

**THE URBAN INFORMAL CREDIT MARKETS:  
AN INTEGRATIVE REPORT**

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by

Mario B. Lamberte\*

I. INTRODUCTION

This paper pulls together the major results of the various studies on urban informal credit markets (ICMs).<sup>1/</sup> The major topics are organized according to the terms of reference (TOR) for the country study drawn up by Ghate (1986) which were favorably considered by researchers of participating countries during a workshop held in Manila on 28 - 30 May 1986.

The TOR covers a wide range of topics which ought to be considered in the country study. However, the peculiar characteristics of the Philippine financial system (both formal and informal) and the limited budget for the study preclude us from including all the suggested topics.

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The views expressed in this study are those of the author and do not necessarily reflect those of the Institute.

<sup>1/</sup> See Lamberte (1988); Lamberte and Bunda (1988), Lamberte and Balbosa (1988), and Lamberte and Jose (1988). These are parts of a larger study on ICMS in the Philippines, sponsored by the Asian Development Bank (ADB).

In an effort to follow closely the TOR, some important findings which are unique to the segments of the ICMS under study are purposely left out. Major policy implications will be discussed later, after integrating the results of all studies on ICMS in the Philippines under this project.

## II. MAJOR STRUCTURE OF THE INFORMAL CREDIT MARKETS, SIZE AND TRENDS IN SIZE, AND POLICY AND LEGAL ENVIRONMENT

Before one proceeds with studying the ICMS, it is necessary to draw a line first between formal and informal credit markets, and then identify the segments belonging to the latter. It has been fashionable to say that LDCs are characterized by a dualistic financial system. On one hand, there exist the formal credit markets (FCMs) which are regulated by state agencies. On the other hand, there exist the informal credit markets (ICMS) which perform certain financial functions but operate "outside the orbit of institutional and officially regulated finance" (Chandavarkar [1987]). This characterization of the financial market leaves the impression that one has to make a big jump in order to go from one segmented sector to the other. This is not the case in the Philippines. What we have instead is a continuum with participants in the financial market regulated at varying degrees. Some are less regulated than the others whereby they achieve a greater degree of flexibility almost similar to that of completely unregulated participants. The problem now is where to draw the line so that we can properly identify segments of the financial system that belong to the ICMS and FCMs.

The most important hallmark of the ICMS is flexibility. ICMS are flexible because they function "outside the purview of regulations imposed on the formal sector with respect to capital, reserves and liquidity requirements, ceilings on lending and deposit rates, mandatory credit targets, and audit and reporting requirements" (Ghate [1986]). In the Philippines, only the Central Bank imposes such regulations on financial intermediaries directly under its supervision. We may then say that financial intermediaries which do not fall under the direct supervision of the Central Bank belong to the ICMS. Given this definition, we can classify two groups of participants in the ICMS. One group consists of those which are registered with a particular government agency but are exempted by law from regulations imposed by the Central Bank. The other group is composed of financial intermediaries which are not registered with any government agency. If they would be registered, they will then have to be subjected to Central Bank regulations because of the very nature of their operations. Note, however, that they are not necessarily illegal in the sense that sanctions can be applied to them once they become known to authorities. Central Bank regulations and sanctions, after all, can only be extended to officially registered institutions.

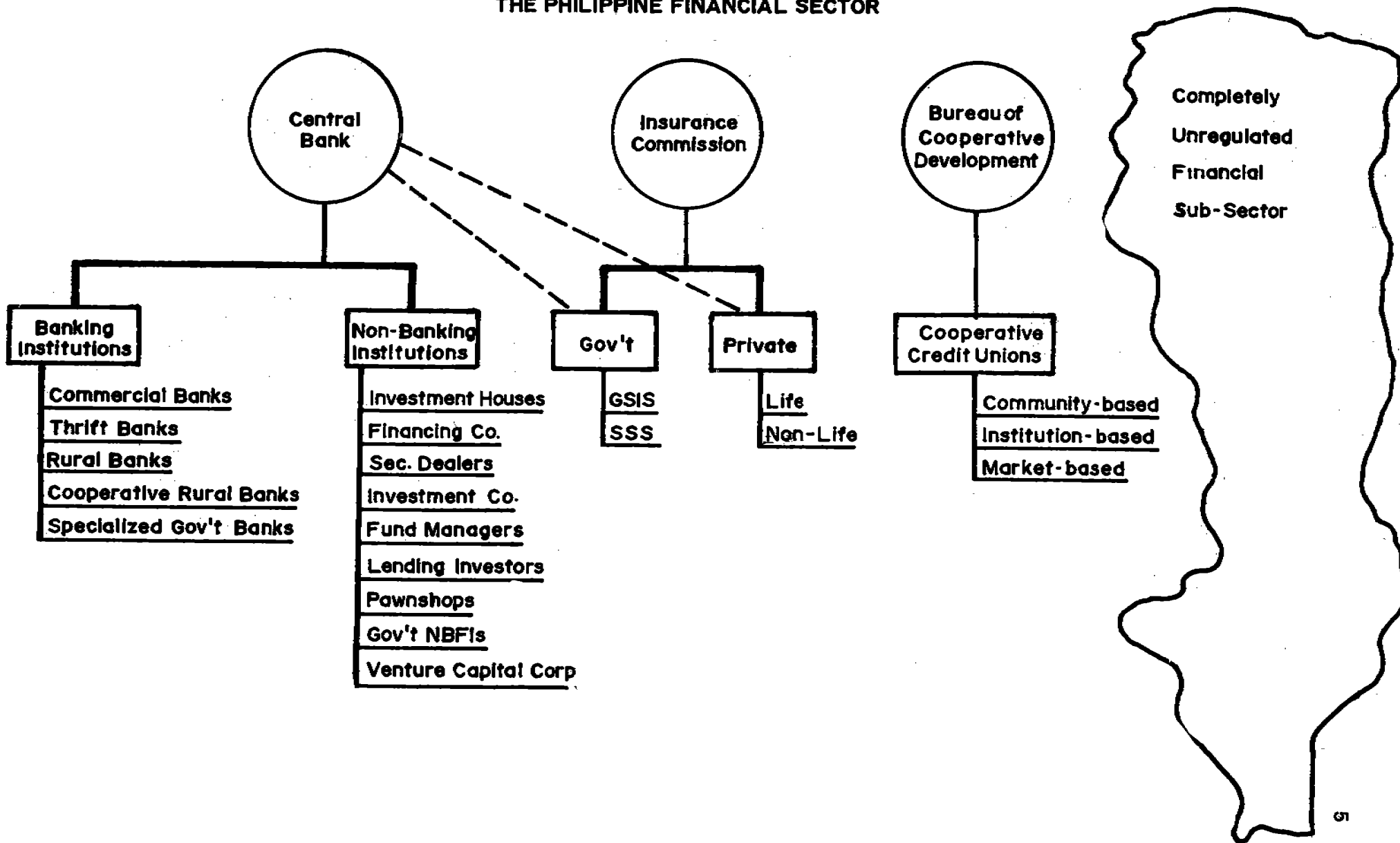
In the Philippines, quite a number of regulatory changes have been effected through the years. It is worth noting that financial intermediaries which once operated outside of Central Bank regulations are now registered with and supervised by it.

