

FINANCIAL FACTORS IN ECONOMIC DEVELOPMENT: A STUDY OF THE FINANCIAL LIBERALIZATION POLICY IN THE PHILIPPINES

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INTRODUCTION

IN recent years, rapid economic development in the ASEAN countries has focused growing attention on the role of the financial sector in development. Financial liberalization theory, especially as developed by McKinnon and Shaw, is the standard and most influential theory in this area, forming the analytical foundation for World Bank and IMF financial-sector structural adjustment lending. Actual experience with financial-sector liberalization to date has produced a lack of clear success stories. The countries with the most impressive development records in Asia—Japan, the Republic of Korea, and Taiwan—give cause for reflection: each of these countries rejected financial liberalization at the early stage of development in favor of financial restraint and policy-guided credit allocation.¹

Ultimately, issues such as the appropriate type of financial system and policy for economic development must necessarily reflect the economic situation of each individual country. Theory alone is not sufficient to generalize about whether financial liberalization or policy-directed finance better supports development. Abstract theoretical research and debate about financial liberalization continues to move forward, but the concrete country-specific policy research so indispensable to support this work has lagged behind. Moreover, there is a tendency in policy discussions to deduce conclusions on the basis of successful cases. It is also vital to look at unsuccessful cases and analyze why they failed.

The Philippine is one country where past financial reform produced disappointing results and where a World Bank-supported financial sector adjustment program is currently under implementation. This paper examines financial reform in the Philippines from 1970 to 1988. It asks, first, why reform, particularly in the early eighties, did not produce the expected results and second, what influence the reform had on broader Philippine economic development. While scholars such

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¹ Refer to Kohsaka [3].

as Hashida [2], Matsuoka [4], and Morisawa [8] have conducted excellent research on the Philippine financial sector, their work centers on detailed analysis of narrowly defined aspects of the system. This paper adopts the opposite approach, studying the financial sector comprehensively over two decades, with special emphasis on the early 1980s.

The essay is organized as follows. Section I develops a framework for analyzing the role of the financial sector in economic growth. Section II sets the stage for later analysis by reviewing the evolution of Philippine financial reform. The next four sections form the core of the analysis, examining the impact of financial reform on savings, efficiency of allocation, long-term capital supply, and use of external capital. The financial liberalization of the early 1980s achieved some success in financial deepening and lengthening capital maturity, but the savings rate failed to improve and investment efficiency worsened. The principal reason for the unimpressive results was the chaotic macroeconomic situation of the mid-1980s, but other factors also contributed. A well-functioning financial market mechanism is the foundation of liberalization yet the necessary capital, manpower, and legal framework were not in place in the Philippines. Furthermore, the liberalization policy itself was inadequate and at times even contradictory, as evidenced by the increase in the share of policy-directed capital allocation under reform. Section VII summarizes conclusions from the analysis and derives lessons from the Philippine experience.

I. THE ROLE OF THE FINANCIAL SECTOR IN ECONOMIC GROWTH

A. *Conditions for Sustainable Growth*

If we let Y and I equal real GNP and real investment, the realized real GNP growth rate g can be analyzed in the following ex post identity:

$$g = dY/Y = (dY/I) \cdot (I/Y) = (1/k) \cdot (I/Y), \quad (1)$$

where I/Y represents the ratio of investment to GNP and dY/I signifies the margin of increase in real GNP per unit of investment, namely the reciprocal of the realized marginal capital coefficient k . In order to attain lasting growth, it is necessary on the supply side that factors of production are appropriately linked and that production capacity steadily expands; at the same time, on the demand side effective demand must expand in accordance with growth in production capacity. If we consider equation (1) as an ex ante relationship, then the growth rate should increase the higher the investment to GNP ratio, given a certain marginal capital coefficient. Because investment I must be financed by savings S or external savings F , the investment/GNP ratio must satisfy the following restriction:

$$I/Y \leq S/Y + F/Y. \quad (2)$$

Thus, when low savings limit investment, expansion of domestic and/or external savings can expand investment and raise growth.

By the terms of equation (1), if I/Y is given, then the GNP growth rate will increase the lower the marginal capital coefficient. In order to lower the coefficient, in other words, to expand marginal real GNP growth per unit of additional investment, it is necessary to promote (i) investment that supports efficient production (ii) in sectors where rapid growth in effective demand can be expected.

B. *The Role of the Financial Sector in Economic Growth*

Accumulation of capital stock through continuous investment is indispensable to sustainable growth. Thus, a mechanism to procure resources from domestic and external savings and then use them to finance investment is needed. Because savers and investors are not ordinarily one and the same, the financial sector is assigned the function of transferring resources from one to the other. How effectively the financial sector performs this function exerts a tremendous influence on an economy's ability to achieve and sustain growth.

Economists frequently point to two main functions of the financial sector in growth, namely mobilization of domestic savings and efficient allocation of capital. Teranishi [14], stressing the importance of long-term capital in growth, adds a third: the "maturity transformation function," whereby financial institutions borrow capital short-term and lend long-term. Also, in the growth-cum-debt strategy, the financial sector plays an additional role borrowing and allocating capital from abroad.

1. *Economic growth and mobilization of domestic savings*

When savings fall short of investment, investment is restricted, thereby suppressing growth. In this case equation (2) suggests that an increase in the domestic savings ratio (S/Y) will raise the rate of investment (I/Y) and increase economic growth g . This process may be complicated by the fact that a significant portion of domestic savings is held in the form of real assets such as buildings, livestock, and gold, and another sizable percentage has left the country through capital flight. Moreover, unofficial unorganized financial markets, or curb markets, claim a significant share of domestic savings.²

Despite these limitations on the pool of mobilizable savings, official market financial assets, nonetheless, represent an important and easily usable form of savings; therefore, reform of the official organized financial market can be expected to increase demand for savings. Financial sector reform improves mobilization of domestic savings in several ways: diversification of bank branch networks leads to acquisition of new deposits; removal of interest controls raises interest rates and increases deposit balances; and introduction of new financial instruments stimulates demand for financial assets.

2. *Economic growth and capital mobilizations*

As a general rule, when an investor cannot supply sufficient capital for investment from internal resources, it is necessary to procure capital elsewhere to cover

² In this connection, the *Far Eastern Economic Review* (August 2, 1990) estimates that borrowing from the curb market accounts for 70 per cent of all borrowing in the agricultural sector in the Philippines.

the gap. In developing countries where direct finance is poorly developed, indirect finance through intermediary institutions is the principal means of transferring resources from savings into investment.³ How effectively mobilized savings are utilized to increase the growth rate depends largely on capital allocation by financial institutions.

First, efficient capital mobilization requires reducing the cost of financial intermediation. Savings mediated by financial institutions are not all transferred into investment; a portion is consumed by intermediation costs. The lower the intermediation cost, the more resources are available for investment.

Secondly, capital mobilized through financial institutions must be allocated so that dY/I increases. That is, financial intermediations are required to allocate the mobilized capital into the investment projects which realize technologically efficient production. Moreover, it is necessary that these investment projects are done in the sectors where effective demand is expected to grow rapidly in the future.

3. *Economic growth and the maturity transformation function*

Many resource-poor developing countries seek to promote economic growth through industrialization. Industrial sector investments have high minimum capital requirements, and because of the long gestation period before such investments yield a profit, the availability of long-term capital is essential to the success of an industrialization-led growth strategy. Greater availability of long-term capital facilitates improvement in the efficiency of investment (dY/I), especially in the industrial sector, and raises economic growth g .

Long-term investment capital is procured by issuing bonds or borrowing from banks and other financial intermediaries. In developing countries, most long-term finance is obtained by the latter means. Pooling resources from deposits, a bank can, after subtracting necessary reserves, lend at a longer maturity than it borrows, performing what is called a maturity transformation function.

The degree to which a bank succeeds in lengthening the maturity of capital depends largely on the volume of long-term deposits it can attract and the size of reserves it must keep.

