A STUDY ON PHILIPPINE MONETARY AND BANKING POLICIES

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A STUDY ON PHILIPPINE MONETARY AND BANKING POLICIES*

*Ernesto D. Bautista***

I. INTRODUCTION

During the past few decades, control over monetary and financial market policies was useu by governments in most developing countries as an important tool in their development strategies. To accelerate industrialization under an import substitution strategy, many countries including the Philippines intervened pervasively in their financial markets through selective credit policies, interest rate controls, fiscal or tax incentives and overvaluation of the currency. A few, such as South Korea and Singapore, attempted early on to integrate their economies with international markets through an export-based strategy. Most developing countries believed that without interventions in their financial markets, financial institutions would continue to service only the most capitalized sectors, neglecting the rural and other sectors considered to be at the forefront of development.

The monetary authorities of these countries implemented accommodative or expansionary monetary policies complemented by various banking policies. In many cases, the central bank went beyond its traditional supervisory and price stabilization function, to act as a development banker performing credit appraisal and management of special lending programs.

Cumulative experience from various countries has shown that extensive interventions in financial markets have led to allocative inefficiency, financial distress and underdevelopment of the financial system, ultimately affecting economic performance. In countries with highly protectionist trade regimes and macroeconomic instability, directed credit programs reinforced existing distortions. In countries that minimized price and other distortions and maintained macroeconomic stability, these programs appeared to have been more successful (World Bank 1989). The impact of directed credit, however, extends beyond allocative efficiency. Many of these programs have become nonperforming loans. The distorted allocation of resources and the erosion of financial discipline have left many intermediaries unprofitable, and in many cases insolvent. Availability of cheap funds from the rediscount window of the Central Bank (CB) undermines savings mobilization and efficient management of loan portfolio, leading to a lower level of financial intermediation. Moreover, by encouraging firms to borrow from banks, directed credit programs have impeded the development of capital markets.

The unfavorable impact on financial market development and growth, exacerbated by the developments in the international market during the 1980s, exposed the fragile economic foundation

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of most developing countries. Confronted with deteriorating terms of trade, falling export volumes, rising international interest rates, and a sudden curtailment of foreign lending, many countries no longer had the foreign exchange to finance large current account deficits or the fiscal resources to subsidize inefficient industries or sectors. More than ever, these developments underscored the importance of sound monetary policy and efficient financial system mobilizing domestic resources to finance development.

This study assesses Philippine monetary and banking policies with the view of identifying preferred policy options and features of a monetary and banking policy program supportive of overall economic growth and, in particular, of agro-industrial development. The specific objectives are:

1. Describe the impact of existing monetary and banking policy on short- and long-term economic development;
2. Identify the general features of monetary and banking policy supportive of agro-industrial development;
3. Describe the expected short- and long-run impact of adopting such monetary and banking policy on specific sectors and on the economy as a whole; and
4. Describe the legislative and administrative measures required to adopt and implement such a monetary and banking policy.

To address these objectives, the paper is organized in four sections. Section 1 gives an overall picture of the present study. Section 2 presents a conceptual framework within which the study is conducted. Section 3 presents an overview of the institutional structure and performance of the banking system. It describes the relationship between the system's performance and the changes in the underlying regulatory framework and economic environment from the 1950s to the present. Section 4 describes the short-run and medium-term impact of existing monetary, credit and banking policies. Finally, the last section identifies and describes the expected impact and the legislative/administrative measures required for the preferred components of monetary and banking policies supportive of agro-industrial development.

II. CONCEPTUAL FRAMEWORK

Over the past 20 years, ideas about the role of money and finance in economic development have changed profoundly. The simple view that "money does not matter" has been replaced by the more complex considerations of the role of finance in general, including the monetary and nonmonetary financial instruments and functions (Long 1983). This development owes much to the seminal works of McKinnon (1973) and Shaw (1973) that highlighted the adverse effect of financial repression on economic growth. Their works have provided the intellectual underpinnings of much of the policy prescriptions underlying financial sector analysis.

That money and finance matter is widely if not universally recognized. Money as a medium of exchange promotes economic efficiency by eliminating much of the time spent in exchanging goods and services. In a barter economy, trade requires a "mutual double coincidence of wants." Thus, specialization is discouraged. Money facilitates specialization by reducing trading costs and linking different markets. The other roles of money as unit of account and store of value serve the same goal.

But as economies grow, and consequently the range of goods and services demanded, new institutional arrangements and structures evolve to service the varied needs of different types of borrowers and savers that only formal institutions -- commercial banks, investment houses and capital markets -- can supply.

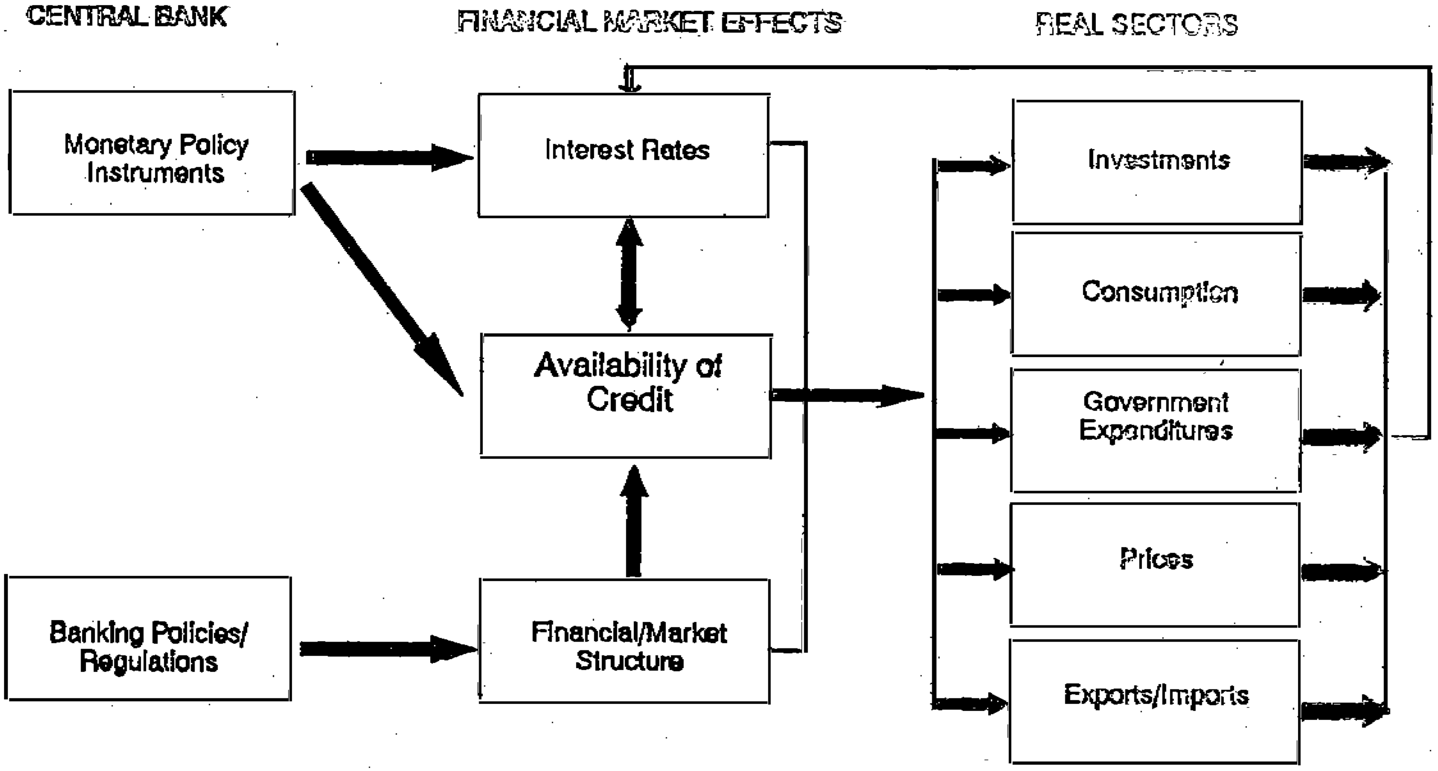
Because of the central role of the financial system in the provision of payment services and in economic growth, most governments have made control and regulation of money and the financial system an important aspect of their development strategy. Historically, governments have controlled the means of payment to guarantee its soundness and to collect seignorage i.e., the income from the creation of money. Governments have also used control of money creation to influence the level of economic activity, and control, allocation and pricing of credit to influence the composition of investment. They have also intervened through various regulatory measures to ensure that financial intermediaries behave prudently. These interventions are effected through the use of various monetary policy instruments such as open market operations of the Central Bank, adjustments in the reserve requirement and rediscount rate, as well as changes in various rules and regulations affecting the operations of financial institutions. The latter include regulations related to single borrowers' limit, capital adequacy ratios, bank entry and expansion requirements, among others.

Monetary policy affects the real economy through the level of interest rates and availability of credit in the economy (Figure 1). Other things being the same, an expansionary monetary policy reduces the level of interest rate, thereby inducing an increase in investment and growth in the economy. The converse applies in the case of contractionary monetary policy. In the same manner, real variables exert feedback effects on the financial market through: (a) the "Fisher effect," (b) the effects of consumption spending, investments and the financing of government expenditures on interest rates, and (c) the effect of trade balance on domestic liquidity.

Financial intermediaries play a central role in this transmission process because of their dual roles. First, they create money and administer the payment mechanism. Second, they mediate between savers/lenders and investors/borrowers. On the one hand, they buy direct financial claims, such as treasury bills, mortgages and loans from borrowers. On the other hand, they offer their own indirect financial claims to lenders/savers in the form of deposits in the case of banks. By specializing in information gathering and portfolio management, financial intermediaries earn a return for performing a function similar to that of a broker. Where there are no distortions in the financial market, the yield on deposits are just equal to the rate of return of borrowers. However, where market imperfections and other policy-imposed distortions exist, a wedge is driven between the gross cost of borrowing and net return on lending. The ultimate effect of these distortions is to drive deposit rate downwards and the lending rate upwards.

In many countries, financial repression i.e., the indiscriminate distortions of financial prices including interest rates and foreign exchange rates, have reduced the real rate of growth and the real size of the financial system relative to non-financial magnitudes. To this end, many countries have made various changes in the structure and operations of their financial systems under the program of liberalization or reforms. However, the experiences have been mixed. While the importance of an efficient financial system is well recognized, the outcome of a financial liberalization program depends to a large extent on the initial underlying institutional structure and the overall macroeconomic condition of the economy.

Figure 1
Transmissions of the Impact of Monetary Policy on the Real Sectors


CENTRAL BANK
FINANCIAL MARKET EFFECTS
REAL SECTORS
Monetary Policy Instruments
Interest Rates
Availability of Credit
Banking Policies/ Regulations
Financial/Market Structure
Investments
Consumption
Government Expenditures
Prices
Exports/Imports

The extent to which an efficient financial system can effectively contribute to development is significantly limited by other complementary macroeconomic and sectoral policies such as trade, investment, pricing policies and institutional structure. Protectionist trade regimes that undermine comparative advantage may not work towards enhancing a country's development even if substantial efforts for financial development are effected. In many countries that had to liberalize their foreign trade sector, previously protected enterprises became significantly less profitable, contributing to the nonperforming assets of financial institutions. In the same manner, highly indebted countries which liberalized their financial sector way ahead of their real sectors experienced financial distress and macroeconomic instability.

Thus, while financial liberalization represents an important step towards enhancing economic development, it is not sufficient. Moreover, as various country experiences indicate, financial development entails more than *de facto* liberalization of interest rates. More fundamentally, unless the underlying institutional structures are in place, the perceived benefits may even turn out to be destabilizing. These considerations need to be emphasized to put in proper perspective the role of monetary and banking policies in development.

III. PHILIPPINE FINANCIAL SYSTEM: INSTITUTIONAL STRUCTURE AND PERFORMANCE

The Philippine financial system has undergone a significant transformation, both quantitative and qualitative, since the 1950s. It started with 11 head offices and 75 branches of commercial banks (KBs), and one savings bank (SB). Since then it has evolved more sophisticated and specialized institutions. Between 1950 and 1960, the system was primarily composed of various types of banking units dominated by KBs. In the 1970s, two major financial intermediaries emerged: non-bank financial institutions (NBFIs) and non-bank thrift institutions (NBTIs). The former include investment houses, financing companies, securities dealers, investment companies, fund managers, lending investors, pawnshops, government non-bank financial institutions and venture capital corporations. The non-bank thrift institutions, on the other hand, consist of mutual building and loan associations and non-stock savings and loan associations. The banking system evolved into four major categories: KBs, thrift banks (TBs), rural banks (RBs) and specialized government banks (SGBs).

While the share of the commercial banking system has declined over the years, it still dominates the system in terms of resource base. As of 1990, it accounted for 76 percent of the system's resources, 87 percent of deposits, 73 percent of the system's total loan portfolio, and slightly more than half of the capital accounts (Tables 1-4). This is despite the fact that its physical network comprises only 25 percent of the system's total network (Table 5).

During the period 1950-1990, the banking system exhibited reasonable but varying rates of growth in total resources, loans, deposit and capital accounts (Table 6). Major developments in the underlying regulatory framework and economic environment explain much of this varying performance. During the period 1950-1970, the system's total resources grew at an annual nominal rate of 15 percent. Deposits and capital accounts registered growth at 12 percent and 18 percent, respectively. This trend continued and peaked during the 1970s, when annual growth rates in the above variables

Table 1. TOTAL RESOURCES OF THE PHILIPPINE FINANCIAL SYSTEM, SELECTED YEARS,
(In Million Pesos)

Institutional Group	1950		1955		1960		1965		1970		1975		1980		1985		1990	
	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share
BANKING INSTITUTIONS a/	1,166.2	100.0	2,048.0	100.0	3,165.2	100.0	8,643.3	100.0	18,752.3	100.0	69,176.0	83.0	193,599.0	86.1	387,769.0	89.5	592,023.0	90.0
Commercial Banks	1,124.1	96.4	1,412.9	69.0	2,336.8	73.8	6,731.0	77.9	14,066.1	75.0	52,595.0	63.1	144,428.0	64.3	279,318.0	64.4	501,140.0	76.2
Thrift Banks	-	-	-	-	-	-	-	-	-	-	2,127.0	2.6	10,547.0	4.7	14,959.0	3.5	37,294.0	5.7
PDBs	-	-	-	-	-	-	-	-	-	-	382.0	0.5	1,618.0	0.7	5,038.0	1.2	11,180.0	1.7
SMBs	-	-	-	-	-	-	-	-	-	-	1,422.0	1.7	7,353.0	3.3	6,797.0	1.6	21,721.0	3.3
SSLAs	-	-	-	-	-	-	-	-	-	-	323.0	0.4	1,576.0	0.7	3,124.0	0.7	4,393.0	0.7
Rural Banks	-	-	7.9	0.4	76.3	2.4	279.0	3.2	655.0	3.5	2,749.0	3.3	5,524.0	2.5	8,601.0	2.0	13,459.0	2.0
Specialized Gov't Banks	-	-	-	-	-	-	-	-	-	-	11,705.0	14.0	33,100.0	14.7	84,891.0	19.6	40,130.0	6.1
Savings Banks	9.5	0.8	25.2	1.2	71.6	2.3	201.4	2.3	724.4	3.9	-		-	-	-	-	-	-
Development Banks	-	-	560.9	27.4	624.5	19.7	1,346.2	15.6	3,219.0	17.2	-	-	-	-	-	-	-	-
Postal Savings Banks	32.6	2.8	41.1	2.0	56.0	1.8	85.7	1.0	87.8	0.5	-	-	-	-	-	-	-	-
NON-BANK FINANCIAL INTERMEDIARIES b/	n.a.		n.a.		n.a.		n.a.		n.a.		14,058.0	16.9	30,820.0	13.7	44,767.0	10.3	61,256.0	9.3
NON-BANK THRIFT INSTITUTIONS c/	n.a.		n.a.		n.a.		n.a.		n.a.		112.0	0.1	318.0	0.1	863.0	0.2	4,771.0	0.7
ALL	1,166.2		2,048.0		3,165.2		8,643.3		18,752.3		83,346.0	100.0	224,737.0	100.0	433,399.0	100.0	658,050.0	100.0

a/ Between 1950-1970, banks were classified as follows: commercial banks, savings banks, rural banks, development banks (which include assets of DBP and private development banks) and postal savings banks.

b/ Between 1950-1970, non-bank financial intermediaries (NBFIs) included the following: Agricultural Credit Administration (ACA), GSIS, SSS, National Investment Development Corporation, PDCP, Bancom Development Corporation, Mutual Building and Loan Associations, Stock Savings and Loan Associations. Starting 1975, NBFIs comprised the following: investment houses, financing companies, securities dealers/brokers, investment companies, fund managers, lending-investors, pawnshops, government non-bank financial institutions and venture capital corporations.

c/ Include mutual building and loan associations and non-stock savings and loan associations.

