

**THE POLITICAL ECONOMY OF CREDIT AVAILABILITY
AND FINANCIAL LIBERALIZATION:
NOTES ON THE PHILIPPINE EXPERIENCE**

by

V. Bruce J. Tolentino

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INTRODUCTION

Over the past two decades, the largest international aid agencies, working with the governments of many developing nations, have pumped funds in excess of U.S. \$8 Billion into specialized lending programs (Von Pischke, 1984). The basic aim of these programs has been to

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**Executive Director, Agricultural Credit Policy Council (ACPC).

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stimulate growth in specific areas considered as priority investment targets - or areas of "greatest need". At the same time, governments also attempted to regulate their countries' financial markets, with the objective of focussing the lending of their banking systems on those preferred areas of investment.

Two decades of international experience have made it clear that these policies and programs have not performed as expected. In many cases these programs have instead created problems and distortions which now require correction before progress can be achieved to resolve the initial conditions. These problems include, among others, banking sub-systems highly dependent on aid (both foreign and domestic), a mentality that equates government lending with welfare assistance, an interest rate structure which favors areas of lower, not higher, comparative advantage for the developing economies, and, significantly, a highly-developed informal, curb financial market which complements and to some extent substitutes for the constrained formal financial system (Adams, et al., 1984).

There seems to be little question that the increased availability of credit (meaning a larger supply of loans) leads to faster economic growth. The main problem seems to focus on just how the greater availability of credit to development projects and enterprises may be stimulated and

secured. There continues to be great tension between approaches that rely on direct government provision, if not fiat and allocation, of loan funds to preferred sectors and purposes (the "targetting" approach) on the one hand, and on the other the more recently-popularized "financial liberalization" package growing out of the work of Shaw and McKinnon (the "financial markets" approach) initially published in 1973.

THE KEYNESIAN PRESCRIPTION

The traditional analysis and prescription of the process of growth to a large extent grew out of the work of John Maynard Keynes (1935). The familiar Keynesian prescription for growth focusses on keeping interest rates low to stimulate investment which in turn produces greater output. The Keynesian approach also emphasizes the need to dampen the preference for cash holdings, such that the holdings of productive assets are maximized (Coats and Khatkate, 1984). This was echoed by Tobin who extended the basic Harrod-Domar growth model to incorporate money, showing that the higher the return to money in a household's portfolio of assets, then a smaller proportion of wealth is allocated to capital, thus decelerating growth (Tobin, 1965). The work of Keynes and Tobin have formed the principal theoretical foundation for controlled low-interest rate policies.

The Keynesian prescription of low interest rates fit well with the appealing, and seemingly common sensical "supply-leading" strategy of financial development (Patrick, 1968). In the supply-led strategy, finance is provided in advance of effective demand. Thus specialized lending institutions and programs were created to service priority commodities, sectors, purposes and clientele. The presence of bankers and banks, it was argued, would help stimulate entrepreneurship and investment. Many developing countries adopted this strategy and many still maintain such programs in spite of growing evidence that it has not only failed to effectively and efficiently stimulate development, but has also introduced counterproductive distortions into the financial markets of the developing world (Meyer, 1988).

THE DISCOVERY OF FINANCIAL REPRESSION

Financial regimes characterized principally by controlled low-interest rate policies have come to be described as "repressed" (McKinnon, 1973; Shaw, 1973). The primary feature of financially-repressed economies are restrictions on interest rates, which are often rationalized not only as stimuli for investment, but also as protection of the public against "usury". Financially-repressed economies also suffer high reserve requirements imposed on bank deposits; compulsory credit allocations which reduce incentives for holding claims on the domestic

banking system; the distortionary provision of subsidized loans; and the costly, yet ineffective, proliferation of specialized, government-run lending institutions created to cater to "preferred" sectors and borrowers. The distortionary effects of these restrictions are often exacerbated by price inflation. The results of repression include negative real deposit rates of interest on monetary assets -- thus the demand for money, and especially the supply by households of financialized savings, falls as a proportion of GNP.