A description of the Philippine financial system and a brief review of its regulatory environment can help clarify these issues. The financial system can best be described by grouping financial intermediaries under the regulatory agency(ies) directly supervising them (see Figure 1).

The Central Bank was explicitly given the mandate to oversee all banking institutions. Its control over banking institutions was meant to ensure the effectiveness of the monetary policy instruments. The usual regulations, such as minimum capital and reserve requirements, interest rate ceilings, etc., were applied to these institutions. As the economy grew, the financial system became more sophisticated. Thus, in the 1960s, several companies/entities registered with specific government agencies participated in the credit markets without being regulated by the Central Bank. New financial instruments, called deposit substitutes, started to emerge in the market. All these innovations arose as a response to the repression of the financial system.

On the basis of the nature of their operations, the registered financial institutions may be grouped into three broad categories namely: (1) institutions which regularly engage in the lending of funds obtained from the public in the form of deposits; (2) institutions which regularly engage in the lending of funds obtained from the public through the issuance of their own debt instruments other than deposits, such as acceptances, promissory notes, participations, etc.; and (3) institutions which regularly engage in the lending of funds but do not obtain funds from the public (either as deposits or their own debt

**FIGURE**  
**THE PHILIPPINE FINANCIAL SECTOR**





instruments). The second and third groups are called non-bank financial intermediaries (NBFIs). Of the three groups, only the first was under the supervision of the Central Bank before 1972. The rest were not regulated by the Central Bank, although they were registered with other government agencies (e.g. Securities and Exchange Commission, Department of Trade and Industry), and as such could then be considered as segments of the ICMS.

The phenomenal growth of the NBFIs, especially in the 1960s, caused a major decline in the volume of total resources of the financial system subject to the direct control of the Central Bank. Funds shifted to the NBFIs because they paid interest rates much higher than the regulated rates. This threatened the effectiveness of monetary policy. The 1972 financial reforms tried to correct this weakness by putting all banking institutions and NBFIs under the control and supervision of the Central Bank. This is more or less along the lines suggested by Gurley and Shaw. According to the Central Bank definition, NBFIs include:

- (a) A person or entity licensed and/or registered with any government regulatory body as a non-bank financial intermediary, such as an investment house, investment company, financing company, securities dealer/broker, lending investor, pawnshop, money broker, funds manager, cooperative, insurance company, non-stock savings and loan association, and building and loan association.
- (b) A person or entity which holds itself out as a non-banking financial intermediary, such as by the use of a business

name, which includes the term "financing", "finance" "investment", "lending" and/or word/phrase of similar import which connotes financial intermediation, or an entity which advertises itself as a financial intermediary, and is engaged in a function where financial intermediation is implied.

In general, NBFIs are not allowed to borrow from the public. The term "public" refers to twenty or more creditors at any one time. However, NBFIs may obtain a license to have "quasi-banking" functions, in which case they are allowed to borrow from the public provided that deposits are not among the debt instruments they issue.

All the financial institutions which are under the supervision of the Central Bank belong to the formal credit markets (FCMs). They are all subject to the minimum capital requirement, although this varies across different types of financial entities. For example, banks have higher capital requirements than non-banking institutions. Their debt instruments are subject to a specific reserve requirement ratio. Their borrowings and loan portfolio, particularly DOSRI<sup>2/</sup> accounts, are frequently monitored by the Central Bank. Supervision includes not only the mere issuance of rules, but visitatorial powers as well so that regulations can be fully implemented, and if violated, sanctions can be effectively imposed on violators.

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<sup>2/</sup>  
DOSRI accounts are bank loans to its directors, officers, stockholders and related interests.

It is then clear that in the Philippines, finance companies, pawnshops and lending investors belong to the FCMs, unlike in other countries. There was a time when several finance companies succeeded in borrowing from the public without getting an authorization from the Central Bank. These were, of course, illegal. It became known to the authorities and the public only when a crisis hit the financial system in 1981. The Central Bank acted swiftly by revoking the license of the violators.

Insurance companies, both government and public, have never been under the supervision of the Central Bank. The Insurance Commission, which is an independent body, is empowered to regulate insurance companies. It is to be noted that insurance companies also engage in direct lending, although it is still limited to their own members. Their funds come mainly from the sale of insurance policies, not from the issuance of debt instruments similar to those issued by NBFIs. However, insurance companies are required to submit financial statistics to the Central Bank. The purpose is to ascertain the effects of their operations on the monetary, credit and exchange situation of the country, and not to supervise them. Since this allows the Central Bank to maintain its control over total liquidity of the system, insurance companies may be considered part of the FCMs.

Another group of financial institutions is the cooperative credit unions (CCUs). They operate like mutual savings and loan associations raising deposits from their members at one end and providing loans to their members at the other end. Except for the cooperative rural banks which are registered as rural banks

under the Rural Banking Act, CCUs are not under the supervision of the Central Bank. Nor are they required to submit financial reports to the Central Bank. The Bureau of Cooperatives Development (BCOD), which is attached to the Department of Agriculture, is empowered to regulate CCUs. However, their functions are minimal and do not include a monitoring of the loan portfolio or the imposition of reserve requirements and other intermediation taxes. Thus, cooperative credit unions operate virtually free of any regulations imposed by the Central Bank on the financial intermediaries under its jurisdiction. Neither are they monitored by the Central Bank. As a result, they have greater flexibility compared to financial intermediaries operating under Central Bank's rules. Interestingly, many of these cooperative credit unions are even larger than some rural banks and thrift banks.

Since CCUs are not supervised by the Central Bank, and since there are no Central Bank-like regulations imposed on their liabilities and loan portfolio, they can be considered as segment of the ICMS.

Aside from cooperative credit unions, there are many institutions/individuals that perform financial intermediation functions. Some of them raise deposits for on-lending. Others use their own funds for on-lending. To the extent that they are not subject to Central Bank regulations, they are considered segments of the ICMS. These include the "paluwagan" or ROSCAS, landlord-lenders, traders/input suppliers, trader/miller lenders, farmer-lenders, and professional moneylenders, among others.

