

## FINANCIAL LIBERALIZATION: WHAT HAVE WE LEARNT?

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### I. INTRODUCTION

The paper attempts to study the Philippines' experience with financial liberalization. Specifically, it examines the impact of interest rate reforms on the flow of loanable funds. It should be noted that there were other financial reforms introduced in the system other than interest rate reforms. But for this paper, we focus mainly on interest rate reforms and the flow of loanable funds in the organized financial market.

The next section briefly sketches the flow of funds from primary savers to ultimate users of funds. It demonstrates the degree of sophistication achieved by the Philippine financial system. Section III examines the impact of interest rate reforms on the flow of loanable funds. The last section concludes the study.

### II. THE FLOW OF LOANABLE FUNDS

The essence of financial intermediation is to increase the flow of funds from surplus units or primary savers to ultimate users of funds at least cost. Financial institutions can do this by offering financial assets that would suit the preferences (in terms of yield, liquidity, riskiness) of wealth-holders so that the latter could be

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induced to shift from holding physical assets to financial assets. At the other end, financial institutions could ensure that savings are allocated to the most productive economic activities.

Figure 1 presents a simplified sketch of the flow of funds from primary savers to ultimate users of funds in the Philippines. It suggests that a certain degree of sophistication has already been attained by the financial system. The proliferation of financial institutions, as may be gathered from Table 1, makes available a wider variety of financial assets to wealth-holders, on the one hand, and a wider set of finance choices for entrepreneurs, on the other.

The figure emphasizes the presence of government financial institutions in the financial system. They tend to be large and are organized for specific purposes. Except for the Philippine National Bank (PNB), they do little intermediation outside of their captive depositors, and instead rely more heavily on support from the Treasury and the Central Bank, and on foreign borrowings. More recently, these government institutions have gained control over a number of commercial banks that used to be owned or controlled by the private sector. Specifically, the Development Bank of the Philippines (DBP) now controls the Associated Bank; the Government Social Insurance System (GSIS), the Commercial Bank of Manila; the National Development Corporation, the International Corporation Bank; the Social Security System, the Union Bank; and PNB, the Pilipinas Bank. Unlike specialized government banks, these government-controlled commercial banks compete directly with private commercial banks in both the deposit and loan markets. Being government-controlled banks, they definitely have an edge over privately-owned banks.

The flow of funds from surplus units to deficit units is determined by a host of factors. We will mention only a few of those factors here. If the interest rate is administratively set at levels substantially below the market rate, then surplus units would shy away from holding financial instruments. At the other end, funds tend to be misallocated, thus reducing the amount to be ploughed back into the system. A high inflation rate resulting in negative interest rates would certainly drive away savers from the financial system. Surplus units would most likely hold nonproductive physical assets least adversely affected by upward price movements.

Another factor that determines the flow of loanable funds is the

**TABLE 1**  
**PHILIPPINE FINANCIAL SYSTEM IN 1983;**  
**TOTAL ASSETS, SHARES, AND NUMBER OF INSTITUTIONS**

	Total assets (million pesos)	Shares (percent)	Number of Institutions
A. Central Bank	130,371.7	—	1
B. Financial System	354,606.2	84.8	
Banking institutions	326,013.0	78.0	1,122
Commercial Banks	235,040.4	56.2	34
PNB	70,502.3	16.9	1
Thrift Banks	16,149.0	3.9	136
PDBs	4,613.2	1.1	45
Savings and mortgage banks	7,399.4	1.8	8
Stock SLAs	4,136.4	1.0	83
Rural banks	9,499.7	2.3	949
Special government banks	65,323.9	15.6	3
DBP	56,529.713.5	13.5	1
Land Bank	8,530.2	2.0	1
Phil. Amanah Bank	264.0	0.1	1
Nonbank financial institutions	28,593.2	6.8	1,474
Investment houses	7,210.4	1.7	14
Finance companies	11,810.8	2.8	336
Investment companies	6,159.9	1.5	65
Securities dealers brokers	683.0	0.2	124
Pawnshops	483.1	0.1	701
Fund managers	1,529.6	0.4	12
Lending Investors	49.2	0.0	120
Nonstock SLAs	648.3	0.2	74
MBLA	18.9	0.0	7
C. Other Financial Institutions	63,485.2	15.2	
Private insurance companies	13,715.7	3.3	136
Special nonbanks	49,658.3	11.9	
GSIS	14,707.2	3.5	1
SSS	16,227.1	3.9	1
ACA	—	—	
NIDC, PHIVIDE, NHMFC and NDC	18,724.0	4.5	
Venture Capital Corp.	111.2	0.0	15
D. Offshore Banking Units (OBUS)	\$4,408.0	—	21
Total (B + C)	418,091.4	100.0	