Financialized savings, however, is the primary source of investment funds, particularly in developing countries where the stock and bond markets are small and the capital markets thin. Financial repression thus exacerbates the fragmentation of the financial market, where:

- a. interest rates on bank lending vary arbitrarily from one group of preferred borrowers to another;
- b. the process of self-finance is impaired. The accumulation of cash balances in preparation for lumpy, discrete investments is made more costly; and
- c. socially-costly inflation hedges become attractive, private liquidity is minimized, and financial deepening outside of the formal banking system becomes prohibitive.

FINANCIAL REPRESSION AND THE INFORMAL FINANCIAL MARKET

An even more important adverse effect of financial repression is the reduction of the flow of loanable funds through the formal banking system. Thus potential investors are forced to either self-finance or resort to the informal, curb market for loans (McKinnon, 1988). Self-finance can be costly, since before large-scale investments are actually made, a process of accumulation of the required savings must be completed. Thus investment programs require more time than would be necessary through an efficiently functioning credit system which arbitrates between the time preference options of borrowers and savers.

It is observed that in financially-repressed economies the informal financial market is very large and active. Detailed evidence on the informal market, like the evidence available on the underground economy, is very sketchy. Fragmentary evidence from the Philippine economy and other similar countries, however, indicate that only three to four households out of ten in the rural areas ever borrow from any source (Tolentino, 1988a). Of those who borrow, three-quarters borrow from informal sources. The rest either self-finance, or enter into quasi-lending arrangements, like contract growing and production (Tolentino, 1988b).

The nominal interest rates charged in the informal sector are often considered to be very high. This is to be expected since default rates and servicing costs of such loans are very high. Moreover, given that a significant proportion of lending is done by the informal sector, the total volume of bank lending is kept low, keeping per unit lending costs in the overall loan market high.

GOVERNMENT INTERVENTION AS A SOLUTION

Providing "solutions" to the relatively high level of interest rates and the constricted availability of loans that has often been the rationale for government intervention in finance, and the consequent development of financial repression. Controls on interest rates and quotas on lending to favored clientele have had effects opposite to expectations, and have actually exacerbated the problems these were intended to solve (Gonzalez-Vega, 1976). Furthermore, governments which have enacted the repressive regulations have found that the task is not as straightforward nor as cheap - for all concerned - as it often seems.

For example, the U.S. government has traditionally provided a high level of implicit subsidies to American farmers via government guarantees on bonds issued by the extensive U.S. Farm Credit System. During the past few

years however, the U.S. government has found that it can hardly afford to cover the losses resulting from the guarantees, which have grown and pyramided over the years. Recent events in the system, as well as the symptomatic bank failures in Texas and Illinois, point to the fragility of the system dependent on government support. The U.S. government is now scaling down the guarantees and relying more on market forces. The European Economic Community is also now realizing the enormity of the long-term burdens that their system of agricultural credit and price supports, and initiatives are now being enacted to scale such subsidies down to more affordable, and less distortionary, levels.

FINANCIAL LIBERALIZATION

The liberalization of the economy from the constraints of repression has come to be accepted as a basic part of the agenda for development proposed by policy analysts and academicians (McKinnon, 1988). The basic prescription for a financially-repressed economy, according to the received wisdom, is the freeing of interest rates so that real interest rates are kept positive, close to open market levels, and attractive enough to draw financialized savings into the stream of loanable funds. Mandated allocations of credit to favored/preferred sectors must be abolished. Appropriate macroeconomic policies, particularly the maintenance of a

stable price level and an equilibrium exchange rate, complete the environment so that potential investors can judge the true scarcity price of capital, and invest according to an undistorted set of criteria based on the productive efficiency of the investment.