Legend: n.a. - data not available

Source: 1950-1970, CB Statistical Bulletin, Volume XXIII, December 1971
1975-1990, CB Fact Book, Philippine Financial System, Various Year

Table 2. TOTAL LOAN PORTFOLIO OF THE PHILIPPINE FINANCIAL SYSTEM, SELECTED YEARS,
(In Million Pesos)

Institutional Group	1950		1955		1960		1965		1970		1975		1980		1985		1990	
	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share
BANKING INSTITUTIONS a/	298.0	100.0	698.0	100.0	1,568.7	100.0	4,126.2	100.0	9,972.9	100.0	43,126.0	89.0	120,364.0	84.8	175,236.0	83.8	290,563.0	89.0
Commercial Banks	292.0	98.0	217.5	31.2	939.5	59.9	2,655.8	64.4	6,422.2	64.4	33,072.0	68.2	88,912.0	62.6	127,665.0	61.1	239,124.0	73.3
Thrift Banks	-	-	-	-	-	-	-	-	-	-	1,424.0	2.9	6,533.0	4.6	7,913.0	3.8	23,051.0	7.1
PDBs	-	-	-	-	-	-	-	-	-	-	302.0	0.7	1,026.0	0.7	2,583.0	1.2	6,069.0	1.9
SMBs	-	-	-	-	-	-	-	-	-	-	900.0	1.9	4,425.0	3.1	3,695.0	1.8	14,785.0	4.5
SSLAs	-	-	-	-	-	-	-	-	-	-	222.0	0.5	1,082.0	0.8	1,635.0	0.8	2,197.0	0.7
Rural Banks	-	-	6.5	0.9	59.6	3.8	221.7	5.4	526.1	5.3	2,324.0	4.8	4,572.0	3.2	6,416.0	3.1	9,325.0	2.9
Specialized Gov't Banks	-	-	-	-	-	-	-	-	-	-	6,306.0	13.0	20,347.0	14.3	33,242.0	15.9	19,063.0	5.8
Savings Banks	6.0	2.0	17.8	2.6	52.5	3.3	121.4	2.9	441.3	4.4	-	-	-	-	-	-	-	-
Development Banks	-	-	456.2	65.4	517.1	33.0	1,127.3	27.3	2,583.3	25.9	-	-	-	-	-	-	-	-
NON-BANK FINANCIAL INTERMEDIARIES b/	n.a.		n.a.		n.a.		n.a.		n.a.		5,244.0	10.8	21,338.0	15.0	33,097.0	15.8	31,433.0	9.6
NON-BANK THRIFT INSTITUTIONS c/	n.a.		n.a.		n.a.		n.a.		n.a.		95.0	0.2	276.0	0.2	734.0	0.4	4,333.0	1.3
ALL	298.0	100.0	698.0	100.0	1568.7	100.0	4,126.2	100.0	9,972.9	100.0	48,465.0	100.0	141,978.0	100.0	209,067.0	100.0	326,329.0	100.0

a/ Between 1950-1970, banks were classified as follows: commercial banks, savings banks, rural banks, development banks (which include assets of DBP and private development banks) and postal savings banks.

b/ Between 1950-1970, non-bank financial intermediaries (NBFIs) included the following: Agricultural Credit Administration (ACA), GSIS, SSS, National Investment Development Corporations, PBCP, Bancom Development Corporation, Mutual Building and Loan Associations, Stock Savings and Loan Associations. Starting 1975, NBFIs comprised the following: investment houses, financing companies, securities dealers/brokers, investment companies, fund managers, lending-investors, pawnshops, government non-bank financial institutions and venture capital corporations.

c/ Include mutual building and loan associations and non-stock savings and loan associations.

Legend: n.a. - data not available
Note: Postal Savings Banks were only mandated to mobilize deposits.

Source: 1950-1970, CB Statistical Bulletin, Volume XXIII, December 1971
1975-1990, CB Fact Book, Philippine Financial System, Various Years

Table 3. TOTAL DEPOSITS OF THE PHILIPPINE FINANCIAL SYSTEM, SELECTED YEARS,
(In Million Pesos)

Institutional Group	1950		1955		1960		1965		1970		1975		1980		1985		1990	
	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share
BANKING INSTITUTIONS a/	892.2	100.0	1,024.1	100.0	1,863.7	100.0	4,349.5	100.0	8,886.0	100.0	27,873.0	100.0	89,498.0	100.0	164,256.0	100.0	359,017.0	100.0
Commercial Banks	855.0	95.9	966.0	94.3	1732.0	92.9	4,002.1	92.0	7,685.7	86.5	21,435.0	76.9	72,913.0	81.5	144,053.0	87.7	312,979.0	87.2
Thrift Banks	-	-	-	-	-	-	-	-	-	-	1,614.0	5.8	7,986.0	8.9	10,283.0	6.3	26,839.0	7.5
PDBs	-	-	-	-	-	-	-	-	-	-	209.0	0.7	773.0	0.9	2,683.0	1.6	6,106.0	1.7
SMBs	-	-	-	-	-	-	-	-	-	-	1,192.0	4.3	6,116.0	6.8	5,625.0	3.4	17,706.0	4.9
SSLAs	-	-	-	-	-	-	-	-	-	-	213.0	0.8	1,097.0	1.2	1,975.0	1.2	3,027.0	0.8
Rural Banks	-	-	0.7	0.1	24.7	1.3	78.7	1.8	260.3	2.9	678.0	2.4	1,699.0	1.9	3,019.0	1.8	7,010.0	2.0
Specialized Gov't Banks	-	-	-	-	-	-	-	-	-	-	4,146.0	14.9	6,900.0	7.7	6,901.0	4.2	12,189.0	3.4
Savings Banks	7.4	0.8	22.0	2.1	60.4	3.2	168.6	3.9	557.8	6.3	-	-	-	-	-	-	-	-
Development Banks	-	-	-	-	0.6	*	34.1	0.8	324.6	3.7	-	-	-	-	-	-	-	-
Postal Savings Banks	29.8	3.3	35.4	3.5	46.0	2.5	66.0	1.5	57.6	0.6	-	-	-	-	-	-	-	-
NON-BANK FINANCIAL INTERMEDIARIES b/		-		-		-		-		-	-	-	-	-	-	-	-	-
NON-BANK THRIFT INSTITUTIONS c/		n.a.		n.a.		n.a.		n.a.		n.a.	9.0	*	40.0	*	179.0	0.1	131.0	*
ALL	892.2	100.0	1,024.1	100.0	1,863.7	100.0	4,349.5	100.0	8,886.0	100.0	27,882.0	100.0	89,538.0	100.0	164,435.0	100.0	359,148.0	100.0

* Less than 0.1%

a/ Between 1950-1970, banks were classified as follows: commercial banks, savings banks, rural banks, development banks (which include assets of DBP and private development banks) and postal savings banks.

b/ Between 1950-1970, non-bank financial intermediaries (NBFIs) included the following: Agricultural Credit Administration (ACA), GSIS, SSS, National Investment Development Corporations, PDCP, Bancom Development Corporation, Mutual Building and Loan Associations, Stock Savings and Loan Associations. Starting 1975, NBFIs comprised the following: investment houses, financing companies, securities dealers/brokers, investment companies, fund-managers, lending-investors, pawnshops, government non-bank financial institutions and venture capital corporations.

c/ Include mutual building and loan associations and non-stock savings and loan associations.

Legend: n.a. - data not available

Source: 1950-1970, CB Statistical Bulletin, Volume XXIII, December 1971
1975-1990, CB Fact Book, Philippine Financial System, Various Years

Table 4. TOTAL CAPITAL ACCOUNTS OF THE PHILIPPINE FINANCIAL SYSTEM, SELECTED YEARS,
(In Million Pesos)

Institutional Group	1950		1955		1960		1965		1970		1975		1980		1985		1990	
	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share
BANKING INSTITUTIONS a/	93.5	100.0	512.0	100.0	646.0	99.5	1,389.0	100.0	2,505.4	100.0	8,833.0	64.7	22,982.0	72.7	39,296.0	71.9	74,231.0	72.1
Commercial Banks	89.5	95.7	158.0	30.9	283.9	43.9	828.3	59.6	1,470.7	58.7	4,879.0	35.7	15,210.0	48.1	28,740.0	52.6	54,290.0	52.8
Thrift Banks	-	-	-	-	-	-	-	-	-	-	291.0	2.1	1,205.0	3.8	1,623.0	30.0	4,446.0	4.3
PDBs	-	-	-	-	-	-	-	-	-	-	87.0	0.6	308.0	1.0	733.0	1.3	1,840.0	1.8
SMDs	-	-	-	-	-	-	-	-	-	-	147.0	1.1	622.0	2.0	391.0	0.7	1,955.0	1.9
SSLAs	-	-	-	-	-	-	-	-	-	-	57.0	0.4	275.0	0.9	499.0	0.9	651.0	0.6
Rural Banks	-	-	5.8	1.1	36.7	5.7	121.6	8.8	226.3	9.0	426.0	3.1	755.0	2.4	1,360.0	2.5	2,280.0	2.2
Specialized Gov't Banks	-	-	-	-	-	-	-	-	-	-	3,237.0	23.7	5,812.0	18.4	7,573.0	13.8	13,215.0	12.8
Savings Banks	1.2	1.3	2.7	0.5	10.0	1.5	28.1	2.0	75.8	3.0	-	-	-	-	-	-	-	-
Development Banks	-	-	339.8	66.4	305.4	47.3	391.7	28.2	702.4	28.0	-	-	-	-	-	-	-	-
Postal Savings Bank	2.8	3.0	5.7	1.1	10.0	1.5	19.3	1.4	30.2	1.2								
NON-BANK FINANCIAL INTERMEDIARIES b/	n.a.		n.a.		n.a.		n.a.		n.a.		4,738.0	34.7	8,378.0	26.5	14,833.0	27.1	24,962.0	24.3
NON-BANK THRIFT INSTITUTIONS c/	n.a.		n.a.		n.a.		n.a.		n.a.		89.0	0.7	242.0	0.8	556.0	1.0	3,724.0	3.6
ALL	93.5	100.0	512.0	100.0	646.0	100.0	1,389.0	100.0	2,505.4	100.0	13,660.0	100.0	31,602.0	100.0	54,685.0	100.0	102,917.0	100.0

a/ Between 1950-1970, banks were classified as follows: commercial banks, savings banks, rural banks, development banks (which include assets of DBP and private development banks) and postal savings banks.

b/ Between 1950-1970, non-bank financial intermediaries (NBFIs) included the following: Agricultural Credit Administration (ACA), GSIS, SSS, National Investment Development Corporations, PDCP, Dancom Development Corporation, Mutual Building and Loan Associations, Stock Savings and Loan Associations. Starting 1975, NBFIs comprised the following: investment houses, financing companies, securities dealers/brokers, investment companies, fund managers, lending-investors, pawnshops, government non-bank financial institutions and venture capital corporations.

c/ Include mutual building and loan associations and non-stock savings and loan associations.

Legend: n.a. - data not available

Source: 1950-1970, CB Statistical Bulletin, Volume XXIII, December 1971
1975-1990, CB Fact Book, Philippine Financial System, Various Years

Table 5. NUMBER AND DISTRIBUTION OF FINANCIAL INSTITUTIONS SELECTED YEARS

Item	1971	1975	1980	1985	1990
ALL	1668	3549	5057	5780	7482
	(Percentage Distribution)				
Commercial Banks	41.5	28.2	30.1	30.7	24.9
Thrift Banks	9.4	6.9	13.3	11.4	8.7
Specialized Government Banks	1.6	1.8	1.5	1.3	1.0
Rural Banks	33.3	23.1	21.7	19.3	14.0
Non-Bank Financial Intermediaries	13.5	40.0	33.5	37.2	51.4

Source: 1990 Yearbook, Selected Philippine Economic Indicators, Central Bank

Table 6. GROWTH OF THE PHILIPPINE FINANCIAL SYSTEM, SELECTED INDICATORS, IN PER CENT

Institutional Groups	RESOURCES					LOAN PORTFOLIO					DEPOSITS					CAPITAL ACCOUNTS				
	1950-70	1970-75	1975-80	1980-85	1985-90	1950-70	1970-75	1975-80	1980-85	1985-90	1950-70	1970-75	1975 80	1980-85	1985-90	1950-70	1970-75	1975-80	1980-85	1985-90
BANKING INSTITUTIONS	14.9	29.1	22.8	14.9	8.8	19.2	22.3	28.8	7.8	10.6	12.2	24.5	26.3	12.9	16.9	17.9	26.7	21.1	11.3	13.6
KBs	13.5	30.5	22.4	14.1	12.4	16.7	23.2	21.9	7.5	13.4	11.6	22.0	27.7	14.6	16.8	15.0	28.6	25.5	13.6	13.6
TB	-	-	37.7	7.2	20.0	-	-	35.6	3.9	23.8	-	-	37.7	5.2	21.2	-	-	32.9	6.1	22.3
PDBs	-	-	33.5	25.5	17.3	-	-	27.7	20.3	18.6	-	-	29.9	28.3	17.9	-	-	28.8	18.9	20.2
SMBs	-	-	38.9	(1.6)	26.2	-	-	37.5	(3.5)	32.0	-	-	38.7	(1.7)	25.8	-	-	33.4	(8.9)	38.0
SSLAs	-	-	37.3	14.7	7.1	-	-	37.3	8.6	6.1	-	-	38.8	12.5	8.9	-	-	37.0	12.7	5.5
RBS	34.2*	33.2*	15.0	9.2	9.4	34.0*	34.6	14.5	7.0	7.8	48.4*	33.1	20.2	12.2	18.4	27.7*	13.5	12.1	12.5	10.9
SGBs	-	-	23.1	20.7	(13.9)	-	-	26.4	10.3	(10.5)	-	-	10.7	*	12.0	-	-	12.4	5.4	11.8
Savings Banks	24.2	14.4	-	-	-	24.0	15.3	-	-	-	24.1	16.2	-	-	-	23.0	14.2	-	-	-
Development Banks	12.4*	25.4	-	-	-	12.2*	17.7	-	-	-	87.6**	61.2	-	-	-	5.0	27.8	-	-	-
Postal Savings Banks	5.1	(6.0)	-	-	-	-	-	-	-	-	3.3	(23.7)	-	-	-	12.6	10.5	-	-	-
NON-BANK FINANCIAL INTERMEDIARIES	-	-	17.0	7.8	6.5	-	-	32.4	9.2	(1.0)	-	-	-	-	-	-	-	12.1	12.1	11.0
NON-BANK THRIFT INSTITUTIONS	-	-	23.2	22.1	40.8	-	-	23.8	21.6	42.6	-	-	34.8	34.9	(6.1)	-	-	22.1	18.1	46.3
ALL	14.9	29.1	21.9	14.0	8.7	19.2	22.3	24.0	8.0	9.3	12.2	24.5	26.3	12.9	16.9	17.9	26.7	18.3	11.6	13.5

* 1955-1970 only.

** 1960-1970 only.

exceeded 20 percent. The serious financial crises in the 1980s resulted in the contraction of the banking system's resource base.

The period 1950-1970 was characterized as a period of dynamic and rapid growth in banking as the number of banking units quadrupled in response to various banking legislations. These included the enactment of the Rural Banks Act in 1952 (RA 720), the enactment of the Development Bank of the Philippines Charter in 1958 (RA 2081), the Law on Secrecy of Deposits enacted in September 1955, and the Philippine Deposit and Insurance Corporation Act, among others. With these developments, bank supervision and examination focused on the licensing of new banking units and branch operations. Minimum initial capital was not enforced except as a precondition to the availment of the CB rediscount window. Monitoring and examination of bank operations were confined to the basics: solvency compliance with the 15 percent risk-asset ratio; liquidity through compliance with the required reserves; and review of financial condition and operations results through reports submitted. A substantial part of bank examination was the validation of balances and review of creditworthiness of bank borrowers. The period also saw the early beginnings of conflict-of-interest control through the regulation on loans against personal security and DOSRI loans (Valenzuela 1989).

By 1970, the rapid expansion in the banking system raised concern that the financial system had become unnecessarily complicated and fragmented. Moreover the emergence of new forms of financial intermediaries challenged the effectiveness of CB regulation and supervision of the system. This paved the way for the adoption of reform measures recommended by the 1971 Joint IMF-CBP Banking Survey Commission. The Commission was created specifically to review the overall system and recommend changes in its structure and operations to guide its future growth. Based on the commission's findings and recommendations, amendments were made to the General Banking Act and the Central Bank Act in 1972-1973. These included the alignment of legal provisions and regulations by functional areas rather than by type of banks, the consolidation of CB authority over banks and non-banks (except insurance companies), a redefinition of CB's responsibilities to exclude the promotion of economic growth, which was to be a primary responsibility of government planning agencies, and the imposition of restrictions on entry of new banks in the system, with corresponding efforts to improve the efficiency of existing banks. These goals were pursued through several programs of action.

The 1970s were also marked by a shift towards a more interventionist monetary and credit policy. In support of the government's rural development thrust, an expansionary monetary policy and other selective credit mechanisms were implemented. These included the Agri-Agra Law, the deposit retention scheme, provision of low-cost Special Time Deposits (STDs), as well as interest ceilings on deposits, loans and rediscounts. The CB took on an expanded developmental banking function, from designing lending programs to overseeing their subsequent implementation and funding through the rediscount window. In effect, the CB's rediscount window assumed a largely allocative function whose adverse effects are now widely known.

In particular, liberal access to the rediscounting of the CB fostered dependence and undermined financial intermediation. The RB system became a mere conduit of cheap government funds performing little deposit mobilization and judicious management of loan portfolio. Hence, when loan arrearages began to mount towards the late 1970s and access to the rediscount window turned restrictive, many RBs became insolvent. This necessitated a special rehabilitation program which proved largely ineffective in addressing the underlying structural weaknesses of the system.

Despite the deterioration in the general macroeconomic conditions and the adverse effects of repressive financial market policies, the banking system continued to post real growth until 1983 (Figures 2-5). This period was also marked by the implementation of important institutional and policy reforms in the banking system. Following the recommendation of the 1979 financial sector review, the CB in 1980 adopted the modified universal banking concept which enabled KBs to engage in near- banking functions. As a complementary measure, a dramatic shift in interest rate policy was adopted. Starting in 1980, ceilings on various categories of savings and time deposits and loans of over two-year maturities were lifted. By January 1, 1983, deregulation was completed with the removal of the remaining interest rate ceilings on short-term loans.

In the face of all these reform measures, the Philippine financial system suffered a serious setback in 1981 in the wake of Dewey Dee's flight from the country, leaving behind debts running into millions of pesos. Although the accumulated debts comprised only a small proportion of the financial system's assets, the default triggered insolvencies on investment houses and finance companies which had significant exposures on him. Major KBs benefitted from the crisis as depositors of non-bank financial institutions shifted their funds to the system perceived to be relatively safer. Because of the potentially destabilizing impact on the financial system, the CB undertook a major liquidity infusion by establishing the Industrial Rehabilitation Fund and the Stock Financing Program (Valenzuela 1989). Additional measures to strengthen the market were adopted, including a more careful evaluation of credit worthiness, delimitation of commercial paper issues to prime papers and prime issuers, and regulations on trust operations and fund management aimed at differentiating between the two.

The period 1983-1985 was the most challenging for the monetary authorities and the financial system. The gradual loss of confidence in the Philippine economy accelarated with the political events of 1983. Faced with massive capital flight, a persistent imbalance in the external current account position and severe foreign exchange deficits, the government introduced a rationing system for foreign exchange and imposed a moratorium on capital repayments abroad. This move weakened the confidence of the country's creditors and led to the withdrawal of supplier's credit. To stem the flight of capital, monetary authorities implemented a tight monetary policy that saw interest rates on loans and CB bills soaring from 14.5 percent per annum before the start of the crisis in 1983 to as high as 40 percent in 1984. The move was a virtual attack on the financial system as banks were besieged with pretermination of deposit accounts in favor of high-yielding CB bills which, given their relative yield and credit risk, were more attractive investment by banks and big depositors. This resulted in the crowding out of loans and a corresponding shift in bank portfolio towards these bills. Between 1984 and 1985, outstanding loans of the banking sector fell by 17 percent. Other complementary measures undertaken during the period was the devaluation of the exchange rate from P 11 to P 18 per $1. Inflation increased from 10 percent per annum in 1982 to a high of 50.3 percent in 1984. As a result, the economy contracted to its pre-1980 level, with GNP posting negative growth rate of seven percent in real terms. Similarly, the current account deficit contracted sharply from its previous level of 8.41 percent of GNP in 1983 to 0.34 percent of GNP in 1985.