The financial policy environment has been greatly altered in the past two decades. In 1980, a set of financial reforms was introduced, including the removal of interest rate ceilings and the reduction of differentiation among types of financial institutions to encourage more competition. Towards the latter part of 1985, the Central Bank started to align the rediscounting rate with the market rate. Likewise, special credit programs were phased out. This is not to say that the financial market is now fully deregulated. In fact, restrictive regulations still remain. Branching and portfolio ceiling regulations are examples of such (see Lamberte [1987]). Also, existing intermediation taxes that drive a wedge between deposit and lending rate are still being imposed.

To satisfy the terms of reference (TOR) of this study, we have focused on four major sources of credit in the urban ICMS, namely: (1) professional moneylenders; (2) "paluwagan" which is a form of ROSCAS; (3) cooperative credit union; and (4) input suppliers. As one goes through the results of the various studies, he can observe the relative importance of friends/relatives as sources of credit. However, we have not emphasized the role of this segment of the ICMS in our studies.

We have included pawnshops in this project because they are the least regulated among the financial institutions belonging to the formal financial markets. The comparative analysis is made richer with their inclusion. Also, the inter-country comparisons can be facilitated especially if pawnshops are considered as a segment of the ICMS in other countries.

The project did not conduct a national survey mainly due to budget constraint. Instead, the case method approach was used. Thus, the role of moneylenders and "paluwagan" was analyzed by studying the financial markets in one low-income urban community. A sample of institution-based and market-based credit unions operating in Metro Manila and their members was utilized to examine the role of this segment in the ICMS. As regards input suppliers and trade credits, the footwear industry in Marikina, Metro Manila was chosen as the subject of the study.

The approach utilized in this project makes it virtually impossible to provide an estimate of the size of the urban ICMS, much less to establish the trends in their size. However, some indicative figures can be obtained from various studies. In Sapang Palay where no formal financial institution is operating, 20 professional moneylenders were found to be active with estimated combined resources of ₱1.05 million as of 1987. Thus, the density ratio is one moneylender per 860 households. Twenty (20) business-oriented "paluwagan" were also found to be active with an estimated membership of 193. Since the number of stalls in the public market is 191, it means that virtually all stallholders are members of a "paluwagan".

On a cumulative basis, resources raised by the ten "paluwagans" are estimated to reach ₱7.2 million pesos in 1987. The size of the "paluwagan" must be large even in areas where formal financial institutions operate. For example, it was found that 28 percent of the sample members of institution- and

market-based credit unions are also members of a "paluwagan" and contributed an average amount of ₱19,096 between January to September 1987. It seems that the potential of the "paluwagan" in mobilizing deposits among non-wealthy individuals/households has been overlooked.

Cooperative credit unions (CCUs) are popular in the country, yet very little is known about their size. A recent study stated that there were 1,469 active credit unions in 1980 with a total membership of 167,844 (see USAID [1987]). However, there is no up-to-date information about their combined assets as well as their sources and uses of funds. In Table 1, we put together the combined assets of the 44 members of NAMVESCO plus the assets of the four institution-based credit unions included in the study. As of 1986, the assets of these CCUs amounted to ₱40.4 million in real terms or ₱278.7 million in nominal terms. These are roughly 28 percent of the combined assets of all pawnshops in the country in the same year. Thus, it can be surmised that the total size of the CCUs as a system is at least as large as that of the pawnshops. What is interesting is that its absolute size is growing faster than that of pawnshops and the banking system. The figures also suggest that the relative sizes of the unregulated (i.e., CCUs) and the least regulated financial institutions (i.e., pawnshops) expanded during the crisis period at the expense of highly regulated financial institutions (i.e., banking system).

Table 1

**COMPARATIVE PERFORMANCE OF SELECTED CREDIT UNIONS,  
PAWNSHOPS AND BANKING INSTITUTIONS**

Year	Selected Credit Unions		Pawnshops		Banking System	
	Real Assets (PM)	Growth Rate (%)	Real Assets (PM)	Growth Rate (%)	Real Assets (PM)	Growth Rate (%)
1980	-	-	101.6	9.7	63,206.2	6.0
1981	-	-	105.9	4.2	67,343.8	6.6
1982	21.6	-	111.1	4.9	75,061.5	11.5
1983	25.1	16.2	114.1	2.7	82,801.7	10.3
1984	21.8	13.2	108.3	-5.0	65,587.1	-20.8
1985	25.5	17.0	119.3	10.1	55,810.0	-14.9
1986	40.4	58.4	146.6	22.9	41,160.0	-26.2

Sources: Table 2 (Lamberte [1988]); NAMVESCO Annual Reports (various years); and Financial Statements of a sample of Cooperative Credit Unions.



We have a more precise estimate of the size of trade credits which we obtained from the flow-of-funds table prepared by the Central Bank (see Table 2). Trade credits availed of by the manufacturing sector in 1986 amounted to P22 billion in nominal terms. Both the absolute and relative size of trade credits had been increasing since 1979 and reached a peak in 1983, a year before the full effect of the balance-of-payments crisis was felt. When banks continued to reduce their lending activities in 1985 and 1986 in view of the instability of the economy, the manufacturing sector increased their dependence on trade credits.

The figures on trade credits presented in Table 2 could have grossly underestimated the actual volume of trade credits since the flow-of-funds table made use only of data from corporations belonging to the top 1000 corporations. In our study of the footwear industry in Marikina where none of the firms belong to the top 1000 corporations, trade credits comprise 82 percent of the value of the sales of the sample footwear manufacturers and 80 percent of the value of their material inputs. In 1986, sales of the sample firms averaged P1.4 million while annual value of material inputs averaged P0.4 million.

### III. SAVINGS, CONSUMPTION CREDIT, ALLOCATION EFFICIENCY, EQUITY, INTERACTION WITH FORMAL SECTORS AND IMPLICATIONS FOR MONETARY POLICY AND DEPOSITOR SECURITY

The savings mobilization role varies according to the segments of the ICMS. In general, professional moneylenders do not

mobilize deposits. The results of our study support this. Funds for on-lending come mainly from their earnings from employment

Table 2

TYPES OF CREDIT OF THE MANUFACTURING SECTOR  
(In Million Pesos)

Year	Loans	Trade Credits	Total
1979	112,836.2 (89.3)	13,540.5 (10.7)	126,376.7 (100.0)
1980	115,553.1 (84.7)	20,894.1 (15.3)	136,447.2 (100.0)
1981	129,477.2 (86.7)	19,916.3 (13.3)	146,393.5 (100.0)
1982	140,146.7 (83.8)	27,079.0 (16.2)	167,225.7 (100.0)
1983	155,369.0 (83.0)	31,878.8 (17.0)	187,247.8 (100.0)
1984	119,154.0 (88.2)	15,891.0 (11.8)	135,045.0 (100.0)
1985	77,091.6 (73.5)	27,753.9 (26.5)	104,845.5 (100.0)
1986	79,718.4 (78.1)	22,376.0 (21.9)	102,094.4 (100.0)

Source: Table VI.1 (Lamberte and Jose [1988]).

business. One started lending money by using the income of her husband who works in Saudi Arabia. However, there is an exception to this general observation. In Sapang Palay, one moneylender is found to be playing the role of an indigenous banker. She accepts time deposits for as low as ₱100 and pays an interest of 80 percent per annum. This is an opportunity not provided by banks whose minimum time deposit is ₱5,000, an amount much higher than what low-income earners can afford. As of the date of the interview, this moneylender had 51 depositors with combined deposits amounting to ₱40,200. This comprised about 70 percent of her loanable funds. This demonstrates the capability of moneylenders to mobilize deposits. What seems to be important is that they can fashion out an instrument that is attractive and affordable to low-income earners.