A number of countries which adopted the Shaw-McKinnon prescriptions seem to have achieved remarkable success: at various times Japan, Korea, Taiwan and Singapore have maintained highly positive real rates of interest and rates of financial growth. Yet other countries which incorporated the Shaw-McKinnon solutions in their economic liberalization programs ended in near collapse, particularly in the Latin American cases of Argentina, Chile and Uruguay. Thus it is clear that the financial liberalization solution is not perfect, and much refinement is needed. But the prescriptions for financial liberalization have come to be accepted almost as truisms in the community of policy analysts and academicians. However, in the larger world of government policymakers and politicians, acceptance of financial liberalization has been much slower, ensnared in great reluctance, and met with intense resistance. The experience of the Philippines in this regard is instructive.

CONSTRAINED LIBERALIZATION: THE PHILIPPINE EXPERIENCE IN FINANCIAL REFORM

The Philippines initiated its efforts of financial liberalization as early as the late 1970s. A review initiated by the government itself into the repeal of the Anti-Usury Law had been ongoing since the mid-70s, and had cautiously recommended a gradual program to partly deregulate interest rates on loans. Implementation of deregulation was accelerated in the 1980-81 period, when the monetary authorities were practically forced into the liberalization process. At that point the International Monetary Fund and the World Bank, flexing their muscles, made their loan program for the cash-starved Philippines conditional upon the implementation of a package of financial reforms. The influence of the international lending agencies, however, paled beside the pressure for reform exerted by the perilous condition of the Philippine economy itself, as it struggled with lagging food production due to drought, the effects of the "oil shock", and a banking system exposed in crisis following the flight of the "high-kiting" industrialist Dewey Dee (Tolentino, 1986).

The package of financial sector reforms initiated in 1980-81 included: (a) the gradual abolition of legal ceilings on interest rates, (b) the reduction of specialization among types of banks; (c) an increase in the minimum capitalization, and thus the size, of banks;

and (d) movement towards the closure of the allocative, low-interest rediscount and seed funding windows made available by the government, particularly those at the Central Bank of the Philippines (Singson, 1985).

It is not surprising that the package of reforms prescribed for the Philippines contained the classic elements of financial liberalization. The Philippines, after all, had adopted and even developed innovations for the supply-leading strategy of financial development lock, stock and barrel up to the late 70s. The Philippine legislature enacted a stringent "Anti-Usury Law" in the 1930s, which prohibited loan interest rates of over 16% per annum. In the early 1950s the government declared a "one-town, one-bank" policy, and instituted very liberal qualification, capitalization and supervision criteria for setting up Rural Banks. These Rural Banks were also provided with generous subsidies, tax exemptions, and low-interest seed funding and rediscounting facilities. The country also built up numerous specialized, targeted lending programs funded out of public funds and borrowings. There were over 50 such programs by the mid-1980s.

The Philippine government did implement the financial liberalization program. The Anti-Usury Law was repealed in the late 1970s. Interest rates on both loans and deposits have been fully market-determined, since late

1985. Only about half of the specialized lending programs remain, and these are mostly those that operate at close to market rates and are less targeted than those closed. Many of the special privileges and subsidies enjoyed by the Rural Banks have been withdrawn, and the "one-town, one-bank" policy is no longer followed. An extensive program to rehabilitate the Rural Banking system is now being implemented, and it is expected that the Rural Banks will emerge from the process as a smaller, but stronger and more independent set of banks with a comparative advantage in lending to agriculture, particularly to the small farmers (Dominguez, 1988).

FINANCIAL LIBERALIZATION IN THE PHILIPPINES: THE PROSPECTS

Do all the changes described above imply that the Philippine financial system has been liberalized?

At best, the Philippine record at liberalization is mixed. In spite of intense public resistance, the most obvious repressive factor - the interest rate structure has generally been market-oriented since late 1985. Progress has been made toward minimizing the special, privileged lending and rediscount windows of the government and the Central Bank. Specialization among the different types of banks has been slightly reduced. The Central Bank is now actively shifting away from the role of development banker to that of the steward of macroeconomic stability and monetary management.

The Quotas.