4. *Economic growth and foreign capital*

An economy in which investment is restricted by inadequate savings can realize higher investment and therefore higher growth g by importing foreign capital to expand F/Y . While this constitutes a strategy of development through overseas borrowing, financial institutions play a vital role in ensuring that foreign capital makes a positive contribution to development. First, intermediation, especially by government banks with the authority to issue official guarantees, can make foreign capital available to investors who, for reasons of poor creditworthiness or imperfect information, would not otherwise have access to such funds. Second, financial institutions take responsibility for allocating foreign capital, utilizing their

³ The ratio of stock market capitalization to GNP in the Philippines in 1989 was 27.1 per cent.

own analytical resources. As such, they determine what sort of investment goals foreign capital will finance. The efficiency with which they perform this function does much to determine whether a development strategy financed by foreign capital will succeed or not.

C. *Financial Liberalization Theory and Economic Growth*

Financial liberalization theory argues for improved growth through financial sector reform.⁴ According to liberalization theory, financial sector segmentation through artificially low interest rates and excessive regulations as seen in many developing countries reduces the mobilization of savings and lowers the efficiency of capital allocation. In order to remove these significant barriers to growth, liberalization theory calls for eliminating artificially low interest rates and easing controls on business, thereby allowing the market mechanism to operate. Advocates of this position argue that removal of interest ceilings will enhance savings mobilization by the official market and at the same time enhance growth through the realization of efficient capital allocation. A distinctive characteristic of this theory is its emphasis on the importance of official indirect financing and on the centrality of the market mechanism. The theory asserts that direct finance and the unofficial market, often considered so important in moving capital in the Third World, are only of secondary importance.⁵

If liberalization theory is correct, countries that have implemented financial reform based on the theory should demonstrate the following characteristics: (a) a positive correlation between positive real deposit interest rates and the savings rate, (b) a positive correlation between the degree of financial deepening and the growth rate, (c) a positive correlation between real interest rates and the level of investment, and (d) a positive correlation between real deposit interest rates and the economic growth rate.⁶ The remainder of this essay assesses liberalization theory in light of these hypotheses for the case of the Philippines.

II. PHILIPPINE FINANCIAL REFORM IN THE 1970s–1980s

A. *Preparation for Liberalization, 1970–78*

In the early seventies, the Philippine financial sector faced serious problems in all areas, from efficient capital mobilization and intermediation to lengthening the maturity of capital.⁷ Several factors caused these problems, inadequate specialization and lack of competition central among them. Capital allocation did not meet economic needs and the cost of intermediation failed to improve. Exclusion of nonbank financial institutions and short-term capital market transactions from the regulatory system hurt bank competitiveness and discouraged long-term transactions.

⁴ Refer to McKinnon [5] and Shaw [13].

⁵ On the importance of unofficial finance, see Van Wijnbergen [15]; for a welfare economics analysis of unofficial finance, refer to Okuda [9].

⁶ Refer, for instance, to Dornbush and Reynoso [1].

⁷ This section heavily depends on Matsuoka [4] and Rosario [11].

Investment rates were fixed at low levels, further impeding long maturities and spurring capital flight. A backward agricultural finance system aggravated inefficient mobilization of domestic capital.

In response to these problems, the Philippine government initiated financial reforms in the 1970s based on the report of the IMF/Central Bank of the Philippines Banking Survey Commission of 1972. The reform sought first to improve the efficiency of financial intermediation and capital allocation by promoting competition and expansion of scale. More concretely, it encouraged bank consolidation and eased regulations on financial institutions. In 1972, the government revised the Central Bank Act to permit the central bank to lend to government financial institutions to purchase bank stock and to develop a system of supervision over nonbanks engaged in quasi-banking activity. The General Banking Act was also revised to facilitate consolidation and more efficient intermediation. The revision raised interest rates; regulated foreign ownership of stock and control of executive positions in newly consolidated banks; removed controls on the ratio of risky assets to capital; strengthened limitations on ownership of stock with voting rights attached; and established a system of central bank investigation of the qualifications of bank executives and high-level management. In 1976 and 1977, regulations on commercial banks and savings banks were also rationalized.

The second goal of the 1970s reform was to encourage longer capital maturities. This involved creating both incentives for the long end of the market and disincentives for the short end. To promote long-term bank lending, the government approved bank investment in related firms, raised ceilings on investment in land, buildings, and other fixed assets, and raised the ratio of risky assets to capital. Interest rates on capital with a maturity longer than 730 days were liberalized. To restrain short-term financial transactions, controls implemented in 1976 raised the minimum issue volume and regulated the minimum maturity of deposit substitutes. A year later the government introduced a 35 per cent tax on short-term capital market transactions.

The third broad goal of reform was to improve mobilization of savings. The government took two sets of measures for this purpose, one aimed at savers in general and one targeting the agricultural sector. For the former, new financial instruments such as commercial paper, mortgage-backed securities, and movable asset mortgage-backed securities were introduced. For the agricultural sector, other goals such as regional development and increased food production were combined with improved savings mobilization. Regulations on regional distribution of bank branches were put in place along with a five-year plan for establishing regional banks. The government strengthened official agricultural credit (central bank rediscounting) by expanding agricultural banks. It also initiated a system of 25 per cent compulsory commercial bank lending to the agricultural sector. Finally, to promote more effective use of foreign capital, the reform introduced a foreign currency deposit system in 1970, formalizing it into law in 1972. Moreover, in 1976 an expanded foreign currency deposit system was established along with the introduction of offshore banking.

B. *Evolution of Financial Liberalization*

Early in the 1980s insufficient savings mobilization, inefficient allocation and high intermediation costs continued to burden the Philippine financial system. These problems were the ongoing result of inadequate competition, the small scale of financial institutions' operations, and excessively short capital maturities. Aiming to resolve these problems, the Philippine government initiated further financial reform in 1980, and a 1979 joint IMF-World Bank report⁸ served as the basic guideline. Seeking fundamentally to expand on the reforms of the seventies, the reforms had three objectives: (1) improved financial market efficiency through a series of measures to promote competition and realize economies of scale; (2) strengthened capital mobilization capability, centering on long-term capital; and (3) rationalization of financial market regulations. The first step to achieving these goals was to revise the laws regulating commercial banks, savings banks, agricultural banks, and quasi-bank financial institutions. Most significantly, the government introduced a universal banking system (an expanded commercial banking system), which became law in April 1980 and went into effect in July of the same year. At the same time, controls on specialty sectors were also rationalized to energize other financial institutions. Interest rates were also liberalized. Interest ceilings on savings, fixed-term savings, NOW (negotiable order of withdrawal) accounts, deposit substitutes, and loans of over 730 days were removed in July 1981, and ceilings on short-term lending were removed in January 1983.⁹

In addition to these broad reforms, the overall 1980 package also included more specific measures tailored to each of the three major objectives. Enhanced efficiency was sought through rationalized controls on financial institutions and incentives to expand the scale of operations. Measures to rationalize business regulations included permission for savings and agricultural banks to open demand deposit accounts, previously the exclusive domain of commercial banks; approval for commercial banks to conduct securities business; rationalization of regulations on agriculture and private sector development banks; and approval for investment houses to conduct trust and foreign exchange operations. In order to encourage consolidation among financial institutions, the government raised minimum capital requirements, approved 100 per cent investment by commercial banks in savings and agriculture banks, and introduced a system whereby regulations were eased in proportion to the scale of business. At the same time, to guard against excessive concentration, a requirement for prior central bank approval of acquisition of corporate stock by a financial institution was put in place, along with a regulation against financial institution executives and/or senior managers holding concurrent post in each other's institutions.

⁸ Refer to World Bank [16].

⁹ The Dewey Dee incident of 1981, occurring while these measures was under implementation, gave rise to instability in the short-term capital market, and required steps to restore investor confidence. Thus, in September of that year regulations were enacted segregating the trust business from the investment and loan business, and in December guidelines on issuance of commercial paper were strengthened.