The CCUs and "paluwagan" are an important means of mobilizing deposits among low-income earners. These are basically self-help institutions designed to assist those who do not have access to the credit facilities of the banking system. Saving with these institutions entail very low transactions cost simply because they operate in a limited geographic setting, e.g., public markets, offices, etc. and cater to fairly homogeneous individuals, e.g., market vendors, employees, etc. In such a situation, it is very easy to install a low cost system of collecting deposits like hiring collectors in the case of market-based CCUs and payroll deduction in the case of institution-based CCUS. In contrast, the transactions cost for depositing in a bank is prohibitively high. Our study, for instance, shows that

a bank depositor living in Sapang Palay spends on the average ₱13.93 every time he deposits/withdraws money from a bank.

One attractive feature of these informal savings institutions is reciprocity. Members save with the expectation that they can borrow, and they tend to save more if they want to borrow more. As shown by the results, these savings institutions facilitate saving-investment decisions of low-income earners. In particular, the existence of a variety of "paluwagan" offers them opportunities to save and overcome the problem of indivisibilities in investment and consumption in accordance with their financial capacity.

Savings mobilized by CCUs and "paluwagan" are quite substantial (see Table 3). As of the date of the interview, the average fixed deposit of the sample CCU members stood at ₱9,145. This is about 12 times greater than their average initial fixed deposits. Considering that respondents of the study have been members of their respective credit unions for an average of 8.7 years, it means that on the average, each member has been increasing his fixed deposit by ₱967 per year. In Sapang Palay, "paluwagan" members received "sahod" or kitty averaging ₱26,080 from the "paluwagan" for the past two years. These are not insignificant amount of savings mobilized by such institutions.

There are clear indications that the existence of CCUs and "paluwagan" has brought about net addition to total financial savings. For instance, among the sample CCU members, almost half do not have deposits with a bank, and among the sample

Table 3

## SAVING BEHAVIOR OF CCU MEMBERS

	Fixed Deposits		Savings Deposit		Time Deposits	
	No.	Ave. Amt. (P)	No.	Ave. Amt. (P)	No.	Ave. Amt. (P)
1. CCU	82*	9,144.25	46 (56.1)	13,301.60	-	-
2. Banks	-	-	45	38,584.10	12	32,287.54
3. Paluwagan	-	-	-	-	22	19,096.26

\*Two respondents did not give the answer.

Note: Figures in parentheses are percent.

Source: Table V.16 (Lamberte and Balbosa [1988]).

"paluwagan" members, 72 percent do not have deposits in a bank. Interestingly, among bank depositors, only a handful of them were able to borrow from a bank (see Tables 4 and 5).

Segmentation seems to be more pronounced in the ICMs than in the FCMs. For instance, cooperative credit unions and "paluwagan" tend to operate in areas where members are fairly homogeneous, like all are market vendors in the same locality, or employees of the same firm. Loans are given only to members. Input suppliers do the same. That is, they grant trade and cash credits only to manufacturers directly buying raw materials from them. Even moneylenders tend to narrow down their lending to "suki" or prime clients. Indeed, this puts into question the allocative functions of the ICMs. The high degree of segmentation seems to prevent these institutions from channeling funds from low to high productivity uses.

The perceived favorable equity impact of ICMs can also be questioned. For example, one credit union was found charging 25.2 percent per annum for loans up to ₱500 with a maturity period of 5 months while it charges only 13 percent per annum for loans above ₱1,000 with a maturity period of 12 months. With the loan capacity formula which credit unions are using, big depositors can borrow amounts several times larger than those of small depositors. This is aggravated by the fact that the effective interest rate is not adjusted according to risk. Likewise, results show that input suppliers tend to charge higher effective interest rate on trade credits to small footwear manufacturers than to big footwear manufacturers.

Table 4

## BORROWING BEHAVIOR OF CCU MEMBERS, JANUARY - SEPTEMBER 1987

Sources of Credit	(1) No. of Respondents	(2) Average Amount Borrowed (₱)	(3) Average Maturity days	(4) Average Interest (%)
1. CCU	80 (97.6)	21,760.30 (23,615.20)	258.7 (572.4)	19.5 <sup>1/</sup> (5.8)
2. Banks	4 (4.9)	12,750.00 (18,191.12)	322.5 (75.0)	19.5 (7.33)
3. Professional Moneylenders	7 (8.2)	2,785.70 (2,118.50)	65.7 (30.3)	120.0 (0.0)
4. Friends/Neigh- bors/Relatives	14 (17.0)	10,607.14 (10,388.93)	95.0 <sup>2/</sup> (60.0)	6.0 <sup>3/</sup> (-)
5. Traders/Suppliers	26 (51.0) <sup>4/</sup>	51,613.46 <sup>5/</sup> (121,792.49)	53.5 (19.3)	29.3 <sup>6/</sup> (4.2)
6. Paluwagan	22 (26.8)	19,096.26 (41,486.10)	-	-

<sup>1/</sup> Effective interest rate which is the interest rate discounted in advance plus all charges.

<sup>2/</sup> Refers to only 7 respondents. The other 7 respondents have loans without maturity.

<sup>3/</sup> Refers to only one respondent. The other 13 respondents were not charged interest on their loans.

<sup>4/</sup> Refers to only those who are engaged in a business.

<sup>5/</sup> Refers to an average amount borrowed per month.

<sup>6/</sup> Price differential between goods bought in cash and on credit. This is based on the responses from 15 respondents.

Note: Figures in parentheses in column (1) are percent, while in columns (2) - (4) are standard deviations.

Source: Table V.21 (Lamberte and Balbosa [1988]).