In spite of the progress that has been made, there still remain a number of constraints to true financial liberalization. The government has not made any progress in repealing Presidential Decree 717 - the Agri-agra law, which mandates that banks allocate at least twenty-five percent of their loan portfolios to agricultural projects and the beneficiaries of agrarian reform (Cañeda, 1988). There is also a law that requires that at least seventy-five percent of the deposits generated in a given geographical region be loaned out in that same region. Although the intent of these quotas may be laudable, the actual effects are contrary to the objective. When the quotas are effectively enforced, loans are forced toward projects which are normally rejected by the banking system. Bankers face greater risks, incur greater levels of default, and the costs of such risk and default are borne by society as a whole, further constricting the availability of credit (ACPC, 1988).

The experience of the Philippines with quotas has shown that banking system has been able to evade the requirements. The actual proportion of agricultural loans in the Philippine financial system's portfolio has averaged only ten percent over the past two decades (Tolentino, 1988). Banks routinely generate most of their deposit holdings in the rural areas, lend in the Manila

area, but book or record some of the loans in the accounts of their provincial branches (Blanco and Meyer, 1988).

Taxation.

The adverse effects of tax measures and policies on the financial market also need to be considered. The Philippine government currently taxes loans, and also collects a final withholding tax on interest income earned on time and savings deposits. Undoubtedly, these tax measures, aside from shifting the task of tax collection to the banks, and, inappropriately, away from the Bureau of Internal Revenue also dampens the provision of loans and the incentives to save (Llanto, 1988). In an era when interest rates on savings deposits are below the inflation rates of eight to ten percent per annum, the real deposit rate is negative, and is further eroded by taxation.

Reserve Requirements.

A further constraint to liberalization is the high reserve requirement of the Central Bank, which is currently a twenty-one percent on most categories of deposits. Such high reserve requirements effectively tie up a large proportion of potentially loanable funds and cause the banks to incur opportunity losses. Funds tied up in reserves also hamper the development and growth of the capital market, thus constraining long-term finance which can change the term structure of the portfolio of

the Philippine financial system (McKinnon, 1988). Fully ninety-five percent of the system's loan assets are short-term (Tolentino, 1986). In an economy that has to focus on long-gestating agricultural projects to get development moving, a mismatch between credit terms and project characteristics can be fatal.

The Reform of Regulation.

The general experience with financial liberalization has shown that the liberalization process is multifaceted. When the rules causing financial repression are reformed, the administrative and regulatory structures which implemented the oppressive rules also need to be reformed. The Philippine's reform experience has left in its wake a regulatory structure which is not compatible with private-sector ownership and management and minimum government intervention in business and enterprise. For instance, the fact that the government contributed most of the liquidity used for lending by the Rural Banks induced regulations whereby the government effectively ran the Rural Banks through detailed rules governing almost all aspects of bank operations and decision-making. Thus an extensive review of the regulatory structure is required to determine those regulations which continue to repress the financial system, since liberalization changes the premises upon which regulatory activities are founded.

ADJUSTING TOWARD FINANCIAL LIBERALIZATION: TRANSITION MECHANISMS

The process of financial liberalization now unfolding in the Philippines has become a much more complex undertaking since it is currently taking place in a larger context of political and economic renewal and reform.

Adjusting to Representative Democracy.

The Philippines is in the midst of readjusting to the workings of democracy. In the past two years, the Filipinos went through a series of popular, free elections. The new constitution was overwhelmingly ratified. A bicameral Congress, now operating after nearly sixteen years of power and policy concentrated in the executive branch of government, is now rediscovering its powers and flexing its muscles. Thus the special and regional interests of the Senators and Representatives have come into play. It is no surprise that a most attractive area of proposed legislation is the provision of loans under special terms to the representatives' constituencies. There is, therefore, a clear danger in this situation that the economy will slide back into a financially-repressed state. There are at least three dozen draft laws now being considered, the great majority of which, if passed into law, will again create a repressed financial market. Thus major efforts need to be undertaken immediately to heed the lessons of the past,

disseminate these widely, and to specifically educate the policymakers about the results of that experience.