Measures designed to increase the availability of capital, in particular long-term capital, centered on cultivating a securities market, enhancing long-term capital procurement capability, and liberalizing deposit interest rates. To foster growth in the securities market, financial institutions were permitted to hold stock in non-related corporations and conduct stock underwriting and trading activities. In order to expand long-term capital supply, ceilings on commercial bank long-term lending and securities investment were removed and central bank rediscounting targeting quasi-bank financial institutions, important suppliers of long-term capital, was introduced.

Finally, the government conducted a thorough reassessment of regulations on financial institutions with a focus on business structure and improved the bank inspection and supervision system. For example, in 1983 debt information and CAMEL rating system¹⁰ were introduced. Furthermore, in 1984, the management of the central bank's emergency financing facility was made more flexible.

C. Follow-up on Financial Liberalization, 1986-88

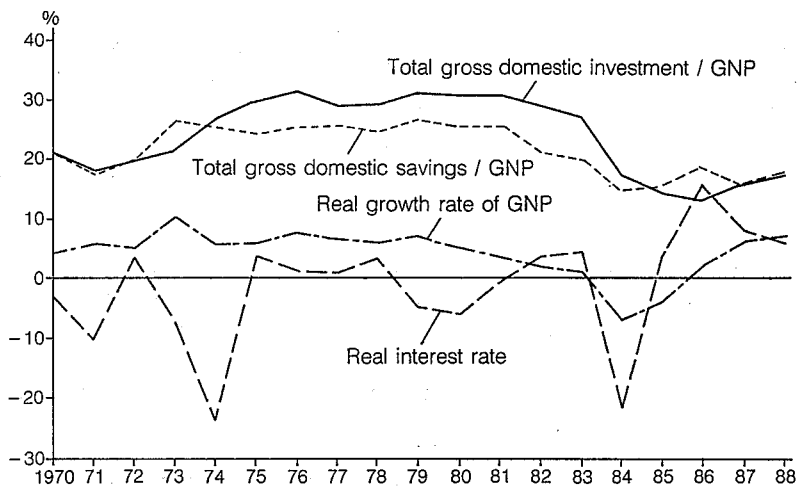
Philippine financial liberalization, interrupted in the mid-eighties by economic turmoil, was resumed in 1987. The principal reason for the unsatisfactory results from the early 1980s liberalization effort lies in the economic confusion of the late Marcos years. At the same time, inadequate financial system infrastructure and unsound management in many financial institutions contributed to the worsening of the situation. The reform policy underway since 1987 focuses primarily on resolving the system-level problems brought to light by earlier reform efforts. Another distinctive feature of the current reform is a broad reassessment of policy-directed finance on the basis of past experience.

The current reform places emphasis on strengthening the market mechanism in finance by revising the Central Bank Act and strengthening supervision of financial institutions by authorities. Appropriate market supervision is a precondition to smooth functioning of the market mechanism and it is indispensable to an effective liberalization policy. In this context, the need to strengthen protection for depositors has been stressed. The reform also incorporates measures to further liberalization with the aim of improving institutional efficiency, including lowering intermediation costs. Specifically, the reform supports strengthened competition and institutional consolidation and plans gradual removal of taxes on financial intermediation activity.

Another important characteristic of the current reform is a radical rethinking of the management of official finance. Experience has shown that a system of direct allocation of capital by government financial institutions to end users is highly susceptible to political pressure. The current reform aims to eliminate this external influence on capital allocation.

¹⁰ A post-examination tool. All the qualitative and quantitative factors considered for the evaluation of a bank are incorporated into a single numerical rating.

Fig. 1. Savings-Investment Balances



Sources: Central Bank of the Philippines, *Annual Report: Statistical Bulletin*, various editions.

III. IMPROVING THE DOMESTIC SAVINGS RATE

A. *The Level of Savings and the Real Interest Rate*

The Philippine domestic savings ratio fluctuated greatly through the 1970s and 1980s.¹¹ In order to increase the mobility of domestic capital, 1970s financial reform expanded agricultural banks and introduced new financial instruments such as commercial paper.¹² Further reform in the early eighties removed ceilings on interest rates.

It is sometimes argued that a rise in the real interest rate stimulates increased demand for savings, leading to a rise in the savings ratio. However, we find no clear correlation between the ratio of Philippine gross domestic savings to GNP (hereafter, the domestic savings ratio) and the real domestic interest rate during the nineteen-year period from 1970 to 1988.¹³

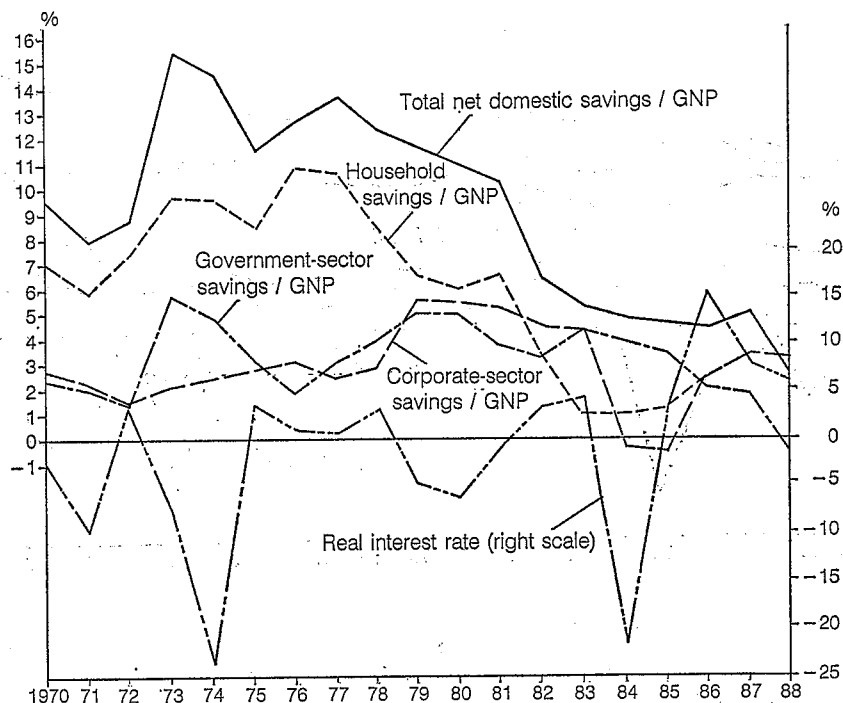
As Figure 1 indicates, savings moved as theory would predict in 1970–71, 1984–85, and 1985–86, increasing in response to a rise in real interest rates and

¹¹ The savings rate in the Philippines reportedly increased in the 1960s as well, but this increase came as a result of improved financial sector infrastructure, specifically expansion of bank branches.

¹² Here, the expansion of agricultural finance produced some positive results in the early seventies, but the share of farm banks in the total structure of financial institutions is so small that this cannot be said to be a major explanation for the increase in savings in the 1970s. Moreover, the introduction of new financial instruments brings about change not so much in the rate of savings but in the structure of financial asset holdings (See Figure 3). The impact of new instruments on the savings rate per se is not clear. (See Figure 2).

¹³ We use the real interest rate of treasury bills, the key reference price for Philippine interest rates, as the indicator of real domestic interest rates.