Table 5

## ALTERNATIVE SOURCES OF LOANS, MATURITY PERIOD AND INTEREST RATE

Source	Respondent		Average Maturity Period (Days)	Average Interest Rate (%/ annum) *	Average Amount Borrowed (₱)
	Number	% of Total			
Bank	0	0	-	-	-
Savings Association	4	8.9	67.5	66.2	1,137.50
Moneylenders	9	20.0	76.4	111.11	1,558.89
Relatives	8	17.8	10.62	0.0	2,525.00
Traders/ Suppliers	24	53.3	12.58	0.0	3,481.67
Others (friends, neighbors, etc.)	7	15.6	23.43	13.7	12,021.43

Source: Table V.11 (Lamberte and Bunda [1988]).



In general, lenders in the ICMs do not restrict the use of loan proceeds. This is one of the attractive features of ICMs. Table 6 shows how borrowers allocated the loans obtained from CCU and "paluwagan". The kinds of members of these savings and credit institutions determine to a large extent the uses of the loans. It should be noted that most members of the sample CCUs and "paluwagan" are market vendors. Thus, a great proportion of the loan proceeds was used for productive purposes. The relatively short maturity period of these loans prompted borrowers to use them for augmenting their working capital. It is to be noted, however, that a significant proportion of the loan proceeds was used for other purposes, such as family consumption, house repairs/improvement, acquisition of household appliances, education, etc. Productive consumption seems to be one of the important uses of loans.

Whether formal and informal sectors are substitutes or complementary to each other is indeed an important issue that must be dealt with. It is, however, unfortunate that the nature of the data of the various studies do not permit us to construct a model to test such hypothesis. Nevertheless, some indicative results can be obtained from the various studies. One indicator of the substitutability of both sectors is that one expands at the expense of the other. We can perhaps examine the behavior of some segments of the urban ICMs through time since these are the only information available to us. When looking at the data on hand, it must be recalled that the Philippines suffered the worst economic crisis during the period 1984 - 1986. As may be seen in

Table 6  
USES OF LOAN PROCEEDS  
(In Percent)

Uses	CCU	Paluwagan
Business	60.0	49.2
Household appliances/furniture	5.8	3.2
House repairs/improvements	1.9	10.2
Family consumption	6.4	9.6
Payment of loans	3.7	12.3
Loans to others	1.7	2.4
Savings	0.9	7.8
Education	8.1	0.5
Medical care	2.5	-
House/lot acquisition	1.2	-
Application for overseas job	-	1.1
Jewelries	0.1	-
Others	7.7	3.8

Sources: Table V.8 (Lamberte and Bunda [1988]) and Table V.13 (Lamberte and Balbosa [1988]).

Table 1, the real assets of both the selected CCUs and the banking system had been growing before 1984. However, during the crisis period, the real assets of the banking system had been shrinking while those of the selected CCUs had been increasing. Pawnshops, which are the least regulated among the formal financial institutions, follow the same growth pattern as that of CCUs. The same can be said of trade credits. As shown in Table 2, both bank loans and trade credits grew in absolute terms before 1984. During the economic crisis both types of credit dropped precipitously. However, trade credits recovered fast and even increased their size relative to bank loans, implying that the manufacturing sector increased its dependence on trade credits when bank loans became scarcer.

Viewed from the macro perspective, results seem to suggest that during normal times, both the formal and informal sectors are complementary, while during abnormal times, both are substitutes to each other. This general observation should however be qualified by taking into consideration the survey results. As already pointed out, financial markets in LDCs are severely fragmented. One cannot easily move from one market to the other. Thus, for non-wealthy individuals who do not have access to bank credit, the question of substitutability between formal and informal credit sectors is irrelevant. As can be gathered from Table 4 and Table 5, only a handful had access to bank credit. However, among segments of the ICMS, some element of substitutability seems to exist. For instance, CCUS and "paluwagan" were organized partly to free members from moneylenders. Thus, only

very few CCU and "paluwagan" members borrowed from moneylenders. Even the moneylender who organized two "paluwagan" units does not lend to the members of her "paluwagan". Also, the availability of trade credits has somewhat reduced the demand for credit from moneylenders.

There seems to be a weak linkage between formal and informal sectors. None of the sample CCUs ever borrowed from a bank. Banks serve as a depository of CCU funds. However, in 1986 deposits with banks comprised only 6 percent of their total assets. The "interlending scheme" which is currently gaining popularity among CCU federations may further weaken this linkage (see below for details). Also, none of the moneylenders interviewed ever borrowed from a bank to finance their lending operations.

Input suppliers have very limited contact with banks as sources of additional funds. Only two of the nine sample input suppliers borrowed money from banks in 1987. One of them obtained a long-term loan to finance the acquisition of fixed assets while the other secured a short-term loan to augment his working capital. Only the latter seems to be able to link the formal credit market with the informal credit market. The reason why the majority did not borrow from bank is that they have access to trade credits. In fact, all of the sample input suppliers availed of trade credits from manufacturers of raw materials.

Depositor security seems to be less of a concern to participants in the ICMS. It should be noted that in the past few years, a number of banks collapsed. Newspapers were then full of stories about the predicament of depositors who tried to claim their deposits from the Philippine Deposit Insurance Corporation (PDIC). In contrast, none of the sample CCUs experienced a run on deposits. In the case of the sample "paluwagan", two managers claimed that a member defaulted after receiving the "sahod" (kitty). To prevent the "sahod" from decreasing in the succeeding turns, the managers assumed the defaulter's liabilities. This gesture is expected of "paluwagan" managers thereby ensuring the security of the contributions of the members. The presence of core members also gives some semblance of stability to the "paluwagan".<sup>3/</sup>

#### IV. INTEREST RATE FORMATION AND TRENDS, COMPETITION BETWEEN FORMAL AND INFORMAL SECTOR, ICMS AS A POSSIBLE SOURCE OF INNOVATIONS, INTERLINKAGE OF CREDIT WITH TRANSACTIONS IN OTHER MARKETS, PROMOTING LINKS WITH THE INFORMAL SECTOR

Various segments of the ICMS have their own way of determining the interest rate on savings deposit and loans. CCUs which are the most organized among segments of the ICMS claimed to have based their interest rate on savings deposits on the prevailing bank rates. During the period 1982 - 1986, the average interest rate on savings deposits of CCUs is observed to be consistently lower by about 1 percentage point than the

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<sup>3/</sup> Core members are those who have been members of the same "paluwagan" units.

average deposit rate given by banks (See Table 7). Interestingly, savings deposit rates of both the CCUs and banks seem to be insensitive to inflation rate. Thus, except for 1986 when the inflation rate dropped sharply to less than one percent, savers have been penalized by both CCUs and banks.

In Sapang Palay where no financial institutions operate, the interest rate on deposits seem to reflect the opportunity cost of capital. In particular, the moneylender who mobilizes deposits pays 80 percent per annum for the deposits in 1987. This is much higher than the inflation rate in that year which was only 3.8 percent.