Source: Nomura Research Institute Study (1984), p. 16, except line D.

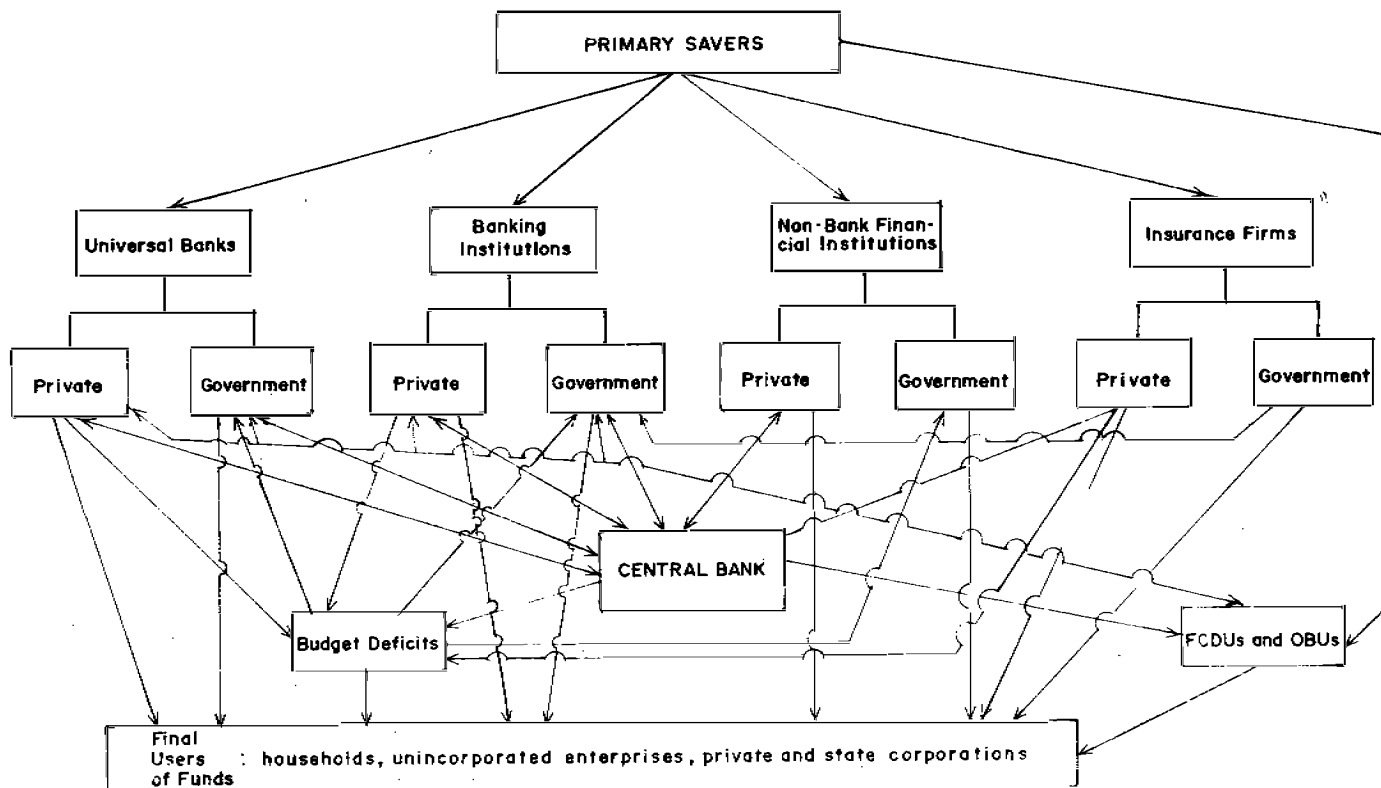


FIGURE 1  
FINANCIAL INTERMEDIATION IN THE PHILIPPINES

stability of the entire financial system. An unstable financial system would drive out potential financial savers. The instability of the financial system can often be traced to the risky portfolio held by banks.

There is one aspect of Figure 1 that is worth emphasizing, that is, the role of budget deficits. If the fiscal sector decides to finance its budget deficits by borrowing from the Central Bank and deposit money banks, then less funds would flow to private productive economic units. It is noteworthy that borrowing from the Central Bank is definitely an easier task for the Finance Minister than raising taxes, especially if he is also a member of the Monetary Board. Aside from being inflationary, this could be one source of instability in the financial system since a massive support given by the Central Bank to the fiscal sector could weaken its ability to stabilize the economy in times of crisis.

### III. FINANCIAL LIBERALIZATION AND RESULTS

Financial repression in the Philippines has its long historical roots (see Lamberte 1985). The Usury Act of 1916 prescribed interest ceilings on secured and unsecured loans. When the Central Bank was set up, it merely accepted the Usury Act as a datum and instituted ceilings on deposit rates starting in 1956. It took a long time before the Central Bank initiated interest rate reforms.

Interest rate reforms can be accomplished either by permitting nominal interest rates to be determined by market forces or by exercising administrative control over interest rates in a flexible manner that is responsive to market conditions. The Philippines opted for initiating interest rate reforms in stages. As identified by Laya (1982), there are three distinct interest