Fig. 2. Savings by Sectors



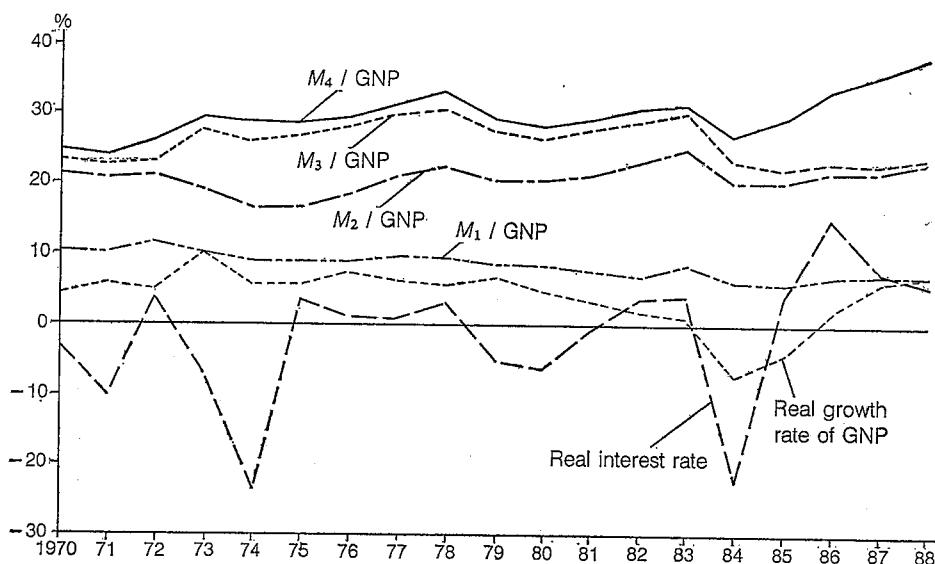
Sources: Same as Figure 1.

decreasing with a decline. From 1972 to 1975 and from 1979 to 1983, on the other hand, savings declined (rose) in spite of higher (lower) real interest rates. Moreover, from 1973 to 1981, domestic savings remained at a high 25 per cent level although time deposit interest rates fluctuated by as much as 20 per cent. Thus, interest levels alone do not explain the high savings of this period.

Figure 2 allows a sector-by-sector analysis of the relationship between the savings and real interest rates. As the figure indicates, the 25 per cent savings ratio of 1973–81 was supported by expansion of savings in the household sector in the early part of the period and by rising corporate and public sector savings later. There was wide fluctuation in the rate of savings across sectors from 1970 to 1988, but the pattern of variation differed substantially from one sector to another. No clear pattern of correlation emerges between sectoral savings behavior and real interest rates.

Where the Philippine domestic savings ratio does show an intimate correlation is with the rate of economic growth. Household savings moved in tandem with the GNP growth rate over the entire 1970–88 period. From 1981 to 1982, the household savings to GNP ratio moved against the GNP growth rate, but this can be interpreted as the influence of rising real interest rates under the gradual liberalization policy begun in 1980.

Fig. 3. The Ratios of Principal Financial Assets to GNP



Sources: Same as Figure 1.

Notes: M_1 =currency in circulation+demand deposits; $M_2=M_1$ +time & saving deposits; $M_3=M_2$ +deposit substitutes; and $M_4=M_3$ +government bonds held by non-financial institutions.

These observations are consistent with the results of the estimation of saving functions.¹⁴ According to the estimation results, savings are not sensitive to change in the real domestic interest rate, while they are sensitive to change in the real GNP and real foreign interest rate.

B. Financial Reform and Financial Deepening

A central tenet of financial liberalization theory is the removal of interest rate controls to achieve a rise in deposit interest. While the assumption is that savings will then rise, the theory does not aim for an increase in the savings rate per se from the removal of controls. Instead, it aims for increased demand for financial assets: higher interest rates spark improved mobility of capital in the official financial market.

¹⁴ Using annual data from 1970 to 1988, we estimated the saving function:

$$S = -3.47 + 0.19Y + 0.13Ry + 0.00Rtr - 0.15Rus - 7.50D,$$

$$(-1.23) (5.40) (0.82) (0.10) (-2.21) (-6.57)$$

$$\bar{R}^2 = 0.8064, D.W. = 2.4824$$

where S , Y , Ry , Rtr , Rus , and D are respectively real domestic savings, the real GNP, the real GNP growth rate, the real interest rate for ninety-day time deposits, the real rate of return on U.S. treasury bills maturing in ninety-one days, and dummy variable for the aftereffect of economic crisis.

What is of great interest here is the strong correlation between movement in demand for domestic financial assets and real interest rates in the Philippines. Figure 3 shows the impact of change in the real interest rate on demand for financial assets. It reveals that, except for 1987 and 1988, there was a tendency for the ratio of domestic financial assets to GNP to move in harmony with the level of real interest rates on time deposits (ninety-day term). The ratio increased from 25 per cent to 38 per cent during the period 1970–88. If we take this ratio as an indicator of financial sector development, then over this period the Philippines experienced financial deepening.

Figure 3 also reveals that the structure of outstanding assets underwent substantial change. The surge in demand for deposit substitutes after 1972 resulted from the sudden expansion of trading in the short-term market after the introduction of new financial instruments such as commercial paper and securitized bonds.¹⁵ A gradual liberalization of long- and short-term deposit rates was started in 1981. Table I shows the results of an estimation of demand for financial assets after 1980. According to the estimation results, financial asset demand in the 1980s showed sensitivity to interest rates and reciprocal substitutability of demand was strong. Figure 3 indicates that demand for deposits and deposit substitutes, which had sustained high levels in the early eighties, dropped sharply after 1984 and was replaced by a rise in demand for treasury bills. Interest rates on Philippine treasury bills had been rising against the background of the ballooning fiscal deficit, and in 1984 TB rates surpassed rates on time and savings deposits. This illustrates that demand for financial assets in the Philippines responds quickly and sensitively to changes in interest rates.

The gradual interest liberalization of the early eighties led to a rise in interest rates, but the domestic savings rate declined. On the other hand, higher interest rates did promote financial deepening and expand the supply of capital in the official financial market, as liberalization theory would predict. Thus, if capital in the official market could be invested more efficiently than in the past, it would still be possible for the growth rate to rise despite declining savings. Whether that possibility was realized depended on the extent to which the efficiency of market-based capital allocation improved with liberalization. Section IV addresses this issue further.

C. *Structural Distortion in the Financial Market and Liberalization*

Financial liberalization produced a rise in real interest rates and an expansion in the volume of capital in the official market. Interestingly, the instrument that saw the most striking increase in demand was treasury bills while demand for bank deposits remained low. This shows the high interest elasticity of demand for financial assets, but it also suggests low trust in financial institutions in the Philippines.

As financial liberalization theory emphasizes, the existence of financial intermediaries that inspire customer confidence is a necessary precondition if liberalization is to be effective in expanding financial mobility through banks and other

¹⁵ Refer to Section II.

TABLE
ESTIMATION OF DEMAND FUNCTIONS

Explained Variables ^a	Explanatory				
	C_0	Y	Rtd	Rtb	Rus
Currency in circulation	5.156 (1.309)	-0.545 (-1.550)	-2.340 (-2.836)	—	-0.819 (-1.029)
Demand deposits	-3.939 (-0.595)	-0.277 (-0.496)	-0.131 (-0.176)	—	2.115 (1.260)
Savings and time deposits ^b	0.496 (0.157)	-0.075 (-0.270)	3.200 (3.713)	-1.475 (-2.400)	-1.544 (-2.135)
Savings and time deposits ^c	5.263 (0.562)	-0.549 (-0.670)	4.893 (1.985)	-2.995 (-1.727)	0.977 (0.528)
Domestic treasury bills	8.662 (0.729)	-0.807 (-0.763)	-7.250 (-1.971)	5.704 (2.280)	-0.796 (-0.318)
Total principal financial assets	2.292 (0.680)	-0.182 (-0.599)	-0.751 (-0.723)	-0.362 (-0.558)	-1.688 (-2.053)

Sources: Hidenobu Okuda, "1980 nendai no Firipin no kin'yū shisan juyō no henka" 15, No. 10 (October 1989).

Note: We assume that demand for asset i , D_i , is represented by the equation:

$$\ln(D_i/Y) = C_0 + C_1 \cdot \ln Y + C_2 \cdot \ln Rtd + C_3 \cdot \ln Rtb + C_4 \cdot \ln Rus + C_5 \cdot \ln P + C_6 \cdot \ln(D_i/Y)_{-1} +$$

where Y (y) is the nominal (real) GNP, Rtd is the nominal interest rate for ninety-day time maturing in ninety-one days. P is the rate of inflation (CPI). $(D_i/Y)_{-1}$ is D_i/Y with the constant term and C_1 through C_6 are coefficients for explanatory variables.

Using quarterly data (the first quarter of 1981 and the first quarter of 1988), we determinants, the Darwin-Watson ratio, and standard deviation. The value indices in

^a The ratio of each asset to nominal GNP.