In response to the situation, the CB continued the rationalization and review of its existing banking regulations. New monetary instruments were introduced in 1983 and 1984 to address monetary stability. These included the blocking of swap differentials and blocked peso deposits. The blocking of swap differentials was introduced to dampen the expansionary impact of losses that CB

Figure 2
Assets of the Banking System

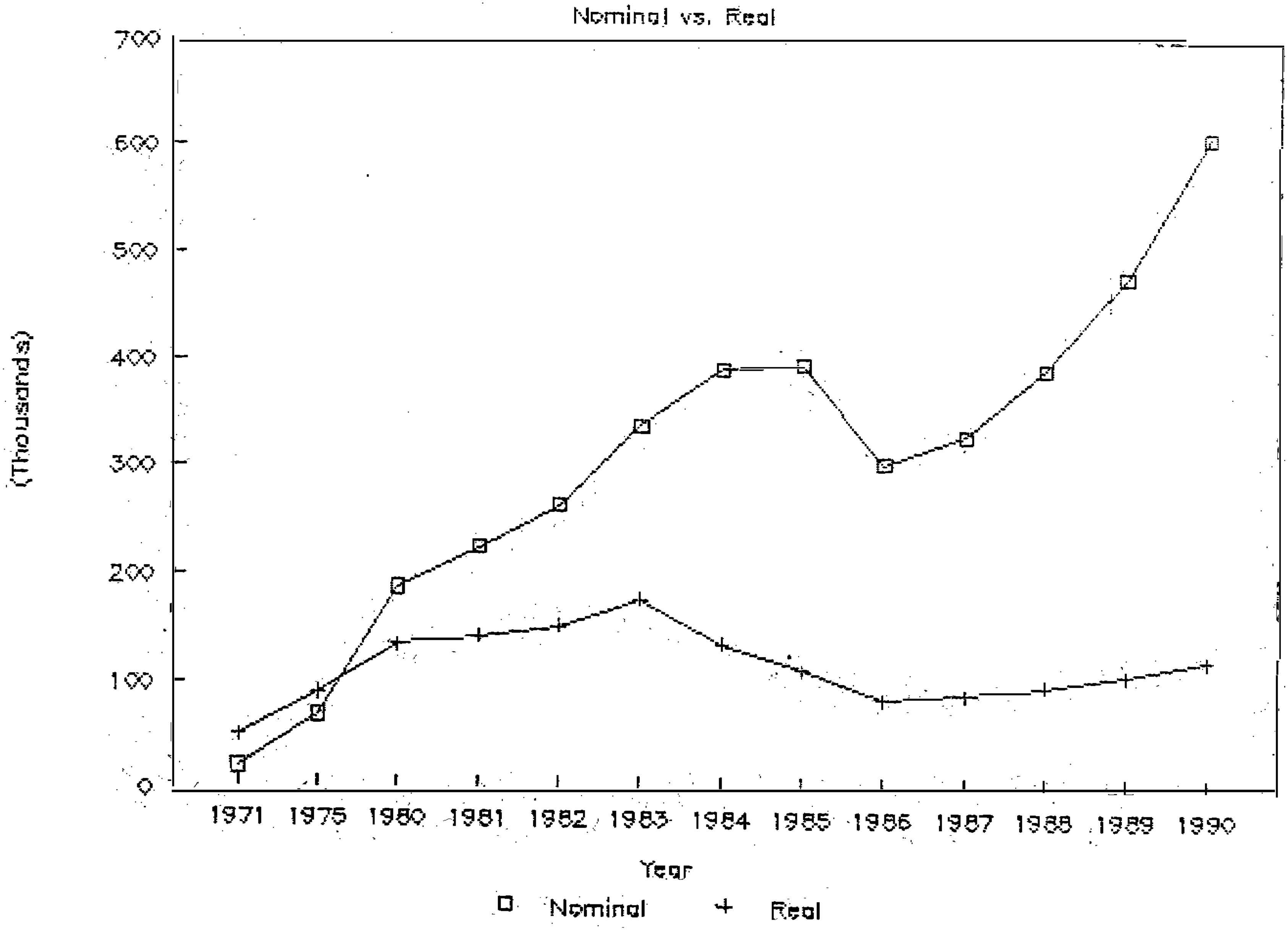


Figure 3
Liabilities of the Banking System

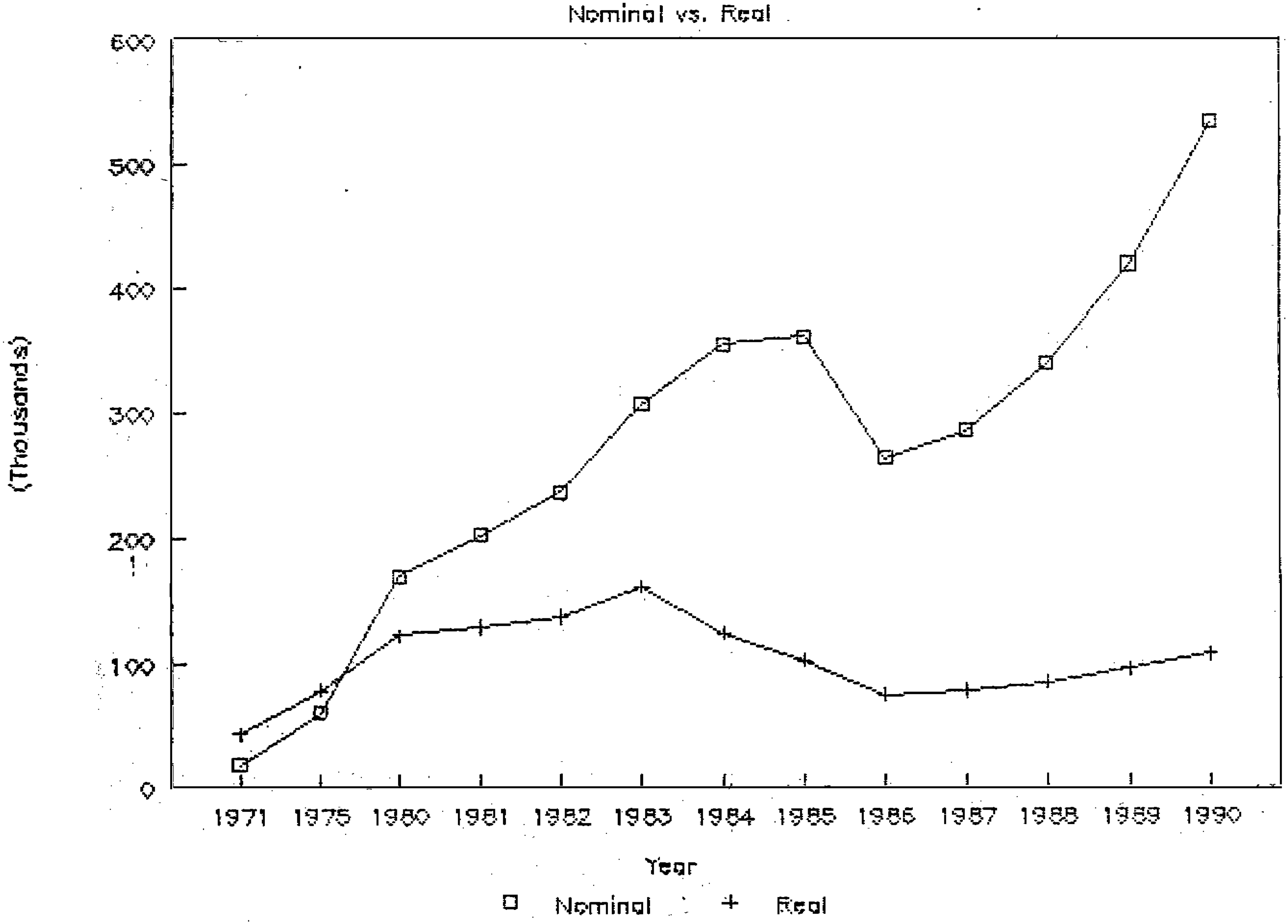


Figure 4
Deposits of the Banking System

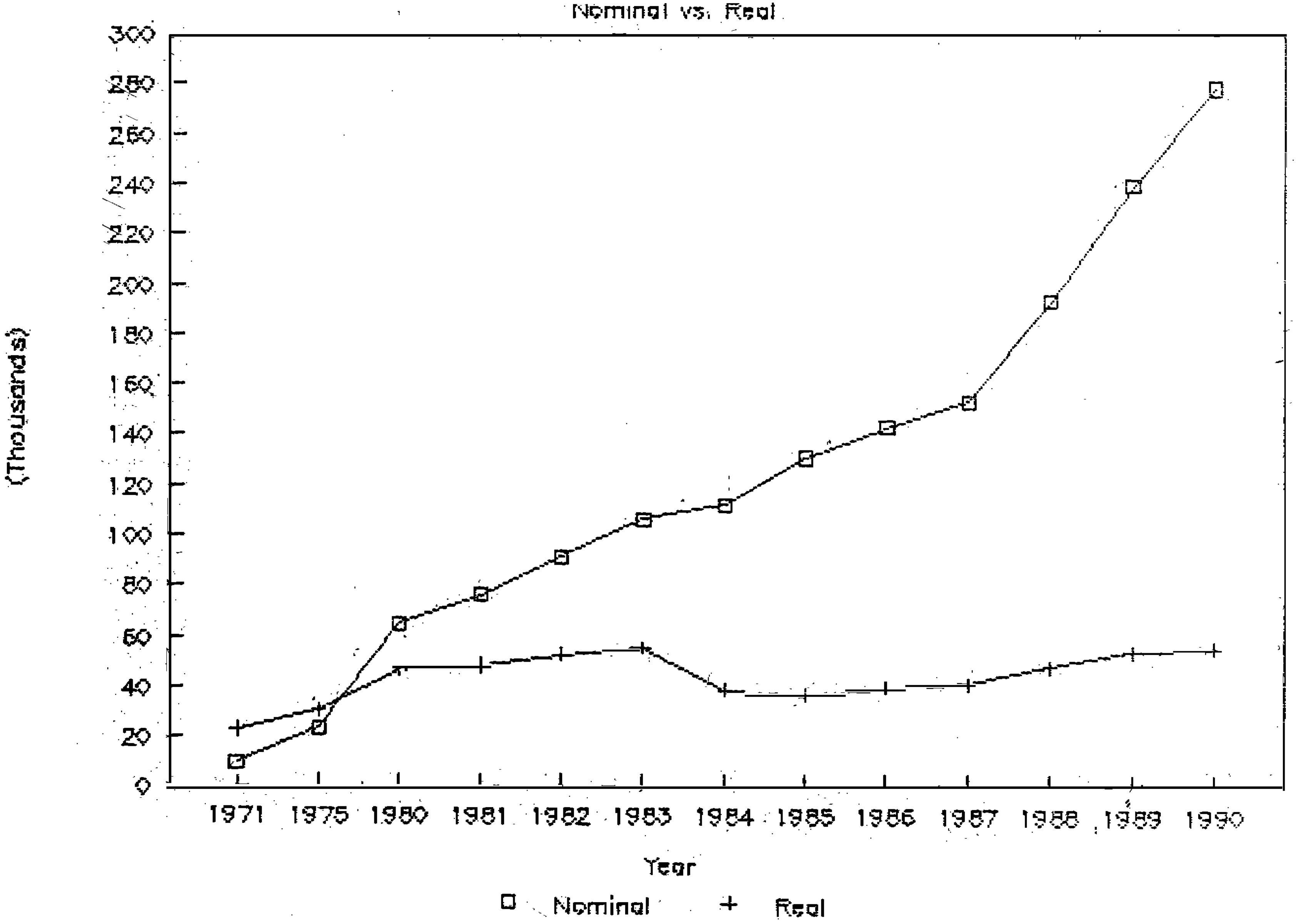
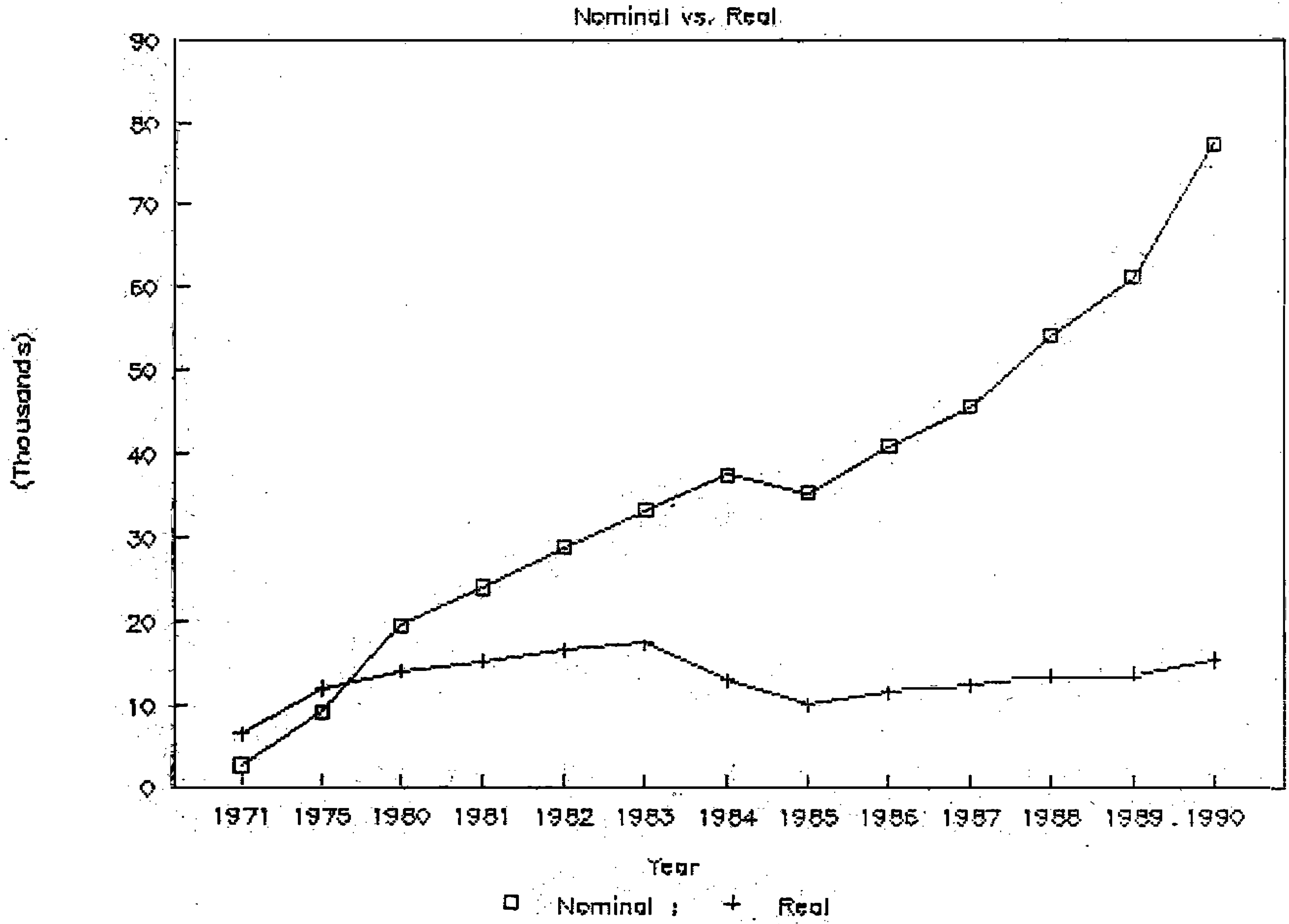


Figure 5
Networth of the Banking System



incurred in swap arrangements. Under the swap transaction, the CB simultaneously engaged in a spot purchase of a foreign currency at the prevailing rate and a future sale of the same currency at a predetermined forward rate. Losses were incurred as a result of the series of peso depreciation, which led to a higher actual rate than the forward cover. Instead of remitting these swap differentials to the banks, the CB blocked their release and placed them in an interest-earning deposit account.

On the other hand, under blocked peso deposit transactions, the CB required local borrowers of Paris Club creditors to deposit the peso equivalent of their outstanding foreign loans on original maturity dates. These peso deposits were placed in non-interest-bearing blocked accounts and provided foreign exchange cover by the CB. Blocking these deposits sterilized the pesos which would have been used to buy foreign exchange to pay the maturing obligations.

IV. IMPACT OF EXISTING MONETARY, CREDIT AND BANKING POLICIES

With the change in government in 1986, monetary, credit and banking reforms initiated earlier gained momentum. These reforms embodied in the 1986-92 Medium Term Development Plan seek to strengthen the monetary and regulatory functions of the CB and enhance the efficiency of the financial system. They are categorized into policy and institutional reforms, with some of the former being ongoing concerns. Thus, a full accounting of their net effects and the possibility of substantial lag effects preclude full analysis at present. Hence, the discussions of the impact should be taken as indicative. For a better appreciation of the issues, a summary of the expected short- and medium-term impact of the various policies is presented in Table 7.

A. *Policy Reforms*

1. Interest Rate Policy

Interest rates on deposits and loans of various maturities and rediscounts have been largely market-determined since 1983. In addition, a uniform rediscount rate aligned with the market rate now applies. It is based on the Manila Reference Rate (MRR) 90 which is a weighted average of the interest rates on promissory notes and time deposits with a 90-day maturity. The rate is regularly re-evaluated and, if necessary, adjusted quarterly. From a largely allocative function, the CB rediscount window now performs a liquidity function. Prior to deregulation of interest rates, banks circumvented the ceiling by passing it on as additional charges and fees.

The Philippine experience in financial liberalization indicates mixed results. Following deregulation, interest rates on loans and deposits increased. The higher interest rates on deposits and borrowed funds, induced by the financial reforms and the low returns on loans and investment carried over by the period of repressed interest rates, combined to put a squeeze on bank profits. This made banks more vulnerable to the balance-of-payment crisis that contributed to financial stress. Moreover, the increase in interest rates on new loans contracted during the crisis period was not enough to compensate for the loss incurred on medium-and long-term loans contracted in the previous period, not to mention losses due to numerous defaults (Remolona and Lamberte 1986).