rate regimes: (a) 1956-73: the low interest rate regime; (b) 1974-80: the transition period during which interest rates were still fixed but frequently adjusted to reflect market conditions; and (c) 1981-present: the floating interest rate regime. The question that this section attempts to answer is: What is the impact of interest rate reforms on the flow of loanable funds? To help us understand the results of the liberalization efforts, we refer to a simple analytical framework mainly drawn from McKinnon (1981).

Let us begin by assuming that all individuals behave according to the "Fisher Effect" model; that is, all individuals would ask for

a nominal rate of interest that already embodies an inflation premium that is sufficient to compensate them for the expected loss of purchasing power associated with the receipt of future pesos. Specifically,

$$\begin{aligned} r_L &= i_L - \dot{p}^e \text{ for lenders, and} \\ r_D &= i_D - \dot{p}^e \text{ for depositors} \end{aligned} \quad (1)$$

where  $r_L$  = real loan rate,  
 $r_D$  = real deposit rate,  
 $i_L$  = nominal loan rate,  
 $i_D$  = nominal deposit rate, and  
 $\dot{p}^e$  = expected inflation rate.

Under an ideal situation where  $\dot{p}^e = 0$  and where there are no market distortions, equilibrium is obtained at point  $a$  in Figure 2, where supply and demand for loanable funds are equated, i.e.,  $L = D$ . At this point,  $r_L = r_D$ . The effect of interest rate repression which prescribes ceilings on lending rate at  $r'_L < r_L$  and on deposit rate at  $r'_D < r_D$  is clear. Supply of loanable funds is substantially reduced to  $D'$ , leaving the market with a large excess demand for loanable funds. Rationing is often resorted to, which does not actually discriminate between profitable and nonprofitable projects, thus compounding further the problem of excess demand for loanable funds.