^b With deposit banks.

^c With non-deposit banks.

intermediary institutions. For this purpose, it is necessary to establish a supervisory infrastructure to ensure healthy financial institutions and to provide deposit insurance or other depositor guarantees in case of bankruptcy. In the 1980s, economic chaos in the Philippines complicated management of financial institutions and bankruptcies increased. The legal and oversight divisions of the financial system had not enough staff and financial backing to effectively prevent financial instability, and once instability occurred, the deposit insurance system also proved inadequate.¹⁶ The fact that this fragile regulatory and insurance system was not

¹⁶ The main deposit insurance institution is the Philippine Deposit Insurance Corporation (PDIC), a wholly government financed organization established in 1963. PDIC's Permanent Insurance Fund is small with its earnings pressured by the interest burden of heavy borrowing from the central bank to cover capital shortages; moreover, the proportion of the deposits it insures that are secured is small and income from insurance fees is too low for effective management. These problems, combined with a severe manpower shortage, mean that PDIC must depend heavily on the central bank for fiscal support and has to accept central bank staff as bank inspectors and managers.

I
FOR PRINCIPAL FINANCIAL ASSETS

Variables	P	$(D_t/Y)_{-1}$	Dummy Variables with Seasonal Adjustment			\bar{R}^2	D.W.	S
			D_1	D_2	D_3			
			0.494 (1.912)	0.312 (1.693)	-0.126 (-2.780)			
-0.382 (-1.711)	0.710 (4.090)	0.092 (2.010)	0.062 (1.360)	0.145 (1.720)	0.943	2.830	0.078	
-0.392 (-2.670)	0.564 (4.612)	0.128 (4.401)	0.050 (1.808)	0.176 (3.757)	0.847	2.319	0.048	
-0.740 (-1.834)	0.744 (5.394)	0.172 (2.239)	0.140 (1.851)	0.131 (0.957)	0.930	2.140	0.130	
-0.083 (-0.146)	0.849 (10.052)	0.409 (3.507)	0.092 (10.868)	0.290 (1.524)	0.977	2.229	0.181	
-0.434 (-2.739)	0.318 (1.607)	0.087 (2.356)	0.042 (1.333)	-0.119 (-2.337)	0.918	1.986	0.052	

[Changes in demand for financial assets in the Philippines], *Kaigai iōshi kenkyūjo hō*, Vol.

$$C_7 \cdot D_1 + C_7 \cdot D_2 + C_7 \cdot D_3$$

deposits. R_{tb} (R_{us}) is the nominal rate of return on Philippine (U.S.) treasury bills a one-period lag, and D_1 , D_2 , and D_3 are dummy variables for seasonal adjustment. C_0 is

derived the above results. Here, \bar{R}^2 , D.W., and S respectively represent the coefficient of parentheses represent the t -values.

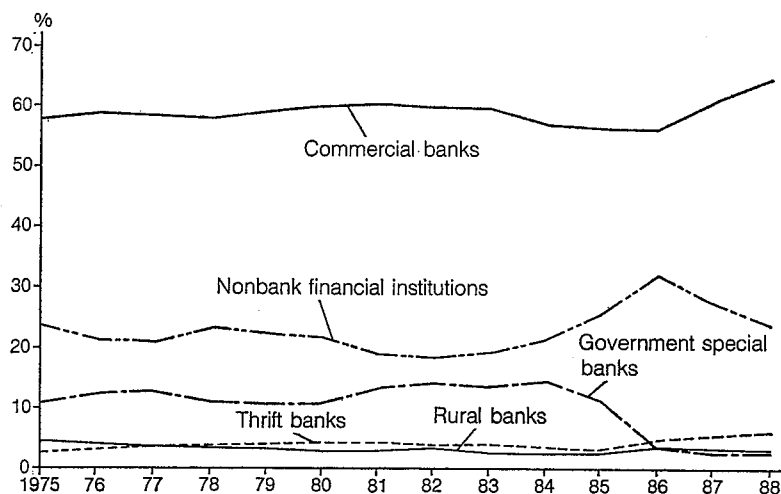
strengthened prior to liberalization surely contributed to the failure of banks and other financial intermediaries to attract more capital resources once liberalization had begun.

IV. PROMOTING EFFICIENT ALLOCATION OF CAPITAL

A. Changes in Principal Lending Institutions

Philippine real market interest rates tended to increase from 1970 to the early 1980s. Real deposit rates moved higher, particularly in the economically stable years of the mid-seventies and the years of financial liberalization in the early eighties. Higher real deposit rates led to an increase in the capital supply in financial institutions and correspondingly, the balance of lending by formal financial institutions as a percentage of GNP rose as high as 86 per cent in 1983. However, the economic unrest of the mid-eighties dealt a blow to demand for financial assets and by 1986 the ratio had fallen to 43 per cent. Real deposit interest rates turned

Fig. 4. Outstanding Loans by Financial Institutions



Sources: Same as Figure 1.

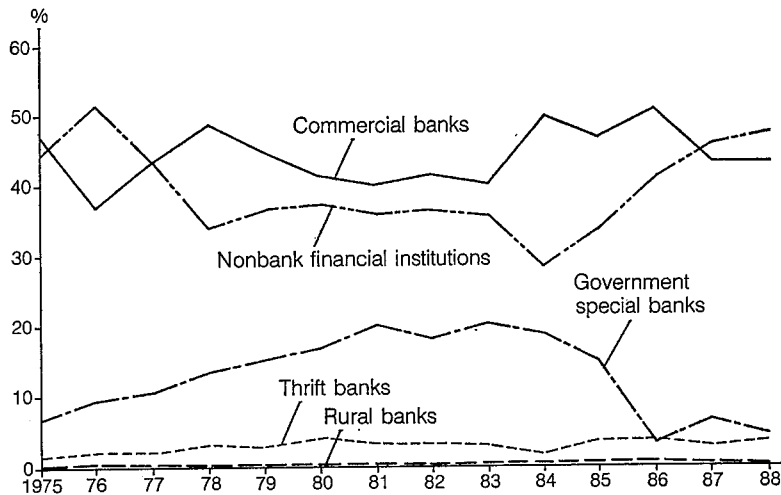
Note: Percentage of total outstanding loans.

positive in the post-1986 period of economic recovery, but the ability of financial institutions to mobilize capital did not improve and the outstanding loan to GNP ratio remained low.

Figure 4 shows movement in outstanding loans by official financial institutions in the Philippines from 1975 to 1988, excluding the central bank. According to the figure, commercial banks accounted for more than half of outstanding loans by the official market over this period. Financing through the formal market includes both direct financing through the securities market and indirect financing through banks; however, the small scale of the Philippine securities market limited its role in the financial market. By volume, banks played the central role in providing investment financing over this period while nonbank financial institutions played a supplementary role. Further, if we look at a breakdown of bank lending, the percentage supplied by the Development Bank of the Philippines (DBP) and other government special banks is low, indicating that commercial banks dominate bank lending.

The share of government special bank (GSB) loans in total outstanding loans increased from the late seventies to the early eighties, peaking in 1984. This means that within the overall process of financial deepening in which the share of lending by financial institutions was rising, lending by GSBs outpaced the overall rise. Movement in outstanding investments by Philippine financial institutions other than the central bank is illustrated in Figure 5. We see that the bulk of outstanding investments is held by commercial banks and nonbank financial institutions, with the share of government special banks falling short of this level. Prior to the onset of economic crisis in 1983, however, GSBs had continuously expanded their share in total investments.

Fig. 5. Outstanding Investments by Financial Institutions



Sources: Same as Figure 1.

Note: Percentage of total outstanding investments.

The Philippine Five-Year Development Plan covering the late seventies and early eighties called for ambitious development financing, including funding for eleven major projects.¹⁷ The capital for these projects could not be procured simply on the basis of expansion in the domestic capital supply so the gap was filled in with overseas borrowing (Refer to Figure 1). GSBs took advantage of their "special" character to borrow heavily abroad and from government sources to raise capital for project loans; as a result, their share in total lending expanded sharply. The growing importance of GSBs over this period highlights the paradox that the weight of policy-directed loans in total lending expanded under financial liberalization.