Table 7 Short- and Medium-Term Impact of Existing Monetary, Credit and Banking Policies

Policy	Short-Run Impact	Long-Run Impact
1. Interest rate deregulation	Increase in interest rate with the lifting of controls	Greater transparency and deepening of the financial market because of: Increased savings mobilization/increased incentive to invest in financial assets, reduction of non-price credit rationing Improved bank intermediation and efficiency, better portfolio return and risk Improved economic efficiency through the quantity but also through the quality and productivity of investments
2. Overvalued exchange rate	Distorts relative prices and penalizes the export sector	Undermines the development of the export sector Consequent high and volatile interest rates undermine the development of capital market
3. High reserve requirement	High interest rate to end-users due to increased intermediation cost of banks Lower intermediation level	Underdevelopment/contraction of the real size of the banking system. This has unfavorable effect on economic growth via the quantity investment.
4. Gross receipt tax	Increase in bank's cost of lending resulting in higher borrowing cost	Affects economic growth via quantity of investments Increase in off-balance sheet activities of banks
5. Agri-agra	Increase in banks' cost of lending resulting in higher borrowing cost	Distorts banks' loan portfolio which results in allocative inefficiency.
6. Deposit retention scheme	Higher borrowing cost	Affects the quality of banks' portfolio and hence banking efficiency.
7. Witholding tax on interest income	Reduces banks' return Disincentive on savings	Makes monitoring of the banking system more difficult to the extent that bank try to circumvent it by investing excess funds in tax exempt instruments regardless of actual liquidity needs.

Table 7 continued

II.	Institutional reforms		
8.	Transfer of CB's management of special lending programs	Greater focus and attention on CB's traditional stabilization function and closer supervision of the banking system. Removes the burden of carrying present and future losses of these programs from its books.	Contributes to more stable financial system
9.	Bank supervision and regulation		
9.1	Expanded coverage of Single Borrower's Limit	Minimizes risk exposure of banks Prevents/minimizes insider abuse	More stable banking system
9.2	DOSRI	Minimizes insider abuse and conflict-of-interest	More stable banking system
9.3	Expanded audit and reporting requirement	Early detection of possible violations Strengthens CB's supervisory function	More stable banking system
9.4	Higher capitalization requirement	Enables banks to generate more volume of business Enhances bank stability	More stable banking system
9.5	Liberalized bank entry and Expansion	Improved access to banking services	Development of the financial market because of enhanced competition and efficiency of the banking system
10.	Strengthening of the PDIC	Enhanced depositors' confidence in the banking system	More stable banking system
11.	Rehabilitation and eventual privatization of DBP and PNB	Restore financial viability of PNB and DBP to reduce continued budgetary losses of NG and make them attractive for privatization	Development of market for long-term paper Reduce government participation in the banking system
12.	Rehabilitation of rural banks	Strengthens RBs to resume lending to rural areas	Development of a leaner but financially viable rural financial system
13.	Phase-out and consolidation of agricultural credit programs into the CALF	Reduce distortion and financial losses from subsidized operations by nonfinancial government institution	More efficient management of credit programs Enhance financial discipline of borrowers Induce bank lending to agriculture through the reduction of lending risk

Within the RB system, a significant segment was able to respond, adjust and perform satisfactorily under the new financial environment. For the majority, deregulation of interest rates improved their intermediation levels and enhanced their competitive efficiency in terms of narrowing differential interest spreads. The liberalization also stabilized their portfolio returns and risk. The risk-efficient portfolios of RBs were found to have better diversified portfolio between loans and non-loan assets, with lower exposure to high-risk agricultural loans and higher deposit mobilization after deregulation (Corales 1990). Since the change in the rediscounting policy of the CB, RBs have increasingly relied on deposits as shown by the consistent rise in their deposits (Table 6). This despite the fact that many RBs were closed by the CB after 1986.

However, while deregulation of interest rates has provided greater yield to financial savers, it has been argued that it was not strongly associated with increases in the real savings deposit liabilities of RBs in the rural areas. More than the interest rate, real income was found to have significantly influenced real savings deposit (Quiñones 1990).

Note, however, that while interest rates are not regulated, the structure of interest rates belies claims that the underlying market structure is competitive. Very large differentials exist between types of deposits and types of loans, and between lending rates of banks and the rediscount rate of the CB. In 1990, the interest differential between savings deposits and lending rates on secured loans for all maturities was about 19 percent. On the other hand, the corresponding interest differential between time deposits and secured loans was four percent, while that between the rediscount rate and time deposit was six percent.

Tan (1989) observed that these differentials were much higher than in other Asian countries. She argued that these were probably the result of price (interest rate) discrimination behavior of big banks under a monopolistic banking structure. Banks are likely to discriminate between two distinguishable groups of depositors -- the small, less-informed surplus units and the affluent and financially sophisticated surplus units with more elastic supply of funds. The differential between rediscount rate and bank deposits has important implications for financial development. Since banks blend their funds, the actual gross margin that banks realize is actually much higher than the simple difference between the two rates. This subsidy element deserves appropriate attention by the CB. It transmits a potentially distorted signal by encouraging banks to source their funds from the rediscounting window, instead of mobilizing deposits from the public. It has also been pointed out that banks can take advantage of this differential to profit out of CB operations (San Jose 1990). A rediscount rate that is lower than CB's open market instruments could induce banks to borrow from the rediscount facility and invest in government securities, thereby making a profit.

Over the long haul, deregulation is expected to bring about more transparency in the system and the eventual deepening of the financial market. Accumulated evidence indicates that financial repression results in the underdevelopment of the financial market. Under a regime of interest rate controls, depositors have no incentive to invest in financial assets since their value deteriorates with inflation. Surplus units would rather prefer to invest in real properties and other inflation hedges which appreciate in value. With lower intermediation, the rate of investment in the economy is reduced, thereby stifling economic growth. Interest rate controls also affect economic efficiency through the quantity, quality, and productivity of investments, as projects with low rates of return are made artificially viable by the ceiling. These compete and crowd out other higher-yielding projects.

Countries with positive real interest rates had considerably higher rates of growth than those of the others (Table 8). Their overall output grew almost three times faster on the average than in countries with negative rates. However, many of the countries with positive real interest rates had more stable macroeconomic policies and more open trading systems which contributed to their high growth rates.

2. Exchange Rate Policy

In managing the exchange rate, the CB has followed an "independent float" system since 1984. The scheme allows KBs under the jurisdiction of the Bankers Association of the Philippines (BAP) to trade among themselves. However, the CB from time to time acts as an active buyer or seller on the trading floor to prevent wide fluctuations in the exchange rate. Invariably, in the face of persistent imbalance in the trade account, the CB has resorted to the use of interest rate policy to defend the value of the domestic currency. This has contributed to high and volatile movements in interest rates, and is viewed as an implicit penalty or tax on exporters because the resulting overvaluation of the currency makes Philippine exports more expensive.

The policy has also serious implications for financial market development. High domestic interest rates translate into high inflation and erodes the real value of financial assets, leading to lower levels of intermediation. On the other hand, volatile movements in interest rates discourage savers from investing in long-term deposit instruments or securities. As a result, banks have found it hard to mobilize and consequently lend term funds. Term transformation has not been accomplished to a significant degree because banks have been unwilling to assume liquidity risk. This has resulted in a situation where the main sources of medium- and long-term financing have been government-directed credit programs, i.e., the Industrial Guarantee and Loan Fund (IGLF) and Apex Financing Program for Industry, and the Agricultural Loan Fund (ALF)/Countryside Loan Fund (CLF) for agriculture.

3. Monetary Management

As part of its monetary instruments, the CB every now and then makes adjustments on the reserve ratio to influence the level of money supply. Although reserve requirements across bank types have become more standardized, reserve requirements have been on the uptrend. Since 1986, required reserves have been adjusted several times from both directions. By the end of 1990, reserve requirement for KBs reached their high point of 25 percent. Nonetheless, RBs and TBs continue to receive preferential treatment vis-a-vis KBs (Table 9). This preferential treatment aims to offset the continued flow of financial resources from the rural areas to the urban areas, and the high cost of lending to the rural sector as a result of risk and high administrative cost. Despite such measure, formal lending to agriculture and rural enterprises has remained low. Moreover, outflow of funds from the rural sector has persisted. Thus it is debatable if financial market instruments are the approriate mechanisms for addressing project risks which are non-financial in origin.

The adoption of a high reserve requirement as the CB's principal tool for monetary management deserves qualification, because of the trade-off between the need to stabilize the economy and the effects on bank intermediation cost. Aside from being blunt monetary instruments, reserve requirements are an implicit tax on financial intermediation. The tax arises because of the

Table 8. GROWTH RATES AND OTHER ECONOMIC INDICATORS FOR COUNTRY GROUPS WITH POSITIVE MODERATELY NEGATIVE AND STRONGLY NEGATIVE REAL INTEREST RATES 1965-73 AND 1974-85, AVERAGE PERCENT

	1965-73			1974-85		
		Negative			Negative	
Indicator	Positive	Moderately	Strongly	Positive	Moderately	Strongly
Real Interest Rate	3.7	-3.7	-13.7	3.0	-2.4	-13.0
GDP Growth Rate	7.3	5.5	4.6	5.6	3.8	1.9
M3/GDP	28.9	27.0	29.1	40.3	34.0	30.5
Investment/GDP	21.4	19.7	21.4	26.9	23.2	23.0
Change in GDP/Investment	36.7	31.1	21.7	22.7	17.3	6.2
Change in Real M3/Real Saving	18.7	12.7	6.4	16.6	8.2	-0.9
Inflation Rate	22.2	7.1	40.2	20.8	23.9	50.3
Volatility of Inflation Rate	17.1	5.3	27.2	12.2	9.1	23.5

Note: Real interest rates were calculated from nominal rates according to the following formula: [(1+r)/(1+p)-1]x 100, where r is the deposit rate and p is the inflation rate. Inflation is the percentage change in the consumer price index (CPI). M3 is currency plus the sum of non-bank deposits of the public at all identified deposit-taking institutions. Real saving is gross domestic savings deflated by the average annual CPI rate. Volatility of inflation is the absolute deviation of the inflation rate from its level the year before. Source: Gelb (Background Paper).

Source: World Development Report, 1989.

Table 9. YEAR-END RESERVE REQUIREMENT RATIOS ON DEPOSITS AND DEPOSIT SUBSTITUTES, BY BANK TYPE

CIRCULAR NO./DATE	YEAR	DEMAND	SAVINGS	NOW ACCOUNTS	TIME DEPOSITS		DEPOSIT SUBSTITUTES	
					<730 days	>730 days	<730 days	>730 days
A. COMMERCIAL BANKS								
752/August 22, 1980	1980	20	20	20	20	20	20	20
782/February 27, 1981	1981	16	16	16	16	5	18	18
908/December 29, 1982	1982	18	18	18	18	1	18	18
945/October 1, 1983	1983	18	18	18	18	5	20	18
1002/April 17, 1984	1984	24	24	24	24	6	24	6
1079/October 3, 1985	1985	23	23	23	23	6	24	6
1122/November 28, 1986	1986	21	21	21	21	5	21	5
	1987	21	21	21	21	5	21	5
	1988	21	21	21	21	5	21	5
1209/ November 5, 1989	1989	20	20	20	20	20	20	20
1269/December 28, 1990	1990	25	25	25	25	25	25	25
	1991	25	25	25	25	25	25	25
B. THRIFT BANKS								
752/August 22, 1980	1980	20	8	12	8	8	20	20
782/ February 27, 1981	1981	16	8	12	8	5	18	18
908/December 29, 1982	1982	18	8	12	8	1	18	18
945/October 1, 1983	1983	18	8	12	8	5	20	18
1002/April 17, 1984	1984	24	14	18	14	6	24	6
1079/October 3, 1985	1985	24	14	18	14	6	23	6
1122/November 28, 1986	1986	21	14	18	14	5	21	5
	1987	21	14	18	14	5	21	5
	1988	21	14	18	14	5	21	5
1209/ November 5, 1989	1989	20	14	18	14	20	20	20
1269/December 28, 1990	1990	23	17	23	17	21	23	23
	1991	25	19	25	19	23	25	25
C. RURAL BANKS a/								
752/December 31, 1980	1980	15.5	8	12	8	8		
752/September 30, 1981	1981	20	8	12	8	8		
782/January 1, 1982	1982	16	8	12	8	5		
945/October 1, 1983	1983	16	8	12	8	5		
1002/April 17, 1984	1984	22	14	18	14	6		
	1985	22	14	18	14	6		
1122/November 28, 1986	1986	21	14	18	14	5		
	1987	21	14	18	14	5		
	1988	21	14	18	14	5		
1209/ November 5, 1989	1989	20	14	18	20	20		
1261/November 30, 1990	1990	23	14	23	14	14		
	1991	23	14	23	14	14		

a/ RBs have no deposit substitutes.
Source: Various Central Bank Circulars.

reduction in loanable funds that is available to banks and the low remuneration (4%) paid on these reserves which is much lower than the market interest rate. Since banks have to pay interest on their deposit liabilities, banks recoup the foregone income on the reserves by increasing their lending rates.

It must be qualified that while the CB has two other monetary policy instruments at its disposal, namely the discount rate and open market operations, their use is hampered by limitations on their efficacy in achieving the desired level of monetary targets and by the associated implications for CB's income position. In the case of the discount rate, while CB sets the rate and terms of access to the discount window, borrowing is initiated by banks and is therefore under their direct control.

In the case of open market operations, the market for government securities is thin, largely confined to 18 or so accredited dealers. More importantly, however, CB is severely constrained in issuing its own bill as this would significantly increase its already huge accumulated losses. Instead, what has actually been done is for the national government (NG) to issue Treasury Bills (T-bills) in excess of its funding requirements and deposit the excess with CB to enable the latter to conduct monetary policy. These considerations have left CB with reserve requirements as its only effective tool with which to conduct monetary policy.

4. Taxation of Financial Intermediaries and Depositors

Another important factor that affects the development of the financial sector is the fiscal or tax regime and incentives imposed on financial intermediaries. Like many countries, the Philippines collects special taxes from financial intermediaries. The most important of these are the gross receipt tax (GRT) and the implicit tax in the form of reserve requirement ratio which was already discussed earlier. On the depositor side, a 20 percent tax levied on income from deposits also increases the intermediation cost.

The GRT is imposed on all receipts of a bank. Formerly applied at a uniform rate, it is now imposed on a sliding scale, with a rate of five percent for instruments of less than two years maturity. Since the GRT is directly related to interest income, it is not a stable source of revenue because it is subject to fluctuations in interest rate. As with the reserve requirement, the GRT increases the cost of intermediation which is passed on to borrowers in the form of higher lending rates. In addition, the imposition of the GRT also causes distortions in the financial system. It is suspected that efforts of banks at evading this have led to an increase in trust accounts in an attempt to undertake normal banking functions on an off-balance sheet basis (World Bank 1988). Trust account activities in turn have important effects on the banking system, in particular, the KB system because of their effects on bank solvency and liquidity (Zingapan et al. 1990).

The agri-agra lending requirement is another implicit tax on intermediation. The law mandates banks to set aside 25 percent of their loan portfolio to agricultural lending. Out of this, 10 percent should be alloted for agrarian reform beneficiaries (ARBs) and the other 15 percent for general agricultural lending. Because of the liberal coverage of what is considered as agricultural, banks have generally complied with this. However, for the agra component, compliance has been largely through the purchase of reserve eligible government securities which are paid below market rates. To recover the opportunity cost banks pass this on to borrowers.

Another implicit tax is the required loans-to-deposit ratio or the deposit retention scheme. The scheme requires banks to invest in the same regional grouping at least 75 percent of their total deposits net of required reserves and provision for till money. Although some relaxation in the implementation of this scheme has been effected since 1988, the provision contains a distortion since it narrows the area by which banks can lend. Such restriction prevents banks from exploiting better investment opportunities which may not be available in the same geographical area. This affects the quality of their portfolio and the cost of their operations, and is translated into higher borrowing cost.

Finally, a witholding tax on deposit interest income, which is levied at the rate of 20 percent, also creates distortions. Although it is a credit against income tax, it is not refundable if the computed income tax liability falls short of the amount withheld. Since banks are often in a position where their computed income tax liability is less than the witholding tax collected from them, this causes distortions. Given that the tax is applicable to interbank deposits with maturity of more than seven days, banks evade this by investing their excess funds in short-term deposits of less than seven days on a roll-over basis, regardless of their actual liquidity needs. Such practice makes monitoring of the banking system more difficult to the extent that it might lead to overstatement of actual liquidity in the system (World Bank 1988).

Despite vigorous objections, their repeal or abolition has yet to be effected. On the contrary, a similar loan quota provision made its way in a recently enacted law, the Magna Carta for Small Enterprises (R.A. 6977). Among other things, R.A. 6977 mandates banks to set aside at least five percent of their loan portfolio to small enterprises by the end of the first year of the effectivity of the law, 10 percent from the second to the fifth year, five percent on the sixth year and declining thereafter.

In general, these taxes have led to high intermediation margins and costs among Philippine banks. World Bank estimates indicate an average intermediation cost (AIC) of 7-10 percent during 1983-86. An analysis of the components of this cost showed that in 1986, intermediation taxes (20% Final Tax and GRT) comprised 25 percent of average intermediation cost. Reserves and agri-agra compliance, on the other hand, contributed about 20 percent of AIC (Table 10). Given the negative impact of these instruments on the financial system, there is a strong case for their immediate repeal or phase-out.

B. Institutional Reforms

A number of important institutional reforms in the financial system have been implemented since 1986. Some of these reforms were aimed at increasing the efficiency of the financial system in general, while others were sector-specific. These reforms undertaken by the executive branch of the government are discussed in the following section.

1. Role of the Central Bank in Credit Allocation

The CB performed its allocative function through its rediscount window and the management of special lending programs for agriculture and industry. Starting in 1986, substantial progress was made in moving the CB out of developmental banking into its traditional role of monetary management. With the creation of the Agricultural Credit Policy Council (ACPC) and the

Table 10. COMPONENTS OF THE AVERAGE INTERMEDIATION COST (AIC)
1983-1986, IN PERCENT

Item	1983	1984	1985	1986
TAXES	2.75	3.59	3.13	2.19
	----	----	----	----
20% Final Tax	2.00	2.60	2.19	1.46
5% Gross Receipts Tax	0.75	0.99	0.94	0.73
RESERVES AND AGRI-AGRA	2.65	3.82	3.02	1.60
BANK MARGIN	1.59	1.90	3.92	4.97
TOTAL	6.99	9.31	10.07	8.76
	====	====	=====	====

Source: World Bank Financial Sector Review, 1988.