So far, the analysis compares the consequences of financial repression and liberalization on the flow of loanable funds. It unambiguously shows the favorable impact of interest rate liberalization on the flow of loanable funds. But it implicitly assumes the absence of factors that impinge on a successful switch from a repressed to a liberalized financial system. In actual practice, the switch from a repressed to a liberalized financial system is a tricky business that sometimes may result in failure instead of success. This will be considered next.

Suppose that ceilings on nominal interest rates are removed. However, the Central Bank imposes reserves on the deposit liabilities of banks. It will be shown below that the imposition of reserve requirement on deposit liabilities results in higher loan rates and lower deposit rates, thus reducing the flow of loanable funds. The effect is further magnified if inflation is positive. Consider the supply of loanable funds:

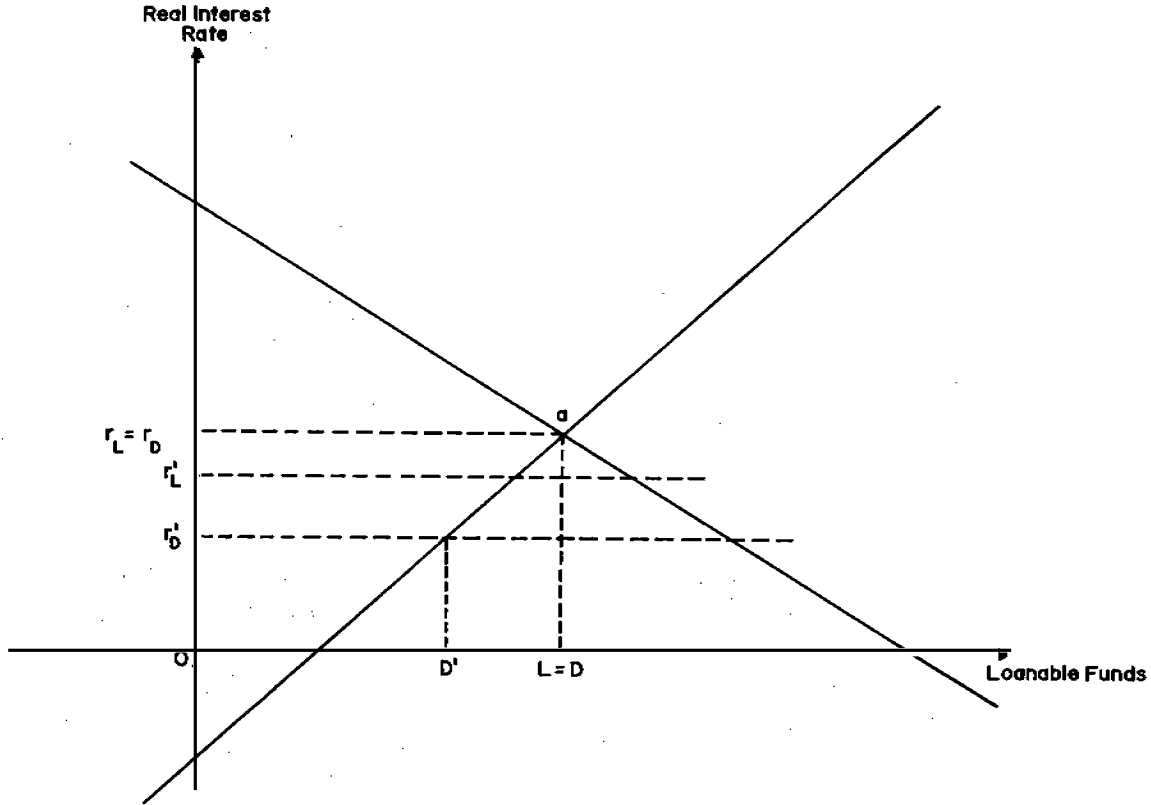


FIGURE 2

$$L = (1 - k) D$$

when  $L$  = supply of loanable funds (2)

$D$  = volume of deposits, and

$k$  = reserve requirement ratio.