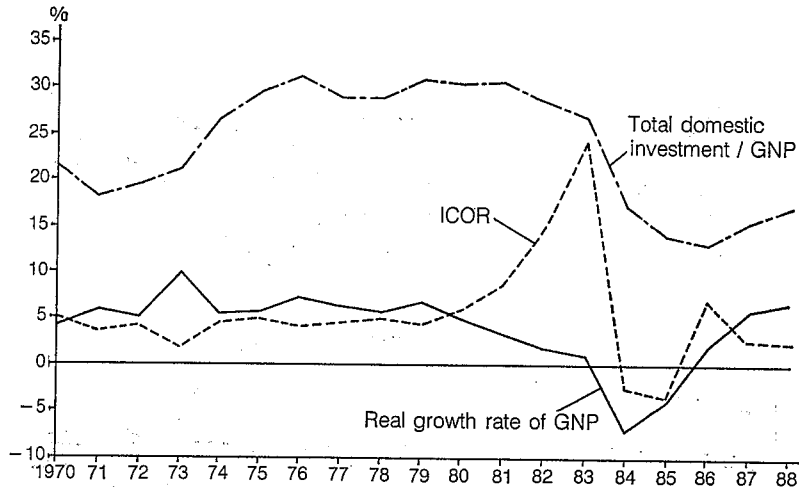
B. Efficiency of Financing and Change in Borrower

Outstanding lending by financial institutions rose steadily both by volume and as a percentage of GNP until the onset of financial crisis in 1983. As Figure 6 suggests, the ex post marginal capital coefficient in the Philippines was virtually fixed at four throughout the 1970s. However, it gradually turned higher in the late seventies and rose sharply in the early eighties, though by the end of the economic crisis in 1986 the coefficient had fallen back to 1970s levels.

Although the real interest rate underwent repeated large scale changes throughout the period under study, close examination reveals it moved in an upward direction overall. The change in the actual marginal capital coefficient, therefore, does not indicate adjustment in the optimum capital-investment ratio to the relative

¹⁷ For a comprehensive treatment of Philippine industrial policy, see Miralao [6] and Sakai [12].

Fig. 6. Incremental Capital-Output Ratio



Sources: For "total domestic investment/GNP" and "real growth rate of GNP," same as Figure 1. For ICOR (incremental capital-output ratio), Philippines, National Statistical Coordination Board, *Philippine Statistical Yearbook*, various editions and International Monetary Fund, *International Financial Statistics*, various issues.

Note: $ICOR = (\text{total domestic investment/GNP}) / \text{real growth rate of GNP}$.

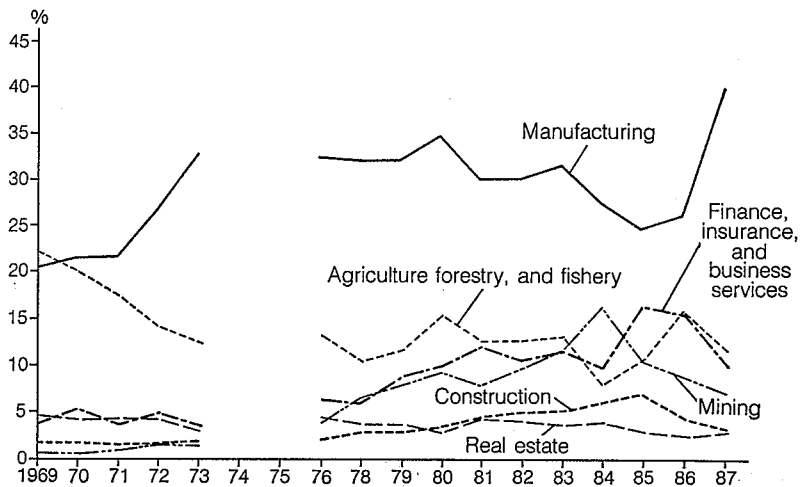
factor price of capital (that is, the real interest rate). Movement in the marginal capital coefficient over this period reflects change in effective demand, not change in the efficiency of investment in production technology. We can conjecture that the rise in the marginal capital coefficient in the late seventies came about because of inappropriate investment, where selection of investment sectors was not related to effective demand.

What is interesting about this is that the trade deficit expanded throughout the seventies. While the Philippine economy maintained strong investment and achieved solid growth throughout the decade, the growing deficit plainly indicates that investment failed to develop industries with strong international competitiveness. Consequently, when the world economy stagnated in the early eighties, the Philippine payments balance deteriorated and economic growth stalled from lack of effective demand. This resulted, *ex post*, in worsened investment efficiency.

What role did the Philippine financial sector play in inappropriate allocation of investment resources? Throughout the 1970s and 1980s, commercial bank loans dominated investment financing. If we look at movement in commercial bank lending by sector in the early 1970s, we see a striking shift in borrowers from the agricultural sector to the industrial sector under the industrialization policy of the second and third four-year plans (See Figure 7).

Next, lending from the late seventies to the early eighties when financial

Fig. 7. Outstanding Loans of Commercial Banks by Industry



Sources: Same as Figure 1.

Note: Percentage of outstanding loans.

liberalization began shows a clear increase in the share of outstanding loans to the mining and construction sectors while the share of agriculture and fisheries was stable and the share of industry declined. The expansion in mining and construction loans reflects project investment under the 1974–77 Four-Year Development Plan and the ambitious 1978–82 Five-Year Development Plan. The data suggest that allocation of commercial bank capital allocation was strongly influenced by government development plans and industrial policy.

The influence of government development plans on financial institutions' capital allocation is clearly expressed in lending by government special banks, whose relative importance grew in the early 1980s. The balance of outstanding loans and investments of the Development Bank of the Philippines, the largest GSB and principal development bank in the country, jumped sharply from the late seventies to the early eighties. Naturally as a government-related bank DBP's financing targets are selected on the basis of the official development policy; nonetheless, the preponderance of lending to low growth sectors is especially striking. For instance, DBP supplementary financing and equity investment in stagnant or failed development projects as a share of total outstanding loans increased, especially at the start of the 1980s.¹⁸ This can mean nothing other than that DBP capital allocation was determined by government development plans.

C. Financial Liberalization Policy and Allocation of Capital

The liberalization of short-term interest rates in January 1983 removed interest controls in the Philippines in principle. It should have been possible then for the

¹⁸ Morisawa [8] offers a detailed analysis of this point.

organized market to allocate capital. Short of market failure, distortion in allocation should not have occurred so long as reliable information was available and financial intermediaries were rationally managed. However, capital allocation was not carried out in response to effective demand. Why did financial liberalization not lead to improvement in the allocation of capital? Essentially the answer lies in continued powerful government influence, formal and informal, on allocation even after reform was implemented. The share policy-directed lending in total loans increased under liberalization; formal government intervention in private sector lending remained large, especially in agriculture; and official economic plans and industrial policy continued to have a strong signaling effect on private lending decisions.

In theory, policy-directed lending by government special banks existed not to distort allocation but rather to address market failure. In reality, it often fell prey to political manipulation or poor management. As the relative weight of GSB policy loans in total lending increased, the tendency of these loans to fund inefficient sectors with low profitability dragged down the efficiency of financial sector investment as a whole.

Systematic government intervention into financial markets after liberalization also distorted allocation. A typical example was the "agri/agra requirement." Introduced in the 1970s, this requirement obligated banks to commit 25 per cent of their lendable resources to the agricultural sector. Agricultural finance occupied only a small share of the Philippine formal market, a reflection of high risk and high information costs. By contrast, informal credit was widely used in the rural economy. The argument can be made that in the agricultural sector where collateral is scarce and credit analysis problematic, informal credit is not a market distortion but actually an efficient market-oriented means of capital allocation.¹⁹ Imposing and continuing a mandatory lending requirement while risk factors remained unchanged was the real market distortion, adversely affecting the efficiency of capital allocation and ultimately leading to low repayment ratios.