Comprehensive Agricultural Loan Fund (CALF) in 1986, most of the agricultural lending programs implemented by the Department of Agriculture were consolidated into the CALF. Other programs transferred were the Agricultural Loan Fund (ALF) to the LBP, the Apex Financing Program (APEX) and the Industrial Guarantee and Loan Fund (IGLF) to the DBP.

This move was in the right direction. With the gradual transfer of these programs to other government financial institutions (GFIs), the CB is freed of these functions and enabled to deploy additional personnel to attend to other functions. This allows the CB to focus on its more fundamental mandate of providing timely examination and closer supervision of the banking system. Over the long haul, this is expected to contribute to a more stable financial system by enabling early detection of fraud and insider abuse, which have been identified as the main causes of the rash of bank failures in the recent past.

2. The CB's Role in Bank Supervision and Regulation

Likewise, major initiatives and reforms have been implemented to strengthen the CB's supervision and regulation of the banking system. These were deemed necessary in the light of the numerous bank failures and financial stresses during the 1980s. Changes effected in these areas covered the following: (a) policies on prudential banking restrictions; (b) imposition of penalties and sanctions; (c) supervisory procedures; and (d) policies on the establishment of new banks and branches. Policies affecting prudential bank management include, among others, minimum capitalization requirement, compliance with the minimum risk-asset ratio, the single borrower's limit (SBL), limits on loans to directors, officers, stockholders and related interests (DOSRI), allowable interlocking directorships and officerships, and provisions for loan loss or doubtful accounts.

Table 11 summarizes the various changes in banking regulations from 1986 to 1991. Some of the more significant changes are discussed below.

Single Borrower's Limit. In the wake of several bank failures, the CB instituted a number of measures to strengthen the banking system. One of these measures was the expansion of the coverage of the single borrower's limit. The new provision requires the inclusion of contingent liabilities in determining the limit to which banks can lend to a single borrower or a group of affiliated borrowers. The regulation limits the aggregate ceiling of guarantee oustanding to 50 percent of a bank's unimpaired capital and surplus standby letters of credit, foreign and domestic, including guarantees except those fully secured by cash, hold-out deposit/deposit substitutes or government securities. For NBFIs, the ceiling must not exceed 50 percent of their net worth. These changes were instituted to prevent insider abuse, which was one of the major causes of bank failures, and to protect banks, particularly government banks, which in the past had overextended lending to politically favored groups.

DOSRI Loans/Interlocking Directorship. To closely monitor loans to directors, officers, stockholders and related interests (DOSRI), the CB requires that loan documents include a depositor's waiver of his right under the existing law of confidentiality of deposits, in case he obtains a loan secured by hold-outs or assignment of deposits. Complementary regulations on interlocking directorships and officerships were also instituted. Under the revised rules, no concurrent directorships or officerships of a bank and an NBFI or of two banks in which majority interest is

Table 11: SUMMARY OF CHANGES IN CENTRAL BANK REGULATIONS, 1986-1991

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1093	Feb. 26, 1986	Requiring RBs to post within their premises a copy of their quarterly Statement of Condition.	
1104	May 26, 1986		Reducing required reserve from 23% to 22 % against KBs: demand deposit savings deposit NOW accounts time deposit (730 days or less) deposit substitutes (730 days or less) TBs: demand deposit deposit substitutes (730 days or less) NBFIs: deposit substitute (730 days or less)
1112	August 4, 1986		Reducing further the required reserves from 22% to 21% for the same accounts stated in Circular 1104
1113	August 14, 1986	Prohibiting banks to rediscount loans granted from Special Time Deposits (STDs) provided by the government for the Gulayan sa Kaunlaran Program.	
1114	September 1, 1986	Setting the loan value of 80% and rediscount rate of 11.75% p.a. for the rediscount facility of the CB for eligible papers in agricultural production, cottage and small industries credit, general purpose working capital financing and other short-term credits.	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1115	September 16, 1986	Prohibiting concurrent officerships between banks or between a bank and a non-bank financial intermediary except with prior approval of the Monetary Board.	
1119	October 18. 1986	Requiring all banking institutions, including banks with expanded commercial banking authority to maintain a 21% reserve against deposit substitute liabilities with original maturities of 730 days or less, except short-term borrowings from banks and non-bank financial institutions for which the reserve requirement shall be 1%. A 6% reserve against deposit substitute liabilities with original maturities of more than 730 days for NBQBs shall also be maintained.	
1122	November 23, 1986		Reducing the required reserves for time deposits from 6% to 5% for all banking institutions (i.e., KBs, Thrift banks, RBs) and non-banks financial intermediaries. Likewise, required reserves against deposit substitute liabilities with original maturities of more tha 730 days is reduced from 6% to 5%.
1123	December 5, 1986	Provides for the inclusion in the determination of the single borrower's loan limit under Section 23 of R.A. 337 the outstanding foreign and domestic standby and deferred letters of credit less marginal deposits and outstanding guarantees, except those fully secured by cash, hold-out on deposits/deposit substitute or government securities. Likewise, aggregate ceiling on issuance of guarantees is provided whereby a bank may not issue more than 50% of its unimpaired capital and surplus standby letters of credit foreign	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
		and domestic, including guarantees, except those fully secured by cash, hold-out on deposits/deposit substitutes or government securities. For NBQBs, it must not exceed 50% of their networth.	
1124	December 5, 1986	Requring each bank to cause an annual financial audit to be conducted by an external independent auditor not later than 30 days after the close of the calendar year and reports of such audit shall be sbumitted to the CB not later than 90 days after the start of the audit.	
1125	December 15, 1986		Reducing the rediscount rate to 10% p.a. from 11.75% p.a. As previously provided in Circular 1114 for the same eligible papers.
1133	February 9, 1987		Exemptions from legal reserve requirement special time deposits and deposit substitutes arising from the lending operations of IGLF and ALF.
1135	February 23, 1987	Requiring the lending bank to keep a complete record of all pertinent loan documents which shall be made available for inspection and/or examination by the CB.	
1143	April 24, 1987	Setting the guidelines for the rehabilitation of rural banks through a capital build-up consisting of a pre-requisite fresh capital infusion and a subsequent conversion and/or plan of payment of all arrearages with the Central Bank which are past due and unpaid as of Dec. 31, 1986.	
1147	June 19, 1987	Prohibiting the account of interest incomes of the loans or loan installments which have matured or have become past due. Also interest	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
		income shall not be accrued for unmatured loans/receivables with indications (i.e., bankruptcy, insolvency, cessation of operations, or such other conditions of financial difficulties to meet financial obligations as they mature) that collectibility has become doubtful. Accrued interest earned but not yet collected shall not be considered as profits and/or earnings eligible or dividend declarations and/or profit sharing purposes.	
1151	Aug. 27, 1987	Provides that ALF facility may be extended to finance both seasonal production credit and medium- and long-term subloans for fixed assets and permanent working capital, except for the acquisition of land. Likewise, the interest rate on the subsidiary loans shall be market-oriented. Different rates may be provided for production and longer-term credit.	
1158	Oct. 5, 1987	Amending Circular 1143 regarding the fresh capital infusion. In cases where capital infusion exceeds the amount of P500,000.00, the excess may be paid into the rural bank by its stockholders and investors in monthly installments, provided that the first installment on the fresh capital infusion shall not be less than the amount required to fulfill the minimum 18% risk asset ratio. Participating rural banks are not qualified to avail themselves of rediscounting unless the required capital infusion is completed.	
1166	Dec. 16, 1987	Requiring all banks and non-bank financial intermediaries to adopt the Statements of Financial Accounting Standards (SFAS) in their financial statements and reports to the CB which are purported to be prepared in accordance with generally accepted accounting principles.	
1172	March 29, 1988		With the exception of rural banks whose applications have already

Circular No.	Effectivity Date	Supervision/Control	Deregulation
			been approved under Circular 1143, as amended by Circular 1158, all rural banks with arrearages are eligible to participate under the program except those with serious irregularities based on examination findings of the CB, For rural banks with supervised credit arrearages where the required capital infusion exceeds the amount of ₱500,000, the excess may be covered by the RBs availing itself of the conversion scheme povided that the alternative should not be construed as preventing the stockholders, if they so desire for the interest of the rural bank, from infusing more than ₱500,000. A rural bank may have the option of sourcing the payments to the CB from its cash resources provided such option will not reduce the liquid funds necessary to meet the deposit reserve requirements and day-to-day operations of the bank.
1183	September 15, 1988		Requiring branches, agencies, extension offices, etc., and/or head offices of commercial banks, and specialized government banks in a particular regional grouping outside the National Capital Region to invest therein, as a means to develop that region, 75% of total deposit liabilities and provisions for 'till money,' 'Deposits' shall exclude: (1) government deposits subject to 75% liquidity floor requirement (2) deposit of banks maintained for clearing purposes in areas where there are no CB clearing units. However, the twelve regional groups have been reduced to three enlarged groupings namely Luzon, Visayas and Mindanao. The enlarged groupings shall be used

Circular No.	Effectivity Date	Supervision/Control	Deregulation
			for purposes of determining the regional retention of deposits. This policy shall be deemed complied with if, in a particular region, the bank's lending for the financing of agricultural and export industries aggregated 60% of its deposits.
1188	October 28, 1988		Eliminating the pre-requisite investment in government securities for purposes of establishing/opening branches and other banking offices by banks.
1191	November 23, 1988	Provides for the formulation and monitoring of the "new Manila Reference Rates (MRRs) which will be based on the weighted average of the interest rates paid during the immediately preceeding week by 10 commercial banks with the highest combined levels of outstanding deposit substitutes and time deposits on promissory notes issued and time deposits received by these banks, of P100,000 and over per transaction account, with maturities corresponding to the interest periods for which such reference rates are being determined.	
1203	May 16, 1989	The CB shall therefore refrain from sustaining weak banks except in times of general financial emergency or when specific banks face problems of liquidity rather than of solvency. There is no bar to granting new licenses and accordingly, the establishment of new banks in the future shall be allowed, with the CB determining the qualifications such as but not limited to compliance with all requirements of existing laws, capitalization, direction and administration as well as the integrity and responsibility of the organizers and administrators.	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
		The CB has lifted the requirement to purchase special five-year government securities as a condition to open new branches. In rural areas that are classified under categories IV and V, all restrictions on opening new branches are hereby removed. In urban and particularly metropolitan areas, the Central Bank shall retain its discretionary policy on branching, but allow a bank to open a new branch as long as the bank's market share in that area would not create any market concentration problems.	
1204	June 23, 1989	Raising the reserve requirement on deposit liabilities and deposit substitutes with original maturities of more than 730 days from 5% to 7 % for all financial institutions (i.e., KBs, thrift banks, and rural banks) including non-bank financial intermediaries.	
1207	August 4, 1989	Raising the reserve requirement on deposit liabilities and deposit substitutes with original maturities of more than 730 days from 7% to 9% for all financial institutions including NBFIs	
1209	September 1, 1989	Increasing on a staggered basis the reserve requirement on deposit and deposit substitute liabilities with original maturities of more than 730 days from 9% to 20% for all financial institutions including NBFIS Reducing on a staggered basis the reserve requirement on deposit and deposit substitute liabilities with original maturities of less than 730 days from 21% to 20%	
1222	January 19, 1990	Sets up the criteria in the establishment of a monitoring and review system in the management of the banks' loan portfolio and other risk assets to ensure that adequate loss reserves are kept sufficient to absorb the loss inherent in these accounts	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1223	January 19, 1990	Allows banks full discretion in the restructuring of their loans (including DOSRI) to provide flexibility in arranging the repayment of such loans without impairing the financial interests of banks but such arrangements should not include loans sourced partly or wholly from foreign currency obligations	
1226	January 31, 1990		Requiring at least 75% of total deposits of KBs and TBs, net of required reserves against deposit liabilities and total amount in vault accumulated in a particular regional grouping outside the NCR be invested therein as a means to develop the region. Deposits shall include TCDs Special Financing but shall exclude (a) government deposits subject to 75% liquidity floor; (b) FCDU deposits; and (c) deposits of banks maintained for clearing purposes in areas where there are no CB clearing units while loans exclude FCDU loans Gives banks an additional 18 months from Dec. 31, 1989 within which to comply with the prescribed ratio under the following schedule: MINIMUM RATIO — TARGET DATE 25% — March 31, 1990 50% — June 30, 1990 62.5% — December 31, 1990 75.0% — June 30, 1991
1229	February 19, 1990	Setting the loan value of 80% and rediscount rate of 13% p.a. for the rediscount facility of the CB for eligible papers in agricultural production, cottage and small industries credits, general purpose working capital financing and other short-term credits	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1233	March 21, 1990	Increasing the reserve requirement on all types of deposits of KBs and NBFIs and on demand deposits, long-term time deposits and deposit substitute liabilities of TBs from 20% to 21% Raising the reserve requirement on savings deposit and short-term deposit liabilities of TBs from 14% to 15% and by 1% point every month to reach 21%	
1234	April 6, 1990		Allowinng KBs and TBs to enter into without recourse transactions involving commercial papers of any maturities provided that these commercial papers are registered with the SEC
1236	April 27, 1990	The broad category of undertakings in which EKB may invest indirectly or through its wholly or majority-owned subsidiary needs prior MB approval, investments shall be allowed in enterprises engaged in agriculture, mining and quarrying, manufacturing, wholesale trade and community and social services following the industrial groups in the 1977 Philippine Standard Industrial Classification (PSIC)	
1237	May 7, 1990	Expanding the allied financial undertakings in which EKBs may invest to include companies engaged in stock brokerage/securities dealer/broker	
1238	May 28, 1990	Temporarily pegs the required reserves against savings and time deposits with original maturities of 730 days or less of TBs at 17%	
1239	May 30, 1990	Allowing TBs with minimum paid-in capital of P20 million to issue Negotiable Order of Withdrawal (NOW)	
1240	May 30, 1990	Allowing TBs with minimum paid-in capital of P50 million to accept foreign currency deposits; those which cannot qualify may apply as foreign exchange agents	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1241	June 19, 1990	Limiting investment of RBs in fixed assets to 50% of networth, excluding government counterpart capital/ investment (both common and preferred shares)	
1242	June 20, 1990	Exempting from the reserve requirements the deposit substitutes againt funds deposited for projects under the special financing program of the government and/or international financial institutions except STDs and deposit substitutes arising from the lending operations of the IGLF, ALF, Apex Financing Program & Industrial Investment Credit Project (IICP) funds, provided the benefits of the exemption from the reserve requirement are shared with the ultimate borrowers/users of these funds	
1243	June 21, 1990	Considering portions of peso loans covered by guarantees of international/regional institutions where the Philippine Government is a member/stockholder such as IFC/ADB as non-risk assets exempting these from the computation of a local KB's single borrower's loan limit	
1244	June 29, 1990		Authorizing banks including Philippine branches of foreign banks to establish off-site. ATMs subject to the following conditions: a. A prior authority from the CB needed b. Off-site ATMs are to be installed only in centers of activities like shopping centers, supermarkets, hospitals, university campuses, provided that the site is within the service area where the applicant banks has a regular branch and adequate control measures are adopted and submitted to the CB

Circular No.	Effectivity Date	Supervision/Control	Deregulation
			c. Services offered are limited to: withdrawal from deposit accounts, deposit balance inquiry, transfer of funds from one deposit account to another deposit account maintained within the same bank, cash advance on credit card, request for checkbook, request for cut-off statement d. General compliance with laws, rules and regulations of applicant banks
1245	June 29, 1990	Providing the requirements for credit accommodation of unsecured loans for KBs, TBs and NBFIs such as: a. xeroxed copy of the latest income tax returns of the borrower and his co-maker duly stamped as received by the BIR b. a copy of the borrower's balance sheet duly certified by an independent CPA if credit accommodation exceeds P500,000 and if borrower is engaged in business, a copy of profit and loss statement duly certified by a CPA Granting of credit accommodations against personal security only in the amounts and for the periods of time essential for the completion of the operations to be financed justified by the financial statements or feasibility/project studies submitted	
1246	July 24, 1990	Approving the request of the SSS that borrowings of participating PFIs under its "Kabalikat sa Pagpapaunlad ng Industriya" are not subject to legal reserves against deposit subtitute nor to the liquidity floor requirements on borrowing from the government	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1252	September 14, 1990	Setting the loan value of 80% and rediscount rate of 14% p.a. under CB's rediscount facility for eligible papers in agricultural production, cottage and small industries credit, general purpose working capital financing and other short-term credits	
1253	September 18, 1990	Providing guidelines for the installation of automatic multi-currency moneychangers (AMCMC) by banks outside their premises such as: a. applicant bank needs prior authority from CB b. installation of AMCMC in centers of activities such as shopping centers, supermarkets, hotels, and airports; provided the site is within the service area where applicant bank has a regular branch and adequate internal control and security measures are adopted and submitted to CB c. transactions of AMCMC shall be booked in specific branches which must be identified at the time of application for the putting up of an AMCMC d. services of off-site AMCMC are limited to changing foreign exchange currency into peso notes and coins, not pesos to other foreign curriencies e. general compliance of applicant banks with banking rules, laws and regulations	
1254	September 27, 1990	Increasing minimum capital rquirements of TBs as follows: a. For existing TBs With HO in MM - P20M With HO outside MM - P10M	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
		Those which cannot comply shall submit within 6 months from September 23, 1990, a plan by which to increase their capitalization within 2 years b. For TBs to be established With HO in MM - P100M With HO outside MM - P 20M	
1255	October 12, 1990		Allowing RBs to impose penalty on past due loans of their borrowers provided the latter's failure to pay their loans on time is due to inexcusable neglect and that the penalty shall be reasonable and not unconscionable
1257	October 23, 1990		Exempting borrowings of financial institutions' from the GSIS arising from their participation in its Industrial and Commercial Lending Program
1260	October 30, 1990	Setting the loan value of 80% and rediscount rate at 14% p.a. under CB's rediscount facility for eligible papers in agricultural production, cottage and small industries credits, general purpose working capital financing and other short-term credits, provided loan value for export credits shall be 100%	
1261	November 9, 1990	Increasing the reserve requirement on all types of deposits of KBs and non-banks with quasi-banking functions; on demand deposits, NOW accounts and deposit substitutes of TBs and on demand deposits and NOW accounts of RBs from 21% to 22% (effective Nov. 15, 1990) and to 23% (effective Nov. 30, 1990) Unifying the reserve requirement on savings and short and long-term time deposits of TBs and RBs at 17% and 14%, respectively.	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1264	November 8, 1990	Providing for the revised guidelines for the Organization of Cooperative Banks.	
1276	March 5, 1991	Exempting from the reserve requirements special time deposits of financial institutions under the special financing programs of the government and/or international financial institutions being or previously administered by the CB and limited to the following programs: (a) CB - Department of Education, Culture and Sports (CB-DECS) (b) Palawan Integrated Area Development Project (c) Agricultural Guarantee and Loan Fund - National Food and Agriculture Council (AGLF-NFAC) (d) Republic Act No. 3690 (RA 3690) (e) Local Counterpart - Bureau of Treasury (LC-BT) (f) Ministry of Agrarian Reform - Central Project Management Unit (MAR_CPMU) (g) Philippine Aquaculture Developpment Fund (PADF) (h) Comprehensive Agricultural Loan Fund (CALF) (i) Cooperative Marketing Program (CMP)	
1280	April 15, 1991		Providing for the revised rules and regulations governing the establishment of branches of RBs as follows : (a) RBs with unimpaired capital of ₱10 M or more, net of government equity, may establish branches in any region, except in the NCR and in the cities of Cebu and Davao.