Note that the supply of loanable funds is now less than the supply of deposits, i.e.,  $L < D$ . If banks were to attain at least zero profits, then

$$i_L L = i_D D \tag{3}$$

or

$$i_L = \frac{i_D}{1 - k}$$

Subtracting  $\dot{p}^e$  from both sides of equation (3) and substituting  $r_D + \dot{p}^e$  for  $i_D$ , we get

$$r_L = \frac{r_D}{1 - k} + \dot{p}^e \left( \frac{k}{1 - k} \right) \tag{4}$$

Equation (4) states that the real loan rate that yields at least zero profits for banks is positively influenced by  $r_D$ ,  $\dot{p}^e$  and  $k$ .

The combined effect of  $\dot{p}^e$  and  $k$  or  $r_L$  is illustrated in Figure 3. With  $k = 0$  and  $\dot{p}^e = 0$ , equilibrium is attained at  $a$ , and  $r = r_D = r_L$ . If  $k > 0$ , then the deposits curve would shift to the left, from  $D$  to  $D'$ . But note that the loan and deposit rates would not be equal to  $r'$ . Instead, the loan rate would be at  $r'_L > r'$  and the deposit rate would be at  $r'_D < r'$ . If we add the condition that  $\dot{p}^e > 0$ , then the real loan rate at which banks realize at least zero profits would be higher than if  $\dot{p}^e = 0$ , and the real deposit rate would be further reduced, thus making deposit instruments less attractive to surplus units. The loci of real loan rates shown in Figure 3 for different inflation rates are actually derived from Table 2. It shows, for example, that if  $k=20\%$  and  $\dot{p}^e=10\%$ , then for a zero real deposit rate, banks' real loan rates should be 2.5 percent to obtain at least zero profits. But if  $\dot{p}^e=20\%$ , then for the same reserve requirement ratio and real deposit rate, banks' real loan rate should be raised to 5 percent. This means that a higher inflation rate would lead to a higher bank spread.

There is one important dimension in our analysis that must be brought out. When lending rates are high during an inflationary



**TABLE 2**  
**RATES OF INTEREST WITH A TWENTY PERCENT RESERVE REQUIREMENT**  
**ON COMMERCIAL BANKS**  
**(In percent)**

$\dot{p}^e=0$				$\dot{p}^e=10$				$\dot{p}^e=20$			
$i_D$	$r_D$	$i_L$	$r_L$	$i_D$	$r_D$	$i_L$	$r_L$	$i_D$	$r_D$	$i_L$	$r_L$
0	0	0.00	0.00	0	-10	0	-10.00	0	-20	0	-20.00
5	5	6.25	6.25	5	-5	6.25	-3.75	5	-15	6.25	-13.75
10	10	12.50	12.50	10	0	12.50	2.50	10	-10	12.50	-7.50
15	15	18.75	18.75	15	5	18.75	8.75	15	-5	18.75	-1.25
20	20	25.00	25.00	20	10	25.00	15.00	20	0	25.00	5.00
25	25	31.25	31.25	25	15	35.00	21.25	25	5	31.75	11.25
				30	20	37.50	27.50	30	10	37.50	17.50
								35	15	43.75	23.75
								40	20	50.00	30.00