Over and above the distorting effect of formal government intervention, the powerful informal influence of government economic plans and industrial policy on lending by private financial institutions also contributed to the failure of allocation to respond to effective demand after liberalization. Official plans exerted so much influence because of the important role of rediscounted financing from the central bank as capital for Philippine private banks. A review of movement in central bank rediscounting to commercial banks and savings banks in the 1980s reveals that rediscounting closely mirrored the direction of government economic plans.²⁰ Structural problems common to developing country financial markets help explain the large influence of official plans on the private sector. Here, we refer particularly to the lack of reliable information and to unsound management of financial institutions themselves. In the Philippines, information distortions and unsound

¹⁹ Van Wijnbergen [15] has done pioneering research on unofficial financial markets. Also, for analysis of formal and informal financing in controlled financial markets from the perspective of microeconomic and welfare economic, See Okuda [9].

²⁰ On this point, refer to Polvorosa [10].

management practices are frequently cited as barriers to efficient allocation, but the structural explanations for these problems can be found in widespread family ownership of firms and inadequate legal infrastructure, both common characteristics of developing countries. Developing country corporations are frequently family owned or managed by a single family, and in most cases no incentive exists for the owners to disclose accurate management information. Moreover, many Philippine banks originated as capital procurement divisions of local zaibatsu-like business groups and still behave like members of such groups. Thus, in both bond and bank markets information about the end user of capital tends to be incomplete and/or unreliable. Capital and manpower shortages also limit the thoroughness of central bank oversight. For all of these reasons, it is difficult for private financial institutions to allocate capital efficiently on the basis of their credit analysis; instead, they rely on the authority of government economic plans and industrial policy.

To summarize, financial reform in the Philippines was implemented without changing extensive government intervention into the capital allocation process; as a consequence, the improvement in the efficiency of capital allocation expected from liberalization did not materialize. Progress in financial deepening brought with it expansion in the supply of capital in the formal market, but under liberalization, the relative importance of government financial institutions increased, agriculture and other policy-directed financing was left untouched, and as such distortions in capital allocation were not corrected. Commercial banks and other private sector financial institutions also failed to realize market-based capital allocation, instead taking signals from government plans and policies which often proved later to be of questionable efficiency and reliability.

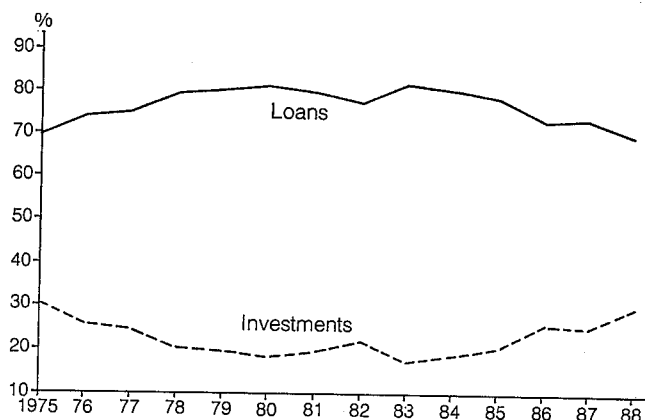
V. LONG-TERM CAPITAL SUPPLY

A. *Movement in the Ratio of Long-term Capital at Major Financial Institutions: Short-term Lending*

Financial reform in the 1970s focused efforts to lengthen capital maturities on improving the supply of long-term capital through indirect finance. The government introduced a policy of promoting bank long-term lending and investment and introduced an offshore banking system aimed at expanding procurement of overseas capital. Reform in the early eighties introduced universal banking, allowing banks to conduct securities business. The hope was that this would foster development of a securities market and thereby expand direct financing of long-term capital. However, the offshore banking system suffered the effects of both inadequate institutional infrastructure and the unfavorable economic situation of the late seventies, remaining small in scale as a result. Today it plays only a very small role in supplying long-term capital. The stock market also took a serious blow from economic instability and although it has been recovering in recent years, its role in capital procurement remains limited. In the end, these systems had little effect on long-term capital procurement or allocation.

As a result of this situation, procurement of investment capital in the Philippines

Fig. 8. Total Loans and Investments Outstanding



Sources: Same as Figure 1.

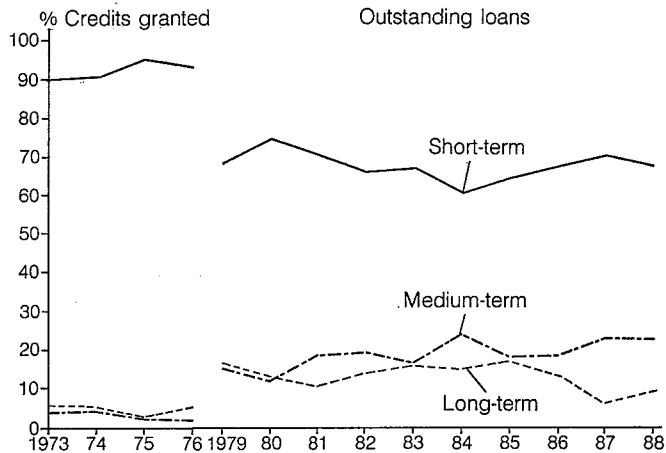
Note: Percentage of total loans and investments outstanding.

relies mainly on lending from financial institutions. If we look at the structure of loans and investments by Philippine financial institutions (Figure 8), loans accounted for 70–80 per cent of the total from 1975 to 1988. While purchases of Philippine treasury bills accounted for most of the investment, it seems reasonable to conclude that little of the capital procured by the public sector through bond issuance actually financed real investment. Thus, in studying Philippine long-term capital supply, the ratio of long-term lending to total lending by financial institutions is an appropriate indicator.

Figure 9 presents the maturity structure of lending by major financial institutions from 1975 to 1988. The graph shows that short-term lending (less than one year) accounted for more than half of all loans while long-term loans contributed only 30 per cent. If we look at all long-term lending by lending institution, we see that commercial banks, which hold more than half of the total assets of all financial institutions, account for the largest share. However, if we consider asset scale, the share of government special banks is also relatively high, revealing a special role for GSBs in long-term capital procurement. But, regardless of the type of institution, the relative importance of short-term lending is high; witness, for example, the 70 per cent ratio for commercial banks. Even for DBP, which should play a central role in long-term lending, short-term financing accounts for 50 per cent of total loans.

In the 1970s, the Philippines achieved relatively high economic growth, but as the second oil shock revealed, economic conditions were not entirely stable. Moreover, the offshore banking system and other measures introduced in the 1970s to promote long-term borrowing and lending yielded disappointing results. Thus, improvements in capital maturities that should have been seen in the seventies were not.

Fig. 9. Outstanding Loans by Maturity



Sources: Same as Figure 1.

Note: Percentage of total outstanding loans.

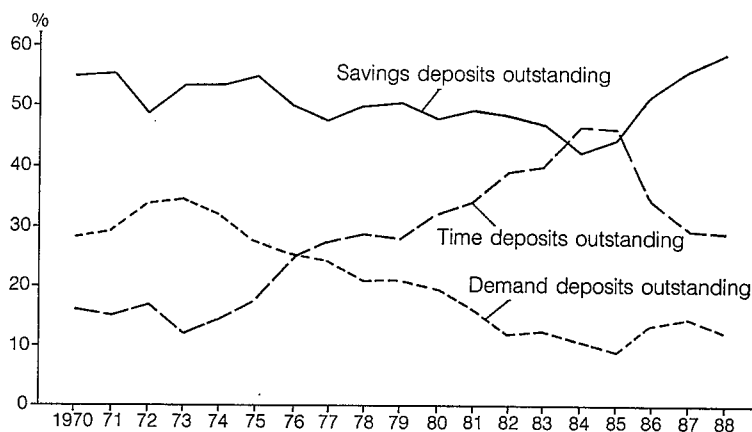
At the start of the eighties, great hopes were placed on universal banking to develop a bond market and expand long-term capital supply. Interest liberalization was carried out at the same time, but it is generally difficult to predict what influence interest liberalization will have on levels of long-term capital. Under a system of regulated interest rates, interests normally rise as the term of a deposit or loan lengthens to compensate for the opportunity costs of long-term capital. Even when you move to market-oriented interests, there is still no guarantee that greater long-term lending will take place than under a regulated interest system. Financial liberalization theory does not explain the relationship between liberalization and long-term capital supply well. The data show that medium and long-term lending increased as a proportion of total lending by financial institutions from 1980 to 1984 after liberalization. On the other hand, from 1984 to 1987 as the economy stagnated against the background of political turmoil, the share of mid- and long-term loans reversed, with the longest maturities suffering the sharpest decline. Since 1986, long-term lending has tended to recover and the ratio of mid- and long-term loans has also risen.

