizai* 27(9)–(10), September.

————. 1987. Financial Liberalization in Asian NICs—A Comparative Study of Korea and Taiwan in the 1980s—. *Developing Economies* 25(4), December.

————. 1990. Macroeconomic Management with External Debt. A paper presented at the Convention of the East Asian Economic Association, Bandung, Indonesia, August.

de Leon, Catalina V. 1989. A Historical View of the Intermediation Cost of Commercial Banks. *CB Review,* April.

McKinnon, Ronald I. 1973. *Money and Capital in Economic Development.* Washington: Brookings Institute.

————. 1986. Issues and Perspectives: An Overview of Banking Regulation and Monetary Control. In *Pacific Growth and Financial Interdependence,* edited by Tan and Kapur. Sydney: Allen and Unwin.

Pascual, Alfredo E. 1984. Financial Institutions and Markets in the Philippines. In *Financial Institutions and Markets in Southeast Asia,* edited by Michael T. Skully. New York: St. Martin's Press.

Manasan, Rosario G. 1988. *Financing Public Sector Development Expenditure in Selected Countries: Philippines.* Asian Development Bank.

World Bank. 1988. *Philippines: Financial Sector Study.* August.

————. 1989a. *Philippines: Toward Sustaining the Economic Recovery.* February.

————. 1989b. *World Development Report.*