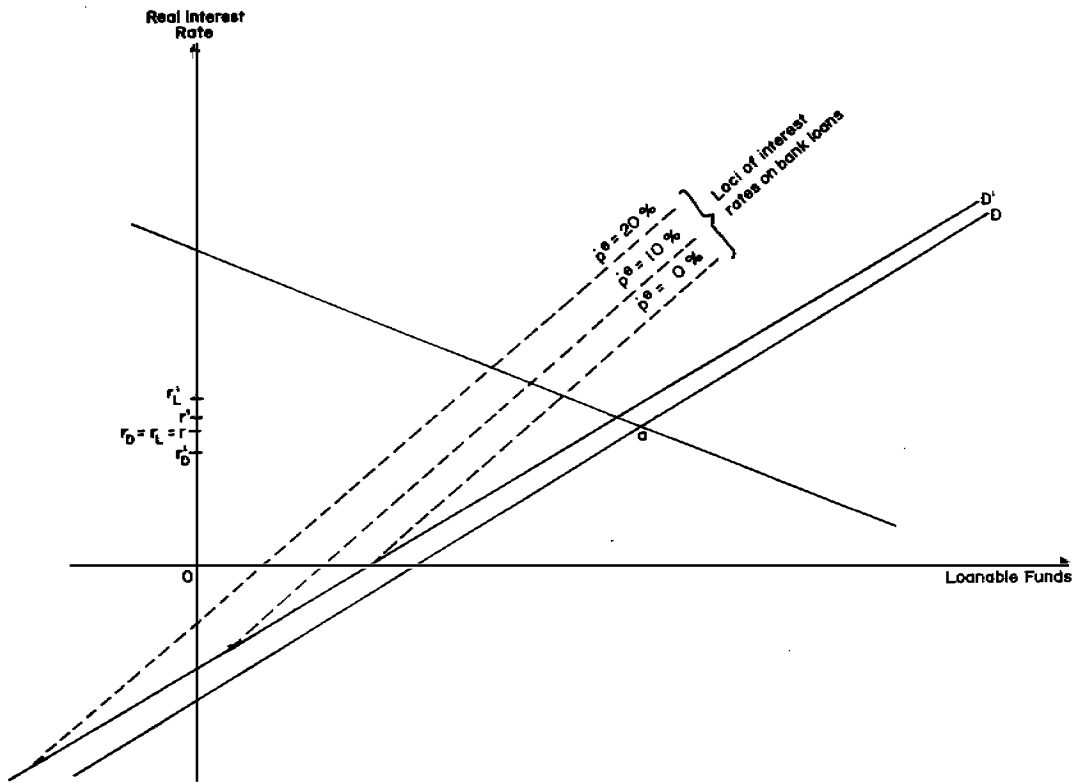


FIGURE 3

period, adverse risk selection would likely result; that is, only borrowers who are willing to take risks and who expect higher returns on their investment would come forward. Indeed, this brings instability into the financial system. As a result, risk-averse savers would withdraw their funds from the system, thus compounding further the unfavorable effect of high inflation rate on the flow of loanable funds.

Thus, our analysis suggests that low inflation rate is an important requirement to a successful switch from a repressed to a liberalized financial system. There are, of course, other requirements other than low inflation rate. Instead of discussing all of them here, we mainly focus on one additional requirement which is deemed very important in view of the current situation of the financial system.

Suppose that banks are completely deregulated. For example, they can take on any liquidity ratio that would satisfy their preferences. Upon perceiving this situation, savers would likely ask for a higher real deposit rate to compensate for the additional risk. But as expressed in equation (4), banks, in turn, will charge higher loan rates to achieve at least zero profits. Again, adverse risk selection occurs, bringing instability to the financial system. The end result, of course, is a much lower supply of loanable funds. This suggests that, even under a regime of floating interest rate, some forms of regulation must be exercised by the Central Bank to reduce riskiness in the portfolio of banks.

The framework discussed above will guide our analysis of the Philippines' experience with interest rate liberalization. In the following, we examine the impact of the change in interest rate policy during the period 1956-84 on the flow of loanable funds. Determining the appropriate measure of the flow of loanable funds is indeed a big problem. In this regard, McKinnon (1982) suggested the use of the ratio of money supply to GNP as a measure of the flow of loanable funds since in a less developed economy it "is indicative of the absolute size of the banking system that reinvests funds, in potentially new directions, from old loans as they mature" (p. 367). McKinnon's measure of the flow of loanable funds is adopted in this study.

Table 3 shows selected financial and economic indicators. The increasing M2/M1 and M3/M1 ratios reflect the growing sophistication in financial intermediation as savers respond accordingly by moving their funds from low- to high-yielding financial assets.