Transition Mechanisms.

The process of full political and economic liberalization will, of course, take time. The undesirable effects of financial repression will linger through the adjustment period. In an era of political freedom, pressures will build up on government as interest groups press for specialized lending privileges perceived as being useful measures to attenuate poverty. This may lead into a renewed cycle of financial repression.

The fact that the process of financial liberalization, particularly its management and phasing, is not yet very well understood increases the danger of a fallback into repression. The unfortunate recent experiences of Chile, Brazil and Peru provide ample evidence that the reform process is no picnic. These South American countries plunged dramatically, over an abbreviated period, into financial liberalization. The result thus far has been a painful withdrawal into a more repressed state (Connolly and Gonzalez-Vega, 1986). Even the foremost author of financial liberalization, Ronald McKinnon, upon observing the South American experience, has suggested that governments implementing liberalization would be well-advised to carefully establish a gradual

phase-in pattern which would allow both the financial and real sectors of the economy to adjust to the removal of the repressive instruments (McKinnon, 1988).

There seems to be a case, therefore, for government enactment of measures which will accelerate liberalization to mitigate the undesirable effects of repression and to reduce the political pressures lobbying for new repressive measures. Possible positive mechanisms include: (a) loan guarantee and commodity insurance systems, (b) seed funding facilities, (c) the development of the so-called "non-traditional" financial intermediaries; and finally, (d) a renewed and intensified refocussing of public investment and attention to the fundamental factors which account for development and growth, such as savings and investment.

Loan Guarantees and Commodity Insurance.

Many governments have realized that government funding of projects is inefficient and ineffective, given the sheer magnitude of the funds required and the fact that governments are poor bankers. Guarantee and crop insurance programs are thought to enable governments to influence the volume and direction of lending by private banks. The comparative advantage of the private banking sector in loan appraisal and monitoring is fully exploited. Guarantees and insurance programs may also be designed to cover only part of the risks involved, and

thus scarce governmental resources may be leveraged for greater coverage.

The Philippines has had a crop insurance system - the Philippine Crop Insurance Corporation (a government corporation) in operation for seven years. Apart from the initial capitalization of the system, the government has found that the system has so far been able to support its operations based on its revenues. The Philippines also has a group of guarantee systems - the Industrial Guarantee and Loan Fund, the Guarantee Fund for Small and Medium Enterprises, the Quedan Guarantee Fund Board, and the Philippine Export Loan and Guarantee Corporation. The performance of these guarantee agencies has been mixed. The most important lesson learned so far is that these agencies, in order to be sustainable, must develop skills in the assessment of the cash flow viability of the projects guaranteed. The attention to cash flow, rather than collateral is what distinguishes the guarantee agencies from banks. When effective, the guarantee agencies are able to facilitate formal lending to that segment of projects which are viable yet poorly collateralized and therefore non-bankable.

Seed Funding Facilities.

Term transformation, or the process whereby the average maturity of the loan portfolio of the banking system is lengthened, is a critical indicator of growth in

developing nations. However, political and economic uncertainty constrain the time horizons of bankers. In most developing countries there usually are adequate funds for short-term lending, but resources for medium and long-term lending are very scarce. The capital market is also thin, and thus the long-term funds generated by pension, retirement, social security, trust and insurance systems do not find their way into long-term loan and equity markets. This situation frequently leads governments to establish seed funding facilities for longer-term projects. The basic objective of seed funding is to initiate bank involvement in longer-term lending.

Seed funding programs are familiar interventions by government in the Philippines. In fact, the Philippine government had as many as fifty such programs at one time. These programs exemplified the hallmarks of financial repression: targetted to specific commodities, sectors or clientele, and the funds were provided at subsidized, below-market rates. The seed funding facilities are currently in operation. Primarily the Industrial Guarantee and Loan Fund, the Agricultural Loan Fund, and the Integrated Rural Financing Program are available at market interest rates, only to banks and financial institutions which meet rigorous standards of performance. Efforts are now being exerted to modify the rules surrounding the operation of the existing seed funds so that these may, in general, be used to fulfill the non-

targeted liquidity requirements of the banks and participating financial institutions.