Circular No.	Effectivity Date	Supervision/Control	Deregulation
			(b) RBs with unimpaired capital of less than ₱10 M net of government equity, may establish branches in the region where the head office is located, except in the NCR and in the cities of Cebu and Davao. RBs in the NCR may establish branches only in Region III and IV while RBs in Cebu City and Davao City may branch out only within their respective regions but outside said cities. (c) Bidding requirements imposed in KBs and TBs shall not apply to RBs. (d) Applicant banks must comply with general banking rules and regulations. (e) Approved branch shall be opened within six months from the date of receipt of notice of approval of application.
1281	April 15, 1991		o Allowing KBs and TBs to bid for franchise in the establishment of branches and setting the minimum bids as follows: AREA — AMOUNT NCR, Cebu City and Davao City — ₱4.0 million 1st class cities and municipalities — 2.0 million other areas — NONE o Declassifying the service area based on the classification of provinces, municipalities and cities by the NSO.

Circular No.	Effectivity Date	Supervision/Control	Deregulation
			o Limiting the member of awarded bids for which no branch/banking office has been opened as yet to 10 for each at any given time.
1286	May 23, 1991		o Lifting the condition that off-site automated teller machine (ATMs) may be opened only in the service areas where a bank has an existing branch. o Deleting the requirements of prior CB approval for the establishment of ATMs, provided banks submit a report to the Supervision and Examination Sector of the CB on ATMs which they establish
1288	June 4, 1991	o Requiring all banks to set aside a portion of their total loan portfolio based on their Consolidated Statement of Condition/Balance Sheet and make it available for small enterprise credit. The portion mandated to be so set aside shall be as follows : 5% by December 31, 1991 10% by December 31, 1992 through December 31, 1995 5% by December 31, 1996 0% by December 31, 1997	
1289	June 6, 1991	o Inclusion of insurance companies among the non-allied financial undertakings eligible for investment by EKBs, provided that no DOSRIs shall hold or own more than 20% of the subscribed capital stock or equity of the investee insurance company.	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1290	June 17, 1991		Deleting the requirement of compliance with the loans to deposit ratio for 4 consecutive quarters as one of the conditions for the processing/approval of a bank's application to (a) qualify for branching privilege; (b) permit to operate new banking offices; and (c) to avail of CB credit facilities and other special financing programs managed by the CB, provided that at the time of application, applicant bank is in compliance with the prescribed ratio.
1294	July 9, 1991	o Raising the private capitalization of existing RBs to ₱1 million and complying with this in 4 equal semi-annual installments starting January 1, 1992, provided banks in the NCR and the cities of Cebu and Davao which will have changes in the majority ownership or control of the voting stocks should comply with requirements for new RBs of ₱20 M and ₱10, repectively. o Requiring new RBs to be established outside the NCR and the cities of Cebu and Davao to put up a minimum private paid-in capital of ₱2 million. o Requiring local cooperative banks to be established to have a minimum paid-in capital of ₱1.25 M as prescribed by the Cooperative Code of the Philippines. o Adopting a capital build-up program for existing CRBs with private paid-in capital contribution of less than ₱1.25 million and complying with this in 4 equal semi-annual installments starting January 1, 1992.	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1295	July 16, 1991	Providing for sanctions/penalties for exceeding the single borrower's limit as follows : (a) Monetary Penalties First Offense - ₱500/day from the day excess started up to date when excess was eliminated Subsequent Offense - ₱5000/day from date of violation (b) Other Sanctions First Offense - reprimand for the directors/officers who approved the availment with warning that subsequent violations shall be subject to more severe sanctions Subsequent Offense - suspension for 90 days for directors/ officers who approved the availment and suspension of bank from branching out and availment of CB rediscounting facilities until excess is eliminated.	
1296	July 16, 1991	o Requiring all KBs (whether existing or to be established, to have capital accounts of ₱750 million each. Requiring all EKBs (whether existing or to be established) to have capital accounts of at least ₱1.5 billion each Allowing banks which do not meet above requirements to submit within three months from date of approval of these policies a plan by which to increase their capitalization within a period of one year. Also, stipulates that CB shall review periodically the need for additional capital by all banks to assure their stability and widen their capability to serve the needs of the public	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1297	July 16, 1991	o Inclusion of insurance companies among the non-allied undertaking eligible for investment by EKBs; such investment by EKBs in any single enterprise should not exceed 35% of the total voting capital stock of that enterprise and that for the purpose of determining compliance with this ceiling, the equity holdings of the bank in the undertaking, when combined with those of its wholly or majority-owned subsidiaries shall not exceed 35% of the equity of that undertaking o Superseding CB Circular 1289, dated June 6, 1991.	
1303	August 22, 1991	o Exempting special time deposits of RBs and CRBs under the Multi-Livestock Dispersal Loan Program from the reserve requirement	
1304	August 21, 1991		o Reclassifying the following areas within the cities of Cebu and Davao under the category of "other areas" (for which no minimum bid is prescribed) distinct from the strictly urban and city centers : Cebu City - Pardo San Nicolas Davao City - Caliuan Mintal Panacan Lasang Toril Talomo Lowering the prescribed minimum bid of the North Reclamation Service Area in Cebu City and the Agdao-Sasa Service Area in Davao City from ₱4 million to ₱2 million, being less developed service areas within Cebu City and Davao City.
1306	September 19, 1991	o Prescribing the revised rules and regulations governing the establishment of branches of RBs, specifically compliance with the submission of the following documents :	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
		(a) certified true copy of the resolution of the bank's board of directors authorizing the application for the establishment of the additional banking office; (b) banking facilities and services to be offered; (c) projected statement of condition at the end of the first and second semesters of operations of the proposed banking offices; (d) statement of estimated earnings and expenses for the first 12 months of operation; (e) organizational set up of the proposed banking office showing the proposed positions and annual pay for each and the names, qualifications and experiences of the proposed manager and other officers; and (f) bank premises and initial outlay	
1307	September 25, 1991		o Allowing banks to bid for as many franchises as they can afford o Requiring banks to open and operate the branch covered by the franchise within a period of one year from the date of award
1308	October 3, 1991	o Providing for the specific violations/exceptions which will or may prevent banks from participating in the bidding of branch licenses as follows:	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
		(a) investment in equities exceeds prescribed ceilings;	
		(b) loans in excess of single borrower's limit;	
		(c) investment in bank premises exceeds ceilings;	
		(d) loans granted without supporting financial statements and/or credit information or loans which are not justified by financial statements and/or credit information (total amount of such loans aggregates 5% of networth);	
		(e) loans granted in excess of maximum loan value (total excess in amount is 5% of networth):	
		(f) limit on stockholdings;	
		(g) excess loans to directors, officers, stockholders and their related interests;	
		(h) non-compliance with minimum capital requirement;	
		(i) non-compliance with capital to risk-asset ratio (5 or more times deficient within a 60-day period during the last 6-months);	
		(j) non-compliance with legal reserve for deposits and deposit substitutes;	
		(k) loans approved/released without authority from appropriate body/officer (aggregates to 5% of networth);	

rcular No.	Effectivity Date	Supervision/Control	Deregulation
		(l) loans released without complying with the terms of approval thereof (aggregates to 5% of networth); (m) loans released before full documentation of papers (aggregates to 5% of networth); and (n) when the aggregate of all loans under (k), (l), (m) is equal to 10% of networth o Requiring banks which have been awarded a branch franchise to operate within a year from the date of award, otherwise, the franchise as well as the consideration paid to the CB for said franchise shall be forfeited	
1312	October 15, 1991		o Listing the incentives for mergers and consolidations among banks and other financial intermediaries: (a) revaluation of bank premises, improvements and bank equipment of the institutions based on fair valuation of the property subject to review and approval of the CB; (b) conversion or upgrading of the existing head offices, branches and/or other offices of the merged or absorbed institutions into branches of the new or surviving financial institutions; (c) condonation of liquidated damages and/or penalties on loan arrearages to the CB of RBs which are parties to the merger/consolidation,

Circular No.	Effectivity Date	Supervision/Control	Deregulation
			provided such arrearages are paid in full or covered by a plan of payment payable on an equal monthly amortization schedule over a period not exceeding 10 years; (d) relocation of branches/offices within one year from date of merger or consolidation resulted in duplication of branches/offices in a service area; (e) Payment in installments of outstanding penalties in legal reserve deficiencies and interest on overdrafts with the CB as of the date of merger or consolidation; (f) Booking on staggered basis over a maximum period of 5 years of unbooked valuation reserves and other capital adjustments resulting from the merger/consolidation; (g) Exemption from the 20% + 30% of limitations on voting stockholdings in the new or surviving institution of any person or persons related to each other within the third degree of consanguinity or affinity, or corporations, respectively; this shall be allowed only if: o banks that are being merged are distressed o whenever any of the stockholders exceed the 20% and /30% ceilings, their holdings shall not be increased, but may be

Circular No.	Effectivity Date	Supervision/Control	Deregulation
			reduced and once reduced, shall not be increased beyond the required ceilings (h) In the case of TBs, the merged or consolidated bank may be allowed to establish branches in Metro Manila provided the paid-in capital of the merged or consolidated bank is at least P100 million, subject to the provision of CB Circular 1281 (i) Any right or privilege granted a merging bank under a rehabilitation program previously approved by the Monetary Board or under any special authority previously granted shall continue to be in effect (j) Training of officers and staff of the merging or consolidating RBs by the CB
1314	October 21, 1991	o Authorizing stock savings and loan associations (SSLAs) to use the term "Savings and Loan Bank" anc not the term "Bangko ng Bayan" in their corporate or business names provided they have complied with the required minimum paid-in capital and the term has been duly incorporated in the SSLAs corporate or business name as it appears in the articles of incorporation o Imposing a P100 administrative fine for violation of foregoing rules	
1315	October 29, 1991	o Sets the terms of reference for the implementation of the CFIEP with the following objectives:	

Circular No.	Effectivity Date	Supervision/Control	Deregulation
		(a) raise the capital base of the countryside financial institutions by encouraging existing and new investors to infuse fresh equity into said institutions and thereby accelerate the government's economic development efforts;	
		(b) reduce the debt burden of eligible countryside financial institutions and the corresponding financial strain on the government in continually assisting them; and	
		(c) improve the long-term viability of the countryside financial institutions as an effective means to mobilize savings and credit	
		o Allowing operating RBs & TBs whose main operations are in the countryside and individuals, cooperatives and/or corporations qualified to make an investment in the RB or qualified TB to participate in the Program	
		o Covers all past due borrowings of RBs and TBs as of August 30, 1991 in the form of rediscounted loans, CB:IBRD loans including those under plans of payment and arrearages converted into LBP equity under CB Circulars 1143 and 1172	
1316	October 31, 1991	o Prohibiting RBs from declaring cash dividends if arrearages with the CB amount to P1 million or more, unless covered by an approved plan of payment which is being fully complied with and that cash dividends shall not exceed 10% per annum	

Sources: Lamberte and Relampagos, "An Assessment of Policies Affecting the Financial Sector," 1986-88.
Various Central Bank Circulars, 1989-91.

held by one bank, is allowed unless prior approval from the Monetary Board is secured. These changes are expected to minimize conflict of interest and avert insider abuse.

Audit and Reporting Requirement. To make bank transactions more transparent, the CB requires an annual financial audit of banks by independent auditors. To facilitate its job of supervising banks, the Monetary Board requires banks to keep a complete record of all pertinent loan documents which shall be made available for inspection and/or examination. In 1990, the CB required KBs and TBs to submit proof of financial capacity of their outstanding credit accommodations on an annual basis. While these measures were intended to strengthen the supervisory function of the CB, some measures were also enacted to give banks limited discretion in specific areas of bank operation and management. This included allowing banks full discretion in the restructuring of their loans, including DOSRI loans, to provide flexibility in arranging repayment without impairing the financial interest of banks. However, such arrangements do not include loans sourced partly or wholly from foreign currency obligations.

To enhance its examination capability, a number of measures were also implemented by the CB. In 1986, the CB introduced a pilot group to audit the computer system of banks. In addition, a monitoring and review system in the management of loan portfolio and other risk assets was established to ensure that adequate reserves are maintained to absorb the loss inherent in these accounts.

Finally, in a major policy shift, the CB in a circular dated May 16, 1989 moved away from the policy of sustaining weak banks except in times of general financial emergency or when specific banks face problems of liquidity rather than solvency. This is in sharp contrast with the policy followed during the 1981 liquidity crisis that led to the government's take-over of weak banks (Lamberte and Relampagos 1990).

Capital Adequacy. The above measures were intended to enhance the effectiveness of bank supervision. To strengthen the financial structure and encourage competition in the system, measures were similarly instituted. To improve banking stability, increases in the capital base of banks were enacted. As early as 1980, the CB had been gradually increasing the minimum capital requirements of various types of banks. On July 16, 1991, the minimum capitalization of KBs and universal banks was raised from P500 million and P1 billion, respectively, to P750 million and P1.5 billion (Table 12). Meanwhile, existing TBs with head offices in Metro Manila are now required to increase their capital base from P 10 million to P 20 million. Those with head offices outside Metro Manila are required to make the necessary adjustment from P5 million to P10 million. The increase in capital requirement is particularly required of new TBs in Metro Manila. Beginning 1990, new TBs in Metro Manila have to put up P100 million while those with head offices outside Metro Manila have to raise P20 million.

The minimum capital requirement for RBs was also increased to improve the viability of the system. Under the previous guidelines, existing RBs outside Metro Manila were required to have a minimum capital ranging from P0.5 million for ordinary RBs to P2 million for Cooperative Rural Banks (CRB). This guideline was superseded by a 1991 circular which increased the required capitalization for RBs to P1 million for existing RBs, P2 million for new RBs, and P1.25 million for CRBs. The new provision requires that the incremental capital has to be paid-up in 2 years.

Table 12. CHANGES IN THE MINIMUM CAPITAL REQUIREMENTS, BY BANK TYPE, IN MILLION PESOS

Item	1980	1989	1990	1991
Commercial Banks a/				
Ordinary KBs	100	500	500	750
Unibanks	500	1000	1000	1500
Thrift Banks b/				
(a) Existing				
With HO in Metro Manila	10	10	20	20
With HO outside Metro Mla.	5	5	10	10
(b) New:				
With HO in Metro Manila	20	20	100	100
With HO outside Metro Mla.	10	10	20	20
Rural Banks c/	0.5	0.5		
Within Metro Manila			20	20
First Class Cities			10	
Cebu and Davao City				10
Outside Metro Manila and First Class "A" Cities				
(a) Ordinary RBs			0.5	
(b) Integrated RBs			0.75	
(c) CRBs			2	
Other Areas				
(a) Existing				1
(b) New				2
(c) CRBs				1.25

a/ Source: CB Circulars 793 (July 10, 1990), 1214 (November 8, 1989) and 1296 (July 16, 1991)
b/ Source: CB Circulars 740 (July 10, 1980) and 1254 (September 27,1990)
c/ Source: CB Circular 741 (July 10, 1980) and 1294 (July 9, 1991)

These changes in capital requirements have important implications for the banking industry. While the expanded average net worth would enable banks to generate more volume of business and improve the public's perception of their stability, it may also result in greater concentration in the banking industry, which is perceived to have an oligopolistic structure. In the context of the 1972 capital build-up program, Saldaña (1984) found that the program increased the level of concentration of firms in the banking industry. Previously noted trade-offs between profitability and .leverage or liquidity risk were accentuated after the perfection of the capital build-up program. That is, the average profitability, leverage and liquidity risk indicators of the banking system increased after the CB legislation of 1972.

To further strengthen the financial system, liberal provisions and incentives for consolidation and mergers were also instituted. The incentive structure provided, among other things, the condonation of liquidated damages and /or penalties on loan arrearages to CB of RBs under rehabilitation; staggered booking of unbooked valuation reserves and other capital adjustments resulting from merger or consolidation; and exemption from the 20 percent and 30 percent limitations on voting stockholdings in the new institution, of any person or persons related to each other within the third degree of consanguinity or affinity.

Bank Entry and Expansion. Important measures to increase competition were also adopted, including the relaxation of the deposit retention scheme and the liberalization of rules on bank entry and expansion. The new guideline on deposit retention expands the definition of the service area into only three major island groupings: Luzon, Visayas and Mindanao. In response to various criticisms on the restrictive policy on bank entry and branching, the CB has gradually liberalized entry regulations since 1989. These policies included lifting the required purchase of special 5-year government securities; lifting all restrictions in opening new branches in service area categories IV and V; and the establishment of off-site automated teller machines (ATMs) without CB approval and in service areas where a bank has no existing branch. Starting 1992, the CB is expected to further loosen up restrictions on bank branching.

These deregulation measures are expected to improve access to banking services and enhance efficiency of the system. Tan (1989) and Chan (1991) argued that the restricted bank entry policy in the Philippines has been responsible for the shallowness of the country's financial sector. The policy was inimical to savings mobilization as shown by the low M3/GNP ratio of the Philippines compared to other Asian countries. Moreover, shielding inefficient banks from increased competition has resulted in high intermediation costs.

3. Role of the Philippine Deposit Insurance Corporation (PDIC)

The Philippine Deposit Insurance Corporation (PDIC) has generally played a passive role in the financial system as it merely paid insured deposits of failed banks and occassionally helped package rehabilitation schemes for troubled banks. It is also saddled with personnel problems as a result of the spate of bank failures it has had to attend to. For these, it has relied on the CB's personnel complement to undertake some of its functions. Because of its limited capitalization, the PDIC depends heavily on borrowings from the CB to pay insured depositors of failed banks. Strengthening and expanding PDIC's present functions can contribute significantly in protecting depositors and enhancing their confidence in the banking system.