Lending rates in the ICMS vary according to type and size of loans, maturity period, repayment scheme, type of lenders and to the degree of monopoly power exercised by lenders. In the case of CCUs, the determination of the effective lending rates is somewhat complicated. Interest rate payments are collected in advance and additional charges (i.e., service fee, loan redemption insurance, collection charges) are being imposed. All these have the effect of raising the effective interest rate. Table 8 shows that the nominal rate, which is what is known to members, is only half of the effective interest rate, the other half being accounted for by the advanced payment on interest and other charges. Indeed, the average effective lending rate of CCU approximates the lending rate of banks. This has disproved the off-repeated claim that CCUs charge lower lending rates than banks.

Table 7

TRENDS IN THE INTEREST RATES ON SAVINGS DEPOSITS  
(Percent Per Annum)

Year	CCUs		Banks	
	Nominal	Real	Nominal	Real
1982	8.6	-1.6	9.8	-0.4
1983	8.6	-1.3	9.7	-0.3
1984	8.7	-41.6	9.9	-40.5
1985	8.6	-14.5	10.8	-12.3
1986	8.0	7.2	8.6	7.8

Source: Table IV.1 (Lamberte and Balbosa [1988]).

Table 8

LENDING RATES OF CCUs, 1986  
(In Percent)

	CCUs	NR	NRC	NER
1.	BVDCI	6.5	11.9	13.5
2.	PSPDCI	7.0	18.7	23.0
3.	CMDCI	6.5	17.3	20.9
4.	DTDCI	10.8	21.6	27.6
5.	MCMCCI	7.9	22.3	28.7
6.	MVDCI	6.5	20.9	26.4
7.	UPCCI	10.0	12.2	13.8
8.	FEUCCI	9.0	13.0	14.9
9.	DSE(CBP)KBCI	9.0	10.0	11.1
10.	PECCI	12.0	14.0	16.3
	Average	8.5	16.2	19.6

Source: Table IV.2 (Lamberte and Balbosa [1988]).

Note: NR = nominal lending rate

NRC = nominal lending rate plus other charges

NER = nominal effective lending rate discounted in advance.



Interestingly, lending rates greatly vary across CCUs operating in Metro Manila. Even CCUs belonging to the same federation have different lending rates. The variation in the lending rate is mainly due to the differences in the nominal rates and service charges.

Variation in the lending rates cannot be completely attributed to the geographic location of the credit markets. In a small urban community, we found that interest rate differential among moneylenders for loans of the same maturity is quite substantial (see Table 9). According to the moneylenders interviewed, they do not bother to check the interest rate charged by other moneylenders since they find this exercise futile in view of the excess demand for credit in that community.

We tried to examine the components of the lending rates of moneylenders. The results shown in Table 10 are somewhat mixed. Moneylender A realized a net spread of only 1.5 percent despite a very high lending rate. Two moneylenders, namely F and G, incurred a loss in their lending operations. Since they are new entrants into the market, the loss incurred could be considered as part of the sunk costs necessary to establish themselves in the informal credit markets. The other four moneylenders enjoyed substantial profit margins. Moneylenders D and F who have the biggest number of clients realized the largest spread. It seems surprising though to observe that borrowers do not transfer to moneylenders who charge relatively lower lending rates. The wide dispersion of lending rates among moneylenders and the lack of ability among borrowers to shift from one moneylender to another

**Table 9**  
**INTEREST RATE CHARGED PER ANNUM BY MATURITY,**  
**SIZE AND TYPE OF BORROWER**

		Moneylenders						
		A	B	C	D	E	F	G
<b>A. By Maturity</b>								
(1)	1 - 7 days	-	-	91%	-	-	120%	-
(2)	15 days	-	-	-	-	-	-	-
(3)	30 days	-	-	195%	224%	-	120%	-
(4)	45 days	97%	-	195%	-	-	-	96%
(5)	60 days	70%	97%	-	137%	-	-	-
(6)	90 days	-	193%	-	-	175%	120%	97%
<b>B. By Size</b>								
(1)	small (less than ₱2,000)	same for all	97%	same for all	same for all	same for all	60%	same for all
(2)	large (₱2,000 and more)	-	193%	-	-	-	120%	-
<b>C. By type of borrower</b>								
(1)	new	120%	same for all	same for all	190%	same for all	same for all	same for all
(2)	old	84%	-	-	140%	-	-	-

Source: Table IV.7 (Lamberte and Bunda [1988]).

**Table 10**  
**COMPONENTS OF LENDING RATES OF MONEYLENDERS**

Items	A	B	C	D	E	F	G
Weighted average <sup>1/</sup> lending rate	59.2	108.8	126.8	135.4	131.2	90.0	72.6
Less: Cost of Funds <sup>2/</sup>	45.0	60.0	60.0	60.0	60.0	60.0	60.0
Gross Spread	14.2	48.8	66.8	75.4	71.2	30.0	12.6
Less: Transactions Costs							
1. Processing/ Collection Costs <sup>3/</sup>	4.2	10.4	1.8	2.5	0	0	0.7
2. Administrative <sup>4/</sup> Costs	8.5	15.3	17.4	4.6	22.9	85.8	5.7
3. Cost due to <sup>5/</sup> delayed payments	0	0	0	9.2	0	9.8	17.3
4. Cost of default <sup>6/</sup>	0	0	0	0	0	20.0	1.8
Total	12.7	25.7	19.2	16.3	22.9	115.6	25.5
Net Spread	1.5	23.1	47.6	59.1	48.3	-85.6	-12.9

<sup>1/</sup> The lending rate is weighted by the relative frequency of loans by maturity and is computed on the basis of nine months (i.e., January - September).

<sup>2/</sup> Refers to the actual cost of borrowed funds for moneylenders A and E. The rest refer to the opportunity cost of using own capital which is assumed to be the same as the cost of borrowed funds of moneylender E who is mobilizing deposits. All are computed on the basis of nine months.

<sup>3/</sup> Taken from Table IV.8. (Lamberte and Bunda [1988]).

<sup>4/</sup> Salary of the moneylender based on the minimum wage of ₱54.50 per day. Part-time is equivalent to one-half day.

<sup>5/</sup> Interest rate due to delayed payments (see Table IV.9).

<sup>6/</sup> Refers to actual cost of loan default (see Table IV.9).

Source: Table IV.12 (Lamberte and Bunda [1988]).

are indeed an indication of severely fragmented capital markets prevailing even in a small urban community like Sapang Palay.

The effective interest rate on trade credit is found to consist of the explicit and implicit rates. The explicit rate can further be broken down into the discount rate on post-dated checks and plain interest rate. On the other hand, the implicit interest rate arises out of price differential of inputs or of outputs in the case of "tie-in" credit arrangement. The results of estimating the effective interest rate on trade credits and their components are presented in Table 11.