TABLE 3  
 SELECTED FINANCIAL AND ECONOMIC INDICATORS  
 (Figure are averages for the period)

Regimes	M2/M1	M3/M1	Financial ratios		Real interest rates		Lending rate*	GNP Growth rate	Inflation rate	Budget deficits**
			M2/GNP	M3/GNP	SD	TD				
I. Low Interest Rate Regime 1956-73	1.80	1.83	.23	.23	-1.84	-1.06	5.69	5.28	6.31	0.56 <sup>a/</sup>
II. Transition Period 1974-78	2.18	2.93	.20	.27	-7.21	-3.78	-1.93	6.14	14.5	1.22
III. Floating Interest Rate Period 1981-84	3.06	3.65	.22	.27	-10.58	-1.62	2.6	.19	20.78	2.89

a. From 1966 to 1973.

\* For less than 730 days secured loans.

\*\* As a percentage of GNP.

Notes: M1 = currency in circulation + demand deposits

M2 = M1 + savings and time deposits

M3 = M2 + deposit substitutes

SD = savings deposits

TD = time deposits

One can immediately observe from Table 3 that, as an economy moved from the rigid and low interest rate regime to the transition period, the average M3/GNP ratio increased from 23 to 27 percent, indicating that the move towards a regime when interest rates were still administratively fixed but constantly adjusted by the Monetary Board to reflect market conditions did produce favorable results. However, the move towards a fully flexible interest rate regime did not increase at all the flow of loanable funds.

Why did the switch towards a fully liberalized regime fail to produce the desired results? To answer this question, we have to look at other aspects of the operating financial policy framework. During the floating interest rate period, the Central Bank opened a lot of rediscounting windows that virtually nullified the selectiveness of its selective credit program (see Table 4). This caused disintermediation in two ways. First, both private and government-owned banks took this opportunity by increasing their borrowings from the Central Bank. Thus, they became mere conduits of Central Bank funds instead of intermediaries mobilizing the funds of surplus units. Second, the inflationary impact of this expansionary policy discouraged surplus units from investing their funds in financial assets yielding negative real returns. The table above shows that the floating interest rate period was characterized by an average inflation rate substantially higher than that of the previous regimes.

Fiscal deficits are another aspect that must be examined. As can be observed in Table 3, the average fiscal deficits for each subperiod have been rising and seem to be positively correlated with the average inflation rate. It should be noted that a significant portion of the budget deficits was financed by the Central Bank. For example, borrowings by government from the Central Bank through the "rediscounting with the government" facility averaged ₱2.5 billion annually between 1980 and 1987. It already reached ₱3.5 billion during the first half of 1983 (San Jose 1983). So, to help bring down inflation, fiscal discipline must be instilled. Or, at the minimum, the Central Bank should not be called upon to finance budget deficits. But this is a tall order in a setting wherein the Central Bank is not entirely independent from the fiscal sector. Perhaps, it is high time we had a Central Bank that is completely independent of the fiscal sector. Only then will the fiscal sector be forced to be extra careful in managing its deficits, while the Central Bank can pursue its task of stabilizing the economy more effectively.