There are several proposals and legislative initiatives for strengthening the PDIC's role. Among these proposed measures are appointing the PDIC as receiver/liquidator of troubled banks and increasing its capital base. The appointment of the PDIC as receiver in all cases of bank failures is expected to solve the problem of conflict of interest which is alleged each time the CB acts as conservator, receiver, and liquidator of distressed banks. Such a situation has led to increased personal suits against CB personnel, thereby affecting their performance.

From these various proposals, a consolidated version of HB 7640 and SB 1539 was recently enacted (R.A. 7400). The new law provides, among other things, for the following: an increase in PDIC's permanent insurance fund from P2 billion to P3 billion; an increase in the maximum insurable deposit amount from P 40,000 to P 100,000; an increase in the assessment rate from 1/12 to 1/5 of one percent per annum; the participation of two representatives from the private sector in PDIC's Board; and the power to issue a cease and desist order. However, the new law does not contain a provision that automatically empowers the PDIC as the receiver and liquidator of troubled banks.

While these new provisions significantly address some of the identified concerns, it is arguable whether these would have a significant impact. For instance, Lamberte and Relampagos (1990) argued that increasing the coverage of insurable deposits from its current level of P40,000 to some higher figure would bring little benefits to small depositors. This is because 96 percent of the total number of deposit accounts of the banking system as of 1987 are already covered by existing maximum deposit insurance coverage. Large depositors usually place their resources in high-yielding securities and trust accounts which are subject to lower reserve requirements. Moreover, increasing the insurance coverage has the probable effect of inducing moral hazard problems among banks. It is for this reason that, in the context of the Savings and Loans (S & L) scandal in the United States, a similar proposal was vigorously resisted.

However, increasing the permanent insurance fund is likely to bring more benefits to depositors. This is because of PDIC's low capital base which prevents it from paying all insured depositors promptly. Similarly, the increase in the assessment rate provides an additional revenue for PDIC to service its portfolio of insured deposits.

4. Rehabilitation of DBP and PNB

A major institutional reform undertaken in the financial sector was the rehabilitation and restructuring of the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP). Priority was accorded to these two institutions by the national government (NG) among all other Government Financial Institutions (GFIs) because of the size of their non-performing assests (NPAs) and the concomitant budgetary losses these entailed for the government. Both banks became insolvent as a result of behest loans granted to favored political groups during the previous administration. To relieve these institutions of the financial burden of servicing their nonperforming assets, the government arranged the transfer of such assets to the Asset Privatization Trust (APT) in 1986. Simultaneously, institutional strengthening activities were undertaken. These included substantial staff reduction, rationalization of branch networks, change of senior management, and introduction of systematic credit procedures.

It must be emphasized that while financial rehabilitation was necessary because of the concomitant budgetary losses and adverse effects on the financial system, the complementary privatization program is aimed at ensuring their continued viability, and providing an unequivocal signal of the government's intent to get out of economic activities that the private sector could undertake better, and more efficiently. This also forestalls potential moral hazard problems as a result of the restructuring exercise.

The financial restructuring in the case of DBP resulted in the reduction of its assets from P74 billion in 1985 to P10 billion in 1986. In the case of PNB, the restructuring plan involved the transfer of P47 billion in assets to APT and liabilities of P55 billion to the national government, plus a write-off of an additional P5 billion in assets.

The objective of the financial restructuring is to reorient DBP into a wholesale bank with private sector orientation to mobilize long-term funds and act as a market in long-term papers. This institutional reorientation is especially important because of the scarcity of term credits needed for the development of the economy. As a complementary measure, a number of special credit programs/windows previously administered by the CB were transferred to DBP and LBP. These included the transfer of IGLF and APEX to DBP, and ALF to LBP. Internally, institutional strengthening to support DBP's reorientation to wholesale banking included the creation of a capital market department and a financial institution department. In the case of PNB, the eventual objective of the rehabilitation is to retain its expanded commercial banking functions, with government retaining a minority interest after its privatization. It must be emphasized that although GFIs, especially DBP, are expected to perform developmental functions, they are at the same time required to be financially viable and not dependent on special assistance from the government.

At present, DBP and PNB have attained normal operational status. Freed from the burden of its nonperforming assets, PNB has been one of the most profitable financial institutions in the country for the past two years. With its impressive performance, the first block of government shares comprising 15 percent of equity offered to the public was sold out in advance. A second block of government equity for public offering which is intended to reduce government share to a minority interest of 49 percent is expected to be equally successful. In the case of DBP, it has also realized profits from its operations. Negotiations are on-going for the privatization of its branches in the light of DBP's reorientation into a wholesale bank.

5. The Rural Banking System

As a result of their loan arrearages problem and the shift towards market-oriented credit policy, a significant number of RBs were rendered insolvent and/ or put under receivership. However, due to their important role in the rural economy, the government undertook a program of financial rehabilitation in 1986. The program was designed to strengthen the RBs through a capital build-up program consisting of prerequisite fresh capital infusion and/or plan of payment of their arrearages with the CB. Of the total licensed RBs of 1,016 as of 1990, 524 applied for rehabilitation. Of these, 484 had their applications approved by the Central Bank.

Interestingly, a complementary program called the Countryside Financial Institution Enhancement Program (CFIEP) was recently established with a similar objective, but with a different incentive structure and modes of compliance. This is meant to entice RBs and other rural financial institutions to put up the required capital infusion and/or to enter into merger or consolidation, or both.

The rehabilitation program in general is expected to strengthen the rural financial market by weeding out inefficient banks. Since it may be too early for the impact of the 1986 rehabilitation to be felt, we can only conjecture that the establishment of such a complementary program strongly suggests the difficulties encountered in enlisting the participation of RBs. Given the poor performance of the previous rehabilitation attempt in 1979, it may be asked why the CB has preferred the rehabilitation approach, instead of a much more stringent criteria. It has been argued, for instance, that because of the stigma attached to bank failure and weakness, rehabilitated banks have experienced difficulty in attracting clients who would prefer doing business with stable banks (Tan 1989).

In addition, a new legislation to enhance the viability of the RB system was recently enacted. R.A. 7353, which is a consolidated version of HB 28736 and SB 1554, provides for various fiscal incentives, exemptions and other privileges.

The major incentives include (a) exemptions from payment of all taxes, fees and charges except corporate income tax and local taxes, fees and charges of all RBs created under this Act for a period of five years; (b) lower reserve requirements; and (c) mandatory subscription by GFIs in the form of preferred shares equal to the fully paid subscribed and unimpaired capital of the private stockholders.

It needs to be emphasized that if the intent of R.A. 7353 is to address the problems and enhance the viability of the RB system, these are being addressed by specific programs such as the ongoing CFIEP. Moreover, a number of provisions in the new law are contrary to current policy. For instance, the mandatory subscription by GFIs contravenes current privatization efforts. Similarly, a specific provision allowing appointive or elective public official to serve in any capacity raises the possibility of conflict of interest, and sets a disturbing precedent.

6. Directed Credit Programs in Agriculture

In 1986, the consolidation of special lending programs of the Department of Agriculture into the Comprehensive Agricultural Loan Fund (CALF) signalled a radical shift in policy orientation of the government. As part of the new policy orientation, direct lending programs were terminated. Instead, agricultural credit guarantee schemes were promoted and expanded through capital allocation from the CALF portfolio. Underlying the new policy orientation was the view that the key to integrating the rural financial market is the introduction of financial innovations through the reduction of lending risk and administrative cost.

This is a significant move,in view of various country experiences on the adverse consequences of subsidized directed credit programs on the development and growth of the financial market. On the other hand, credit guarantee mechanisms are perceived to have only minimal distortions because they presumably leave intact the decision processes and institutional relationships of the private credit market. As such, they are also perceived to be generally cost-effective since a guarantee institution can leverage a given fund base by a multiple compared to direct lending programs. Nonetheless, recent analysis of the performance of existing agricultural credit guarantee mechanisms indicate that while the subsidy cost of these mechanisms are indeed lower than government-directed credit programs, the benefits in terms of additional lending are much limited than previously expected. Moreover, most of the benefits have accrued to the banks and to program beneficiaries, most of whom have well-established records of financial transactions with banks, or with proven credit worthiness (Llanto et al. 1991; Bautista 1992).

C. Impact on Informal Credit Market

In view of the size and importance of informal credit markets in the Philippines and in most developing countries, a discussion of the impact of financial market policy reforms on their operations is clearly in order. While there exists no systematic data base that clearly captures the impact of changes in financial market policy on informal credit markets, evidence from various over-time household surveys suggest that financial market policies affect informal credit markets via the availability of formal credit.

Bautista (1992) drawing from various studies noted that cheap credit policies during the 1970s, which resulted in an increased flow of formal credit to agriculture, were accompanied by a decline in the proportion of households borrowing from informal sources. In the 1980s, when various financial and banking reforms were implemented in tandem with a more restrictive credit policy environment, the size of the informal credit market expanded from previous levels. Surveys indicate that financial and agricultural sector policies have varying effects on rural credit markets. While expansionary credit policies during the 1970s resulted in an increased flow of credit, this merely substituted for informal credit in the short-term without the concomitant lasting effect on farmers' credit-worthiness. In contrast, nonfinancial agricultural sector policies in the 1970s such as land reform and public investment in irrigation had more profound and real effects. The income effects arising from increased productivity led to increased consumption demand. Hired labor substituted for family labor, leading to the emergence of more active labor markets. Moreover, the larger market attracted new entrants and induced competition in trading and other auxiliary activities in rural economies. These in turn shaped various aspects of informal credit markets.

V. MONETARY AND BANKING POLICIES FOR AGRO-INDUSTRIAL DEVELOPMENT: INDICATIVE IMPACTS AND LEGISLATIVE/ADMINISTRATIVE REQUIREMENTS

This section describes the expected short- and long-run impacts and the legislative/administrative requirements of preferred monetary, credit and banking policies supportive of agro-industrial development. The preferred set of policies discussed below takes off from the policy gaps identified in the previous section.

A. The Countryside Agro-Industrial Development Strategy (CAIDS)

The CAIDS was adopted by the Aquino government in December 1989 through Resolution No. 39, as its centerpiece development strategy. It has been identified as the focal strategy for the attainment of rapid, sustainable, and equitable economic growth. The main features of the CAIDS are: modernization and increase in productivity of agriculture, industrial competitiveness, growth and dispersal through agro-based industrialization, and integration of economic activities in the country. These are envisioned to be accomplished through private sector initiatives.

The five major strategies identified are: (a) increased production and stabilized supply of basic food commodities; (b) aggressive modernization and diversification of agriculture to increase productivity and encourage the establishment of agro-processing plants, to intensify the linkage between agriculture and industry; (c) enforcement of conservation and rejuvenation measures to ensure long-term sustainability of land and marine resources; (d) countryside industrialization; and (e) establishment of competitive outward-oriented industries which will generate the foreign exchange needed to finance development.

To operationalize CAIDS, various implementation mechanisms were identified. These included the establishment of People's Industrial Estates (PIEs), Regional Industrial Centers (RICs), and Agro-Industrial Development Areas (AIDAs). The PIEs were identified as the major implementing mechanism for the operationalization of CAIDS.

The PIEs concept envisages a core or anchor of processing activities centered around the raw materials readily available in the area. The development of PIEs takes into consideration the following: (a) establishment and viable operation of appropriate processing plants and common service facilities by organized private sector groups; (b) linkage of farms to processing areas and market centers; (c) provision of basic infrastructure support facilities; and (d) enhancement of agricultural production.

The RICs were envisaged to operationalize the regional dispersal of industries. These would supply the technology and other inputs needed by the PIEs. Finally, the AIDAs were conceptualized to provide a more concrete and focused mode of implementing CAIDS. It involves the identification of areas/villages as strategic centers for agro-industrial development.

Given the nature of the proposed economic activities, the development of viable micro, small and medium enterprises (MSMEs) has been identified as a key component. While the government hardly used to pay enough attention to MSMEs, there has been an increased interest in the potential role of MSMEs. This is based on the experiences of Japan, Taiwan and Korea, where MSMEs served as anchors in their successful drive towards industrialization. The increased interest is further bolstered by the recognition that MSMEs are thought to be labor-intensive and generally able to generate jobs at lower investment cost than larger industrial firms (Lamberte 1990) and to play two important roles in the economy: (a) as downstream users of upstream products (e.g. footwear requiring leather, garments requiring textiles; furniture using lumber); and (b) as export earners for the economy (Fabella 1988). Within this framework, monetary and financial policies will be supportive by addressing the need for mobilizing resources, maintaining price stability, enhancing efficiency in the financial intermediation process and stimulating economic growth.

B. *Monetary, Credit and Banking Policies for Agro-Industrial Development*

It is to be emphasized that while monetary, credit and banking policies can support agro-industrial development, they cannot work independently of the rest of macroeconomic policies. Lessons from various countries including the Philippines show that financial reforms carried out against an unstable macroeconomic background can make instability worse. Complete liberalization of interest rates in countries with high and unstables rates of inflation can lead to high real interest rates and wide spreads between lending and deposit rates. Reforms should start by controlling fiscal deficit and establishing macroeconomic stability. In the same manner, where prices are distorted owing to protection or price controls, financial liberalization may not significantly improve the allocation of resources. In fact, deregulation may worsen matters by causing the financial sytem to respond more flexibly to bad signals.

Thus, the primary task of crafting a package of preferred policy options on monetary, credit and banking policies is to finetune current policies in order to: (a) minimize sectoral bias; (b) strengthen or improve the foundation of banking and finance to enforce contracts, disclosure requirements, and the structure of prudential regulation and supervision; and (c) fill up existing gaps that constrain the development of sectors critical to overall economic development. Direct intervention in finance must be minimized, and must be replaced by an adequate, less invasive system of laws and regulations.

Table 13 provides a listing of preferred policy options and initiatives on monetary and banking policies and the associated legislative/administrative requirements for implementing such programs.

1. Stable Movements in Monetary Aggregates

As a basic prerequisite for development, in particular for agro-industrial development, monetary policy must be geared towards maintaining stability in the general price level. Stable inflation through prudent monetary and fiscal policies has a favorable effect on long-term investment planning decisions of business and on the development of the financial sector. One disturbing feature of monetary policy in the Philippines, discussed earlier, is the use of interest rate policy to defend the exchange rate. This has resulted in more volatile and high domestic interest rates, with important implications for financial market development. High interest rates lead to higher inflation (Mariano 1985), which is what the present policy of exchange rate stabilization is trying to avoid. The biggest casualty of having an overvalued currency is the export sector.

Although the need for a stable exchange rate is imperative, a realistic exchange rate policy is equally important. This means that the CB should adopt an even less interventionist stance. While desirable, this has serious fiscal implications for the CB's income position. Because of the CB's huge losses. further losses can seriously undermine its effectiveness as the central monetary authority.

It must be emphasized that the CB's continuing losses stem, to a large extent, from the foreign exchange liabilities of certain public and private enterprises, which it was asked to assume in 1986. Losses were also incurred through forward and swap transactions as a result of the steep depreciation of the peso. Thus, unless a comprehensive solution to CB's financial condition is found, CB may feel constrained in pursuing a more liberal exchange rate policy, lest it incur possible losses in the process.

A program for a comprehensive and immediate financial restructuring of the CB needs to be seriously considered in this context. However designed, such a restructuring program must be able to provide a mechanism for clearing from the CB's book the following major sources of its losses: (a) the foreign exchange liabilities assumed from public and private enterprises transferred by the national government; and (b) outstanding forward and swap accounts. This may require a phased

Table 13. Indicative Short- and Long-Run Inputs of Suggested Monetary, Credit and Banking Policies and their Associated Legislative and Administrative Requirements

Desired Policy Environment/ Policy Reform	Expected Impacts		Legislative and Administrative Requirements
	Short-Run	Long-Run	
1. Stable movements in monetary aggregates thru liberal foreign exchange market and exchange rate policy	Minimize high and volatile movements in interest rates	Favorable effects on long-term investment planning decision of firms	Within CB/NB mandate
		Enhance development of capital market	
	Minimize distortion in relative prices	Enhance export competitiveness	Within CB/NB mandate
	May have some inflationary effects depending on the relative movement and direction of the exchange rate	Encourage entry of foreign investments	
		May have unfavorable effects on CB's income position which may affect its efficacy unless NG undertakes a prompt and comprehensive financial restructuring of CB	Requires Congressional legislation on CB's Charter if NG equity infusion is made
2. Liberal Bank Entry and Branching Policy	Improved access to banking services	Enhanced competition and increased efficiency of the Banking System	Within CB/NB mandate
3. Effective Supervisory and Regulatory Structure	Early detection of fraud, insider abuse, mismanagement and recklessness. This will encourage more prudence and better management of banks.	Enhanced confidence and stable banking system	Generally within CB/NB mandate. Empowering CB to issue cease and desist order as one of its regulatory instruments requires amendments to its Charter, hence, legislation from Congress.