The discount rate on post-dated check is almost the same for plain trade credit and tie-in credit. The same is true of the plain interest rate. However, the implicit interest rate on trade credit greatly differs between the two sources of trade credit. The implicit interest rate charged by input suppliers is twice as high as the implicit interest rate charged by wholesalers/traders who are also input suppliers. This result needs some explanation.

Wholesalers/traders have usually marketing contracts with big retailers or exporters. To assure themselves of a steady supply of footwear manufacturers, they engage in tie-in arrangements with footwear manufacturers. This is the best way they can reduce business risk arising from non-delivery of goods when they have no control on production. Since footwear manufacturers have alternative outlets for their products and have also alternative sources of inputs, wholesalers/traders are therefore compelled to

Table 11  
COMPONENTS OF EFFECTIVE INTEREST RATE

Source/Component	Percent per year	Percent Share
<b>A. <u>Plain Trade Credit (Input Suppliers)</u></b>		
Discount rate on post-dated checks	33.18	28.51
Plain interest rate	7.35	6.32
Price differential	75.84	65.17
Total	116.37	100.00
<b>B. <u>Tie-in Credit (Wholesalers/traders who are also input suppliers)</u></b>		
Discount rate on post-dated check	31.84	40.67
Plain interest rate	9.60	12.26
Price differential	36.85	47.07
Total	78.29	100.00

Source: Table IV-20 (Lamberte and Jose [1988]).

give footwear manufacturers a better price for their products. This is corroborated by another finding which shows that when it comes to dealing with wholesalers/ traders, footwear manufacturers claimed to have dictated the price of their products. The marketing contract also reduces the risk of default on the credit wholesalers/traders extended to footwear manufacturers.

This is not, however, the case with input suppliers who are solely supplying inputs. Footwear manufacturers find the necessity of borrowing from them since their working capital is tied up with the trade credits they extended to their customers. Therefore, input suppliers can exercise some degree of pricing power which is reflected in greater overpricing of inputs.

The total effective interest rates charged by input suppliers and wholesalers/traders who are also input suppliers are 116.37 and 78.29 percent per annum, respectively. As already pointed out above, the difference can be mainly attributed to the implicit interest rate charged by both sources of trade credit. In both cases, the implicit interest rate accounts for the major proportion of the total effective interest rate on trade credits. It is to be noted that the effective interest rates paid by footwear manufacturers for their trade credits are substantially higher than the interest rate charged by pawnshops and finance companies. However, these are not substantially different from those charged by informal moneylenders.

In determining the effective interest rate, results show that input suppliers discriminate between small and large firms. In particular, small firms are charged higher rates than large firms. The customers of the latter are usually big, well-established department stores, such as Shoemart, Isetann, COD, Fairmart, etc. Post-dated checks issued by these customers are considered less risky compared with those issued by small retailers, and therefore, they command a lower discount rate. In addition, large footwear manufacturers are found to have better bargaining power with their input suppliers compared with small ones, and therefore, they are able to get better terms. In other words, larger firms are charged lower implicit interest rate on their trade credits than small firms.

Another interesting result we found is that input suppliers determine first the total effective interest rate, and then adjust the relative shares of explicit and implicit interest rates.

Table 12 presents a comparison of the lending rates among segments of the formal and informal sectors starting from 1981 when interest rates were liberalized up to 1986. The lending rates greatly vary among these segments of the financial markets. Banks and CCUs appear to have the lowest lending rates. If we add the implicit interest rate to the discount rate on post-dated checks, then the effective interest rate on trade credits could have been the highest among the interest rates of the various segments of the financial markets. Interestingly, the real lending rates of the various segments of the financial market

Table 12

TRENDS IN THE LENDING RATES  
(Percent Per Annum)

Year	Banks		Finance Cos.		Pawnshops		CCUs		Discount Rate on Post-dated Checks	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
1981	16.5	3.4	28.0	14.9	26.5	13.4	-	-	28.2	15.1
1982	16.5	6.3	28.9	18.7	23.4	13.2	20.99	10.74	28.2	18.0
1983	18.6	8.6	34.3	24.3	35.3	25.3	20.99	11.00	30.5	20.5
1984	26.2	-24.1	58.9	8.6	43.2	-7.1	20.72	-29.62	36.0	-14.3
1985	26.9	3.8	40.4	17.3	48.2	25.1	20.52	-2.60	42.0	18.9
1986	14.0	13.2	27.5	26.7	52.2	51.4	19.63	18.86	31.7	30.9

Sources: Table 8 (Lamberte [1988]); Table IV.2 (Lamberte and Balbosa [1988]); and Table V.7 (Lamberte and Jose [1988]).



established an increasing trend since 1981. The trend was interrupted in 1984 and 1985 when inflation rates soared to 50.3 and 23.1 percent, respectively, but then again it re-established itself in 1986 when the economy started to stabilize. One implication of these results is that the interest rate liberalization failed to encourage more competition in the financial system. Other policies, such as the overly restrictive bank entry and branching policies could have negated the effects of interest rate liberalization. In view of the oligopolistic market structure of the banking system, the interest rate liberalization gave banks an opportunity to raise the lending rates. It has been observed that the real bank spread has widened since the removal of the interest rate ceilings (see Lamberte [1987]). Results seem to suggest that the increase in the lending rates in the formal sector have spilled over into the informal sector.

For a credit market to be sustainable in the long-run, the repayment rate should be reasonably high. Loan repayment partly hinges on the financial practices being used. ICMS tend to create financial practices that suit well the cash flow pattern of borrowers. In a low-income urban community, we found a variety of "paluwagan" from which a member can choose depending on how much money he/she wants to raise and on her cash flow pattern. Thus, one may join a daily "paluwagan" that requires small amount of contribution or one that demands a bigger amount of contribution (see Table 13).

Table 13

**CHARACTERISTICS OF THE SIX "PALUWAGAN" UNITS  
(Sapang Palay)**

	Paluwagan units					
	A	B	C	D	E	F
1. Date started	24 June 1987	8 March 1987	14 June 1987	3 May 1987	15 March 1987	30 April 1987
2. Frequency of contribution	daily	weekly	daily	weekly	bi-monthly	monthly
3. Value of one share (₱)	20.00	100.00	140.00	350.00	2,000.00	3,000.00
4. Total number of shares	70	20	34	28	19	15
5. Lot or "sahod" (₱)	1,400	2,000	4,760	9,800	38,000	45,000
6. Number of members	22	16	26	24	18	10
6.1 core members	18	12	24	7	6	10
6.2 new members	4	4	2	17	12	-

Source: Table V.1 (Lamberte and Bunda [1988]).