**TABLE 4**  
**REDISCOUNTING WINDOWS OF THE CENTRAL BANK**

Facility	Implementing Circular	Date	Loan Value (%)	Rediscount Rate (%)	Lending Rate (%)	Maturities
<b>A. Regular Rediscounting</b>						
1. Supervised credits	784	Feb. 27, 1981	100	3	12	120 days
1. Supervised credits	784	Feb. 27, 1981	100	3	12	120 days
2. Nonsupervised credits	784	Feb. 27, 1981	80	8	14	60 days/120 days/ 270 days
3. Small/medium scale Industry	784	Feb. 27, 1981	80	8	14	120 to 270 days
4. Exports	784	Feb. 27, 1981				
Nontraditional				3	12	90 days
Traditional			80	8	14	10-40 days for sight drafts/ 120-170 days for production credits
5. Masaganang Maisan	828	Oct. 9, 1981	100	3	15	120-270 days
6. Special programs						
NGA, FTI	784	Feb. 27, 1981	100	3	6	180 days
Grains Quedan/ Food Quedan	881	June 25, 1982	80	3	10	190 days
7. Tax credit certificates	802	June 1, 1981	80	8	14	180 days
8. Tobacco trading	715-801	Feb. 1, 1980/ June 1, 1981	80	8	14	180 days One to five years; or the maturity of the paper/ last amortization whichever comes first
9. Energy generating projects	803-872	June 18, 1981/ April 26, 1982				
Mini-hydro			100	3	10	
Dendrothermal			100	3	8	
10. Stock financing	807-851	June 26, 1981/ Feb. 15, 1982	80	8	14	180 days
11. Metal financing	873	May 6, 1982	80	8	14	90 days with another 90 days rollover
12. Dollar rediscounting	875-944	May 21, 1982/ Aug. 15, 1983				90 days
Dollars sold to CB			100	12	—	90 days renewable for 90 days
Dollars deposited with CB			100	12	—	368 days or maturity whichever comes first
13. Manpower exporters	842-894-895	Jan. 29, 1983/ Sept. 24, 1982	80	3	12	180 days
14. Orchard growing/ upland farming	Circular letter	Oct. 23, 1982	80	8	14	120 days
15. Congress organizers	918	Jan. 6, 1983	80	3	12	180 days
16. Coconut millers/ dessicators	921	March 28, 1983	80	3	12	90 days
<b>B. Special Rediscounting</b>						
1. Medium-and long-term	846	Feb. 1, 1982				
-- for acquisition of fixed assets			75	11	15	up to 10 years non-renewable
-- for working capital in connection with a proposed or on-going expansion development program			75	11	15	up to 3 years non-renewable

Table 4 (Continued)

Facility	Implementing Circular	Date	Loan Value (%)	Rediscount Rate (%)	Lending Rate (%)	Maturities
- for investment in affiliates and other institutions			70	14	-	up to 7 years non-renewable
- for investment in high grade securities			70	14	-	not to exceed one year
2. Lender of last resort	749-862-864-907	Aug. 1980 March 23, 1982	80% or as may be provided for under an MB resolution			
- Commercial banks					MRR plus 2% or more	90 days
- Thrift banks					MRR plus 2% or more with 5% liquidity	
- NGBGs					24-32% for loans ranging from P150M-300M & over; plus 2% for each roll-over	60 days
C. Emergency Rediscouting	Sec. 90, RA 265/907	Dec. 24, 1982	16% or MRR plus 3%			90 days
D. Rediscouting with the Government	Sec. 95 RA 265					

Source: San Jose (1983) pp. 16-17.

Finally, we should take note that the period 1981-84 was replete with bank failures. The relative absence of regulatory controls by the Central Bank over bank portfolio allowed banks to take on more risky assets. Interestingly, the recent collapse of many banks can be traced to questionable loans made by banks to their directors, officers, stockholders and related interests (DOSRI) which were not closely monitored by the Central Bank. This suggests that even if the financial system were deregulated, some forms of regulation must be exercised by the Central Bank to reduce riskiness in the portfolio of banks. This is essential to regain the people's confidence in the system. Perhaps, standard financial ratios or other financial ratios modified to suit the characteristics of the Philippine financial institutions may be adopted to ensure their stability as the financial system moves from a repressed to a liberalized one.

#### IV. CONCLUDING REMARKS

The main lesson that can be drawn from the findings of the study is that there are requirements to successful liberalization efforts.

One such requirement is the low inflation rate. Unfortunately, the Central Bank pursued inflationary policies — especially those related to rediscounting and financing budget deficits — at the time when the financial sector was liberalized. The other requirement pertains to some forms of regulation that must be exercised by the Central Bank to reduce riskiness in the portfolio of banks. This is to ensure the people's confidence in the banking system.

The failure of the recent liberalization efforts, therefore, can be traced to inflationary policies and to the lack of effective regulations on the part of the Central Bank to reduce the riskiness of the portfolio of banks.

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