Desired Policy Environment/ Policy Reform	Expected Impacts		Legislative and Administrative Requirements
	Short-Run	Long-Run	
4. Enhanced/Stronger Protection to Bank Depositors	Enhanced depositor confidence in the banking system	Foster stability and development of the banking system/financial market	Proposed expanded role of PDIC requires amendment of PDIC's Charter through legislation.
5. Reduction in intermediation of banks via reduction, abolition or phase out of:			
(i) High reserve requirement	Increase available funds for lending Reduction in intermediation cost	Increase in the real size of the banking system	Within CB/MB mandate
(ii) GRT	Increase intermediation spread/ reduce cost of intermediation	Encourage expansion/growth of the banking system	Requires a repeal and/or amendment of the relevant position of the Internal Revenue Code through legislation
(iii) Agri-agra Laws	Reduce cost of intermediation	Lead to more efficient portfolio mix of banks. This would in turn contribute to individual bank's viability and enhanced stability for the system	Requires repeal/or amendment of P.D. 717 through Congress
(iv) Deposit Retention Scheme	Enable banks to exploit better investment opportunities	Improvement in the quality of bank portfolio, reduction in cost of operation and enhanced viability of individual bank/banking system in agency.	Repeal and/or revision of relevant CB Circular

Desired Policy Environment/ Policy Reform	Expected Impacts		Legislative and Administrative Requirements
	Short-Run	Long-Run	
(v) 20% Witholding Tax on Interest Income	'Increase' returns on financial assets	Encourage savings in financial assests, hence, foster deepening of the financial market	Repeal and/or amendment of the Internal Revenue Code through legislation
6. Phase-out and/or rationalization of the operation and interest rate structure of special lending programs across sectors	Reduce financial losses on continuing operation of subsidized lending programs	Improve coordination, monitoring, implementation and accounting for the actual cost to the government of operating these programs Improve efficiency in the utilization of funds and more concentrated rather than dispersed program impact.	The proposed measure can be easily effected through the transfer of lending functions to existing GFIs, i.e., LBP, DBP. The requisite coordination can be handled by existing institutional mechanism such as the ACPC and SMED Council.
7. Provision of adequate and reasonably priced long term finance to agriculture and industry	Encourage investments in improvements and investments in more efficient technologies in production, marketing and industry/manufacturing including post-production technologies in processing, etc.	The resulting capital investment in improvements and new addition to the economy's capital stock can contribute to (1) more diversified economic base, (2) more efficiency, and (3) more balanced economic growth.	The development of a viable capital market requires foremost a stable macroeconomic environment and an institution(s) which can bring together efficiently the suppliers and demanders of funds. Given the inherent risk of such an undertaking, it maybe incumbent that the government through the DBP and

Desired Policy Environment/ Policy Reform	Expected Impacts		Legislative and Administrative Requirements
	Short-Run	Long-Run	
			or LBP takes the lead. The proposed institutional mechanism necessitates that DBP and or LBP gradually evolve or take more wholesale banking function. This would require some reorganization, retraining of existing staff, recruitment and the creation of a specialized division on capital markets. This evolution would not require new legislative amendments to their charters as this is essentially only an expansion into their scope of lending activities. This would require complementary strengthening of credit guarantee mechanism for long-term credits via increased capitalization of GFSME/SBGFB via legislation.
8. Provision of adequate and reasonably priced export credit to small and medium exporters	Expand production capacity of exporters	Create more employment opportunities Generate foreign exchange revenue, thus relieve fiscal constraints Lay foundation for long-run economic growth	The creation of a dedicated rediscounting window for export does not require any extraneous legislation other than a MB decision. A more fundamental constraint is the willingness of banks to lend to small and medium exporters (new and existing) who may not have the track record of credit worthiness. In such a case, export guarantees from PhilGuarantee may ameliorate the situation. To be able to meet potential demand, infusion of, additional capital/equity into PhilGuarantee may be called for. In which case, amendments to its Charter require Congressional legislation.

transfer or assumption in part or whole of these accounts by the government,which is responsible for them, in the first place; or, a substantial equity infusion by the government into the CB; or both.

Equity infusion into the CB requires amendments to the Central Bank Charter, hence, the requisite legislation. On the other hand, the transfer of liabilities may be accomplished along similar PNB and DBP rehabilitation schemes.

There are currently two pending bills in Congress proposing the creation of a truly independent monetary authority. The House version introduces amendments to the present Central Bank Act, while the Senate version is a much more radical departure in that it proposes an entirely new charter for the CB. These bills can be consolidated and harmonized with appropriate amendments on the CB's capitalization level, so as to address the viability issue.

It is important that because of the nature and magnitude of these accounts in the CB's book, the problem has to be dealt with promptly. Otherwise, the CB will incur continuing losses due to exchange rate and interest rate movements, and furthermore, the stability and development of the Philippine financial system will be jeopardized. Unless a comprehensive solution to the CB's financial problem is found, its grip on monetary and exchange rate policies will remain weak.

2. Bank Entry and Branching

Although the existing policy on bank entry and branching is now more liberal than in the past, existing rules must be regularly reviewed to allow further relaxation of entry and branching regulations. The current policy which allows commercial and thrift banks to bid for franchises in the establishment of branches needs to be reassessed. Unde: this scheme, big banks have the decided advantage because of the relative size of their resources. This may result in the perpetuation, if not accentuation, of a more oligopolistic structure for the banking industry, with implications on efficiency and cost.

3. Strengthening Bank Supervision and Regulation

Despite improvements in the financial environment, the Philippine financial system continues to suffer from stress. This results from the continuing macroeconomic instability and the effects of past behavior of borrowers and lenders. Mismanagement and speculation have occurred because prudential regulations and supervision and the underlying legal codes or framework for addressing specific areas are inadequate. Because of the potential negative consequences for the economy of a weak banking system, measures to strengthen the underlying laws and regulations must be vigorously addressed.

The CB in 1987 proposed a number of measures to strengthen its supervisory and regulatory functions. These involved amendments to the General Banking Act. Some of these proposals were subsequently adopted by the World Bank Mission, in addition to its own set of recommendations that were incorporated in the set of conditions attached to the Financial Sector Adjustment Loan. There are also existing bills in Congress that address some of the identified concerns. Most of the concerns raised earlier which require changes in the underlying rules on banking regulations have been addressed by the CB, or are currently being studied. Only those that require amendments to the General Banking Act and of the Central Bank Act remain pending.

Of particular importance is the proposal to empower the CB to issue cease and desist orders. This recommendation has tremendous importance in countering insider abuse at an early stage. The main advantage of a cease and desist order is that the CB will possess a new instrument of intermediate nature that can be used in a graduated manner, well before the maximum means of resorting to liquidation proceedings. A cease and desist order also provides an affirmative action of correcting unsafe and unsound banking practice. Its use will deflect charges that the CB's actions are too harsh and drastic. Empowering the CB to issue a cease and desist order requires amendment of its charter. This requirement is already addressed by the consolidated Senate Bill 1902. However, because of the need to address the financial condition of the CB, a further review and incorporation of necessary amendments to the bill are necessary.

4. Enhanced Role for the PDIC

The PDIC is currently playing a passive role in the financial market. Because of its low capitalization, it has relied on borrowings from the CB to pay insured depositors. On the one hand, the current practice of the CB staff to act as conservators, receivers and liquidators of failing banks gives rise to questions of conflict of interest, and also puts a heavy burden on the CB. On the other hand, it deprives the PDIC of any authority in the affairs of a failing bank even though the PDIC is responsible to pay depositors of insured banks. To address these concerns, the PDIC's role should be expanded. As part of its expanded functions, the PDIC should be the receiver in all cases of distressed banks.

With the recent enactment into law of the amendments to its charter, the PDIC is expected to take on a much more expanded function along the areas suggested above. This is expected to enhance depositors' protection, and boost their confidence in the banking system.

5. Reduction of Intermediation Costs

Although a much more liberal bank entry and branching policy now exists, the continued imposition of various intermediation taxes (5% GRT, 20% tax on interest earnings and high reserve requirements) as well as portfolio-restricting measures (Agri-Agra Law and the deposit retention scheme), will continue to contribute to high intermediation cost. As noted in previous sections, these taxes reduce intermediation which in turn affects overall economic growth. It is therefore important that they are abolished. In view of their fiscal implications, however, a time-bound phased reduction program should be undertaken, taking into account the revenue and monetary implications in the case of reserve requirements.

Likewise, the Agri-Agra lending requirement should be abolished. The agri requirement is redundant since the scope for profitable agricultural lending is substantial and generally complied with, and hence, a quota is not needed On the other hand, the agra requirement is unrealistic and in any case does not result in increased lending for agrarian reform beneficiaries. The phase-out or outright abolition of these implicit and explicit taxes requires an act of Congress. There are, however, pending bills which need only to be pushed more vigorously to effect the necessary legislation. These include HB 31684 and SB 614, which call for the abolition of the 5 percent GRT and the 25 percent agri-agra loan quota policy, respectively. On the other hand, the abolition and/or further relaxation of the deposit retention scheme, and the reduction of reserve requirements need only appropriate action by the Monetary Board.

6. Directed Credit Programs

Significant progress has been achieved in reducing the CB's role in credit allocation. There remains, however, a number of directed credit programs operated by government non-financial institutions. A number of these were just recently implemented, e.g., DTI's *Tulong sa Tao* (TsT), the Department of Agriculture's Livelihood Enhancement for Agricultural Development (LEAD), the Fishery Sector Program (FSP) and the Agro-Industrial Technology Transfer Program (AITTP) of the Technology and Livelihood Resource Center (TLRC), among others.

Many of these programs have duplicating and overlapping objectives. Institutional fragmentation has also come about, because the implementing agencies have their own preferences as to credit delivery institutions. This creates problems not only in coordination and monitoring the programs' implementation but also in accounting for the actual cost to the government in operating these programs. Some of these programs continue to charge lower than market rates of interest to final borrowers. For instance, both the Multi-Livestock Dispersal Loan Program and the Export Industry Modernization Project II charge 10 percent/per annum, while the LEAD grant-assisted component provides grant assistance to non-bankable farmers' group. Yet coastal/municipal fishermen under the Fishery Sector Program have to pay market rates of interest on their loans. The wide range of on-lending rates has led to a confusing mix of signals regarding the direction of credit policy. It has also given rise to claims for similar treatment, i.e., same interest rates, by other borrowers who assert that they are in no better situation than those who get access to credit resources at less than market rates. As a result, there has been difficulty in attracting certain groups to participate in programs that charge market rates of interest.

It is therefore suggested that the government undertake a review towards further rationalizing the interest rate structure and/or consolidating the implementation of these programs. The latter can be implemented through the transfer of funds and lending functions to existing GFIs, i.e., LBP or DBP as the case may be. Consolidation can bring about more efficiency in the utilization of funds, create greater program impact, and minimize subsidy losses to the government.

On the other hand, because of the sectoral thrusts of these different programs, some institutional mechanisms need to be put in place to set policy directions, monitor performance and coordinate overall activities. These activities can be undertaken by existing coordinative bodies, such as the Agricultural Credit Policy Council (ACPC) for agriculture and the newly created Small and Medium Enterprise Development (SMED) Council for industry.

7. Provision of Term Credit for Agriculture and Industry

A major gap that constrains the development of agriculture and industry is the inadequacy of reasonably-priced term credit. The importance of term credit cannot be overemphasized. An agro-industrial development strategy based on post-production processes, such as the processing and/or manufacture of agro-based and/or industrial commodities, hinges crucially on the provision of term credit to finance expansion of existing production facilities and new investments in machineries, post-harvest facilities, transport and communications, and other durable capital.

In agriculture, it is estimated that demand for investment credit during the next five years will reach P215 billion (World Bank 1991). In industry, while no corresponding hard estimates are available on the magnitude of the demand for term credit, it is expected that there will be a substantial need for financing expansion and new projects in industry as a result of a more fundamentally sound macroeconomic environment and liberalized foreign investment climate.

The main sources of supply for medium- and long-term credit as noted earlier are government-directed credit programs. Commercial banks which by far comprise the largest segment of the financial system generally lend short. This is not surprising because of interest rate and exchange rate volatility during the past decade. Their limited participation is usually through ''roll-over'' of their short-term loans and/or by merely acting as lending conduits for funds borrowed from foreign sources or provided by the government. However, this does not mean that long-term funds are not available in the financial system as a whole. The 1988 World Bank Report found that private sector insurance companies, GSIS, SSS and pension funds have consistently generated excess cash. But these have not been lent to either industry or agriculture to a significant extent because of the absence of appropriate capability for project appraisal and related skills. What is needed is to develop a financially viable institutional arrangement which can bring together banks and the providers of long-term funds.

There are at present two existing institutions which can perform these functions for industry and agriculture. DBP is the most logical candidate in the case of industry, while LBP can assume a similar role for agriculture. This institutional arrangement offers the advantage of using DBP's accumulated experience and expertise in term lending. On the other hand, LBP which is currently handling the ALF and the Countryside Loan Fund (CLF) is increasingly gaining competence in this area. It must be emphasized that to avoid possible conflict of interest, DBP and LBP should primarily undertake wholesale operations. Under this set-up, DBP and LBP assume the liquidity and credit risks vis-a-vis participating financial institutions. This institutional arrangement does not require any legislation as these are already being performed to a certain extent. What is needed is essentially to reorganize and strengthen the institutions. This would require, for instance, the creation of a specialized unit to handle specific areas and services related to wholesale banking and mobilization of long-term funds.

Since institutional credit is unlikely to be made available to MSMEs with insufficient collateral, MSMEs access to institutional credit can be improved through appropriate credit guarantee programs. However, provision of credit guarantee should be strictly based on the project viability. Some minimum collateral security should also be required to minimize adverse selection problems among borrowers. There are at present eight credit guarantee institutions/programs in the Philippines. These are the Quedan and Rural Credit Guarantee Corporation (QRCGC), Philippine Crop Insurance Corporation (PCIC), Bagong Pagkain ng Bayan (BPnB), Guarantee Fund for Small and Medium Enterprises (GFSME), the Philippine Export and Foreign Loan Guarantee Corporation (Philguarantee), the Small Business Guarantee and Finance Corporation (SBGFC), the Bankers Association of the Philippines (BAP) Credit Guarantee Corporation, and the USAID-supported credit guarantee corporation. Of these, only GFSME, the SBGFC, the USAID-supported guarantee and

Philguarantee provide credit guarantee for small and medium enterprises. The first provides credit guarantee for domestic producers while the latter two service exporters. The SBGFC rides on the existing credit guarantee facilities/operations of GFSME. Only GFSME provides credit guarantee for term loans.

Given the projected demand for term credit, it is unlikely that the current level of capitalization of GFSME can meet the projected demand to a significant extent. Because of size and maturity features, this may necessitate increased capitalization and other amendments in its charter via appropriate legislation.

8. Rediscounting and Supply of Export Finance

The adoption of a realistic exchange rate policy, while a key ingredient to an export-oriented strategy, needs to be complemented by improved access of existing as well as potential exporters to adequate export financing. The most important export financing scheme is the CB rediscount window.

In 1983, outstanding rediscounts to the commercial banking system was P8.8 billion. This dropped to P5.4 billion in 1985 as a result of the reduced demand for credit following the implementation of stabilization measures from 1984 to 1985. The drop in the level of outstanding rediscounts continued until 1988, followed by a slight increase in 1989. In 1990, outstanding rediscounts in nominal terms increased significantly to P6.6 billion. The limited access to export financing is clearly indicated by the ratio of export rediscounts to value of exports. As of 1990, rediscounted export papers covered only two percent of the total value of exports. This was even lower than the 1985 figure (Table 14).

The decline in export loans is largely related to the fact that the export window is part of the overall rediscount window which, since 1986, has been realigned to manage liquidity in the financial system. Thus, during periods of tight liquidity, exporters' access to financing is restricted which is often just the time when access to export loans is critical. Given the importance of export financing in enhancing the performance of the country's export sectors, some refinancing mechanism must be developed that will 'insulate' the export sector from overall liquidity conditions in the financial market.

One suggested mechanism is a special revolving rediscount window for direct and indirect exporters which is not part of the regular rediscounting window. This can be priced at near market rate to minimize distortions. Note that while this facility can provide liquidity to banks, it is unlikely by itself to significantly improve access and availability of export credit to SMEs, especially first-time exporters, who may not be perceived as creditworthy for lack of adequate information on their export potential and track record. As such it is important that the establishment of this rediscount window be complemented with the establishment and/or strengthening of an effective preshipment credit guarantee mechanism.

Philguarantee is currently providing this kind of service to a limited number of exporters. BAP Credit Guarantee Corporation plans to go into this but has yet to operationalize its guarantee window. With increased participation of MSMEs and new exporters, its effectiveness will depend significantly on how it can deal with the informational problem of creditworthiness described above, and the level of guarantee exposure it can accommodate. This may require more intensive efforts at gathering

Table 14: OUTSTANDING REDISCOUNTS OF THE CENTRAL BANK, LOANS OUTSTANDING OF COMMERCIAL BANKS (KBs) AND EXPORT VALUES

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. Rediscounting	12063	13296	8812	4835	5425	3487	3944	3678	4459	6579
Rice and Corn	1489	1573	28	-	-	-	-	-	-	-
Exports	5846	6122	3844	2092	2162	1174	1736	1999	2687	4594
Sugar	3110	3539	1889	1446	834	822	809	797	788	776
Traditional	1234	950	72	-	243	64	226	231	342	421
Non-Traditional	1502	1633	1883	646	1085	288	701	971	1557	3397
Gold and Copper	-	-	-	-	-	-	-	-	-	-
Emergency/Special Credit Accomodations	3726	3905	3512	2317	2694	1887	1768	1514	1520	1306
Others	1002	1696	1428	426	569	426	440	165	252	679
2. Total Loans Outstanding	86505	98240	115390	120355	91827	88325	101112	126615	165858	149860
3. Value of Exports ($)	5722	5021	5005	5391	4629	4842	5720	7074	7821	8186
Exchange Rate	7.9095	8.5507	11.1345	16.6984	18.7334	20.3791	20.5607	21.0654	21.7204	28.1250
Value of Exports (P)	45258	42933	55728	90021	86717	98676	117607	149017	169875	230231
4. Ratio: Export Rediscounting/Loans Outstanding	6.76	6.23	3.33	1.74	2.35	1.33	1.72	1.58	1.62	3.07
5. Ratio: Loans Outstanding/Value of Exports (P)	191.14	228.82	207.06	133.70	105.89	89.51	85.97	84.97	97.64	65.09
6. Ratio: Export Rediscounting/Total Rediscounting	48.46	46.04	43.62	43.27	39.85	33.67	44.02	54.35	60.26	69.83
7. Ratio: Export Rediscounting/Value of Exports	12.92	14.26	6.90	2.32	2.49	1.19	1.48	1.34	1.58	2.00

and disseminating information among the MSMEs. Subject to the actual magnitude of credit demand, it may also call forth increased capitalization that can be accomplished through legislation.

VI. SUMMARY AND CONCLUSIONS

Based on the analysis of the impact of existing policies, this study identified the gaps and outlined a set of policy initiatives on money, credit and banking supportive of an agro-industrial development strategy. It is emphasized, however, that while monetary and banking policies can be made supportive of developmental thrusts, they cannot work independently of the rest of macroeconomic policies. Recent experiences with financial reforms show that financial reforms carried out against an unstable macroeconomic background can heighten instability. Complete liberalization of interest rates in countries with high and unstable rates of inflation can lead to high real interest rates and wide spreads between lending and deposit rates. Moreover, because of the rigidity and other existing distortions in the other sectors and markets, rapid deregulation in the financial system may worsen matters by causing the financial system to respond more flexibly to bad signals.

As recent Philippine experience illustrates, financial development entails more than *de facto* liberalization of interest rates. Deregulation of the financial system must be complemented by measures aimed at improving the foundations of banking and finance for the enforcement of contracts, disclosure requirements, and the structure of prudential regulation and supervision. Effective regulation and supervision by bank management, by market forces, and by public authorities are all necessary to reduce recklessness and fraud.

Moreover, liberalization should not be limited to the reform of the banking system. It should seek to develop a more broadly based financial system that will include money and capital markets and nonbank intermediaries. Finally, given the prerogative of Congress in setting policy, it is imperative that the Executive Branch and/or the Central Bank establish close coordination with Congress in the pursuit of policy changes requiring legislation, and to forestall legislative initiatives that undermine current policy reforms.

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