CCUs have also fashioned out repayment schemes that take into consideration the cash flow pattern of their members. Thus, in the case of institution-based CCUs where members receive their salary every 15th and 30th of the month, loan repayments are scheduled on these days. In addition, longer loan maturities ranging from 5 to 48 months are granted to members because of their security of tenure in the institution where they are working. In contrast, market-based CCUs use a daily repayment scheme because of the high cash turnover of their members. Understandably, loan maturities are much shorter, not exceeding 200 days.

Moneylenders offer various payment schemes to different borrowers to suit the latter's needs and paying capacity. There are three (3) general payments schemes observed. One payment scheme is called "steady". Loans under this scheme do not have a maturity date but the interest on the principal is paid every month. It is up to the borrower when to pay part, or the whole of the loan principal. Borrowers under the "steady" payment scheme are mostly businessmen who are "suki" of the moneylenders. In effect, moneylenders become the preferred shareholders of the borrowers' businesses.

The second scheme is called the "revolving" payment scheme. Under this scheme, loans have definite maturity dates and therefore do not stay idle in the hands of the borrowers. Borrowers may select either daily, weekly or bi-monthly payment of principal and interest. Interest payments are not collected in advance. A variation of this scheme is one which has no fixed

amortization schedule. The only requirement is that the principal and interest should be paid within the agreed maturity date. This scheme is offered to anybody who is willing to pay the interest.

The third payment scheme is called "Balikbayan" (returnees). Under this scheme, borrowers may ask for a loan from the same moneylender any time they want. In Tagalog, these borrowers are called "balik ng balik" borrowers, that is, they always go back to the same moneylender to borrow. In effect, borrowers have a credit line with moneylenders without a pre-established maximum credit line. Only the most creditworthy among the borrowers of the moneylenders can avail of this facility. Usually, these borrowers are businessmen who are in need of cash to finance their inventory. Both the principal and the interest under this scheme are paid within one day or one week.

Table 14 shows the distribution of the number of loans granted according to the abovementioned three types of loan. "Revolving" credit is the most popular type of credit. The proportion of loans granted under this scheme to total number of loans ranges from 33 to 83 percent. As can be observed, moneylenders granted a substantial number of loans under the "steady" scheme. The proportion varies from 15 to 42 percent of the total number of loans granted. The absence of any fixed maturity on the loan makes it very attractive to borrowers.

In trade credits, the security instrument created is the post-dated check. This is considered the most highly negotiable

Table 14

DISTRIBUTION OF NUMBER LOANS GRANTED BY MONEYLENDERS  
ACCORDING TO TYPE OF LOANS  
(In Percent)

Type of Loans	Moneylenders						
	A	B	C	D	E	F	G
1. "Steady"	17	20	42	30	15	20	31
2. "Revolving"	83	50	33	40	60	80	69
3. "Balikbayan"		30	25	30	25		
Total	---	---	---	---	---	---	---
	100	100	100	100	100	100	100

Source: Table IV.5 (Lamberte and Bunda [1988]).

instrument. In case the issuer of the post-dated check defaults, the footwear manufacturer who used it as a security for his trade credits is still liable to the input supplier who granted him trade credits.

The formal financial institutions are either slow or are not inclined to adopt the innovations introduced by the ICMS. One probable reason is that those innovative techniques do not fit to the size and character of the formal financial institutions such that by doing them, they would be operating in the region of diseconomies of scale. One big bank, namely the Philippine Commercial International Bank (PCIB), tried to solve this problem by creating the so-called "moneyshops". These are small units licensed by the Central Bank to operate in certain locations, notably public markets. The moneyshops' operations are patterned after those of moneylenders. Lately, PCIB opened a Shoe Industry Desk in its Marikina branch. The target clientele of its special credit program are the footwear manufacturers, not the input suppliers. In fact, it tries to compete with input suppliers in discounting post-dated checks by offering a lower discount rate usually one percentage point below the discount rate charged by input suppliers. However, the competition put up by PCIB is still limited to the so-called "prime" checks which are issued by big and well-known department stores in the country. This suggests that the formal sector competes with the informal sector only in less risky financial instruments. With the large volume of post-dated checks floating around in the Marikina shoe industry, the participation of PCIB in the market for post-dated

checks was hardly felt by the majority of the input suppliers we interviewed.

One innovative financial scheme which is gaining popularity among federations of CCUs is the so-called "interlending scheme" or central liquidity fund. CCUs are basically unit banks, like our rural banks. Unlike branches of commercial banks, CCUs do not have funds transfer mechanism to enhance their profitability whenever they have excess or insufficient funds. Also, since they belong to the informal sector, CCUs do not have access to the rediscounting window of the Central Bank to deal with their short-term liquidity problem. The "interlending scheme" is designed mainly to cope with this problem. Member CCUs contribute to the general fund managed by the federation and can borrow several times their contribution. With this scheme, surplus CCUs would have a ready outlet for their excess funds, while deficit CCUs or those experiencing sudden increase in the demand for credit can immediately access external funds without resorting to credit rationing. CCU federations which have this scheme find such activity highly profitable.

Instead of competing with the ICMs, some banks are currently devising schemes to strengthen their linkage with the ICMs. One such scheme being seriously considered is the "wholesale-retail" program in which banks provide wholesale credit to credit union federations which, in turn, retail them to their member CCUs. This is designed to exploit the comparative advantage of both institutions. Those federations which have already an

"interlending scheme" should find less difficulty in adopting such scheme.

The issue on interlinked transactions was partly dealt with earlier when we discussed interest rate formation in the ICMS. We wish to discuss here additional information which we gathered from the results of the study. The interlinked transactions in the urban sector were examined by studying the borrowing behavior of a sample of footwear manufacturers. Results show that about 24 percent of the sample footwear manufacturers obtained trade credits from wholesalers/traders who are also input suppliers. It seems that the practice of interlinking credit with the product markets is also prevalent in the urban, manufacturing sector. Of the total value of trade credits obtained by the sample footwear manufacturers in 1986, 15 percent were contributed by wholesalers/traders who are also input suppliers. Accordingly, interlinked transactions have declined recently due mainly to the sharp decrease in the demand for footwear by foreign buyers. Apparently, wholesalers/traders who are also input suppliers are catering more to the export markets than to the local markets. Obviously, they have difficulty in penetrating the local markets because footwear manufacturers can have direct contact with local customers, like department stores and supermarkets.



## V. CONCLUDING COMMENTS

This paper has tried to pull together the major findings of the various studies on the urban ICMS. The results have certainly increased our understanding of the workings of some segments of the urban ICMS. For instance, informal institutions have successfully mobilized significant amount of deposits from non-wealthy individuals/households. Loan repayment schemes that have been devised by the ICMS take into consideration the cash flow pattern of borrowers. This helps ensure high repayment rates. Certainly, better insights on the operations of ICMS can be obtained once the results of all studies on ICMS under this project are integrated.

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