The Development of "Non-traditional" Financial Intermediaries.

In recent years much excitement has been generated by discoveries arising from research into self-help groups, cooperatives, pawnshops (ROSCAs) and other informal sources of financial services. These informal agents often serve as substitutes for the repressed formal sector. More importantly, the research also indicates that the informal sector also serves as a critical complement for formal finance. Informal lenders and institutions serve markets which the formal sector cannot serve, particularly the rural sector and the poor.

The development of financial functions in the voluntary, self-help groups also serves to strengthen the empowering potential of these institutions. In particular, the informal financial groups provide savings facilities which would otherwise be absent in the rural areas. These savings mechanisms enable the groups to intermediate finance between members with surplus funds and those with deficits. The group also provides opportunities for the poor to pool their individually-meagre resources into volumes large enough to finance lumpy investments.

The experience of cooperative banking in many countries - the Rabobank system of the Netherlands, the Raffeissen Bank of Germany, the French Credit Agricole, and the Japanese and Korean examples - have inspired many governments in developing nations to establish similar systems. The experience with these transplanted structures, however, has generally been disappointing. Recent research shows that while the physical structures of the cooperative financial intermediaries are easily copied, the evolution and historical development of such are not as easily transferred (Llanto, et. al., 1987). The efficient and viable operation of a cooperative bank is more learned than legislated. Private sector domination and responsiveness to the demand and supply conditions in the market is critical for continued viability. Government subsidies cannot be provided endlessly. Thus care and deliberation is required to see to the success of cooperative systems and banking.

Refocussing on the Fundamentals of Development.

One of the most basic concepts that must be remembered in considering the relationship between financial policy and development is that "subsidized credit will not make an unprofitable project profitable", (Adams, 1987). Research and experience shows that the critical elements of agricultural productivity and profitability, ranked in order of significance, are rural

infrastructure like irrigation, roads, bridges and electrification, research and extension (Evenson, 1986); and rational agricultural price policies (Timmer, 1986; David, 1987). Forcing the financial system to lend for "development" purposes may be likened to pushing a string. Yet when the object of lending and investment is indeed profitable, finance will flow toward it naturally, with little or no inducement from government (Tolentino, 1987).

CONCLUSION

The adequate availability of finance is a must for growth. Yet the means to enhance the flow of finance is unclear. We have made a brief review of the good intentions which brought many countries the world over into financial repression. Many of the premises upon which the regulation of financial markets rest are flawed, and thus the regulations are ineffective, or worse, produce unintended and undesired results. Programs of financial liberalization have been attempted in some countries, some with success and the others not achieving any alleviation of financial repression. The lessons of experience now tell us that while financial liberalization is a worthy undertaking, it ought to be implemented with care and deliberation. Moreover, a set of transition measures may be necessary to assist in the adjustment process from the repressed to the liberalized state. Such transition measures include guarantees, insurance, seed

funding, non-traditional credit institutions and a new emphasis on the fundamentals of development.

It also seems clear that political will is necessary to successfully carry out the process of financial liberalization so that growth and development may be accelerated and sustained. Furthermore, the liberalization process involves elements which lie outside the direct purview of the financial system. Political and economic stability is also critical, since depositor and banker confidence through a foreseeable positive horizon must be sustained in order that deposits are generated and maintained, making longer-term investments and loans feasible. Attention to basic development imperatives is also a must. Agrarian reform which provides the foundations for a more equitable sharing of income and wealth, and the resulting greater bankability of beneficiaries possessing titles to their lands, is necessary. The basic infrastructure of development and the fundamental services for agricultural productivity must be in place. These are the elements which truly make the clients of the banking system creditworthy, and their projects viable. The bottom line is therefore the need to focus on the elements which create a resurgent, dynamic economy. This, coupled with financial liberalization, should result in a positively-responding financial sector in service of growth and development.

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