B. Explanation of Short-term Capital Maturities

1. Short maturity of borrowed capital

How much long-term capital financial institutions are able to supply is greatly influenced by the internal financial management of the institution itself and by macroeconomic factors such as the stability of prices or the exchange rate. Nevertheless, the higher the proportion of long-term capital financial institutions procure the more long-term capital they can lend. The principal reason the share of

Fig. 10. Demand, Savings, and Time Deposits Outstanding



Sources: Same as Figure 1.

Note: Percentage of total outstanding deposits.

short-term capital increased in the mid-eighties was difficulty in procuring long-term capital due to macroeconomic instability.

In general, financial institutions can procure capital from two sources: domestically from various forms of bank deposits and overseas by borrowing. As we saw in Section II, a significant share of Philippine investment capital in the 1970s and early 1980s was procured overseas. These funds consisted mainly of long-term loans and they played an important role in financing industrialization, for which long maturities are indispensable. However, Philippine financial institutions lost access to overseas capital (with the exception of official funds) after 1983, making it all but impossible for financial institutions to supplement the long-term fund supply with foreign borrowing.

Capital procurement from the domestic non-financial sector takes place through bank deposits and deposit substitutes. Figure 10 illustrates changes in the structure of outstanding deposits in Philippine financial institutions. The share of demand deposits, a type of short-term deposit, declined continuously from the 1970s on. By contrast, the share of time deposits, the representative mid to long-term deposit instrument, increased steadily through the mid-eighties. In 1985, the ratio plunged as the economy stagnated. Then again, the share of savings deposits, which can be thought of as non-short term deposits, declined through the mid-eighties but increased with the post-1985 instability.

Overall, from the 1970s to the early eighties, capital procured by Philippine financial institutions tended toward longer maturities. Deposit terms also lengthened along with gradual progress in implementing liberalization after 1981. This trend only continued until 1984–85 however, with deposits shortening after that. Shorter loan maturities paralleled shorter terms on capital procurement by financial institutions. This suggests that failure to extend the terms of bank deposits and

other financial assets strongly conditioned failure to lengthen the maturities of loan capital.

2. *Increased risk in lending*

In an indirect finance market, long-term lending complicates risk management. The second reason for the inability to increase the supply of long-term capital in the Philippines is that financial institutions were unable to manage a variety of risks—credit risk, interest risk, and liquidity risk—effectively in the face of macroeconomic instability.

Financial institutions hesitated to make long-term fixed interest rate loans when inflation was accelerating (1983–84) and the future economic outlook uncertain. Also, there was little incentive to lend long when the gap between long- and short-term interests was so narrow; instead, financial institutions preferred to avoid long-term risk and earn multiple commissions at the same time by making short-term loans and rolling them over. Inflation steadily lowered real interest rates, increasing the difficulty in procuring long-term capital through time deposits and heightening liquidity risk in long-term lending.

C. *Financial Liberalization and Shortening of Maturities in the 1980s*

In order to improve the supply of long-term bank capital, it is essential to establish a deposit interest rate system that creates incentive for long-term deposits and long-term loans. Since putting in place an interest structure to promote longer term maturities was not the only aim of liberalization, it is not necessarily the case that longer maturities would have been realized through liberalization even if macroeconomic turmoil had not occurred. However, the fact that the maturity of capital in the Philippines shortened in the mid-eighties after liberalization tells us that it is extremely difficult to build an interest rate structure that gives effective incentive for long-term lending when the macroeconomy is in chaos. Thus, it is necessary to give priority to stabilizing the macroeconomy before attempting to extend fund maturities through financial liberalization policy.

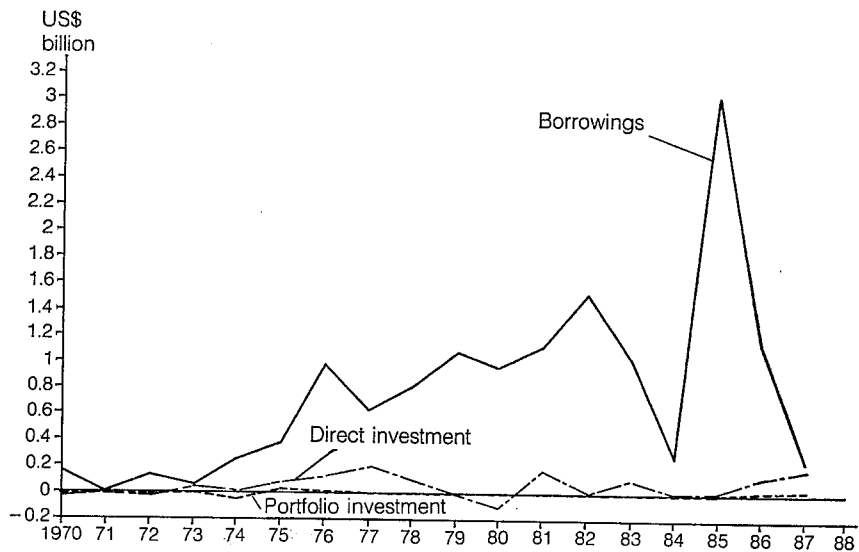
VI. INTRODUCING FOREIGN CAPITAL

A. *The Role of Foreign Capital in Economic Growth*

1. *Procurement of investment capital*

The foremost contribution of overseas capital to Philippine economic growth was to cover the shortfall in investment funds arising from inadequate domestic savings. As stated in Section II, almost all Philippine investment capital in the early seventies was procured domestically, but later the expanded scale of investment required a supplement to domestic savings, and foreign borrowing soared. Between 1976 and 1981, overseas loans financed fully one fifth of all domestic investment. As Figure 11 shows, over this period the majority of Philippine investment capital was procured through borrowing with the share contributed by direct investment or securities investment quite small.

Fig. 11. Inflow of Foreign Capital



Sources: Same as Figure 1.

Viewed over the long term, however, we cannot say that active use of external savings made more investment possible than would have otherwise been the case. In the early seventies, the size of debt service was quite small, and new foreign borrowing spurred an expansion of investment of virtually the same scale. In the 1980s, by contrast, the bulk of foreign borrowing was consumed in repayment of interest and principle on past debt. The investment expansion effect of new foreign borrowing in this period was extremely small; for all intents and purposes, the debt-cum-growth mechanism whereby overseas borrowing stimulates expanded investment which then raises growth did not function.²¹

2. Foreign capital as long-term capital

The second contribution of foreign capital to Philippine economic growth was to increase the supply of long-term capital indispensable to investment for industrialization. At its peak, foreign capital accounted for 20 per cent of total domestic investment. As argued in Section IV, the share of long-term capital in capital

²¹ After the 1983 moratorium on debt repayment, the inflow of foreign private capital came to a virtual standstill and Philippine overseas borrowing was limited almost exclusively to official funds. With economic recovery, direct foreign investment has increased, assisted by debt-equity-conversions. Some progress has also been made in returning overseas flight capital. However, a significant portion of these resources are directed at stock and/or real estate investment: overseas investors strongly demand economic stability before making production-oriented investments.

procured in domestic financial markets was very small; therefore, the external sector played a special role, along with the government sector, as a supplier of long-term capital. If we take into consideration that the government sector itself procured substantial capital overseas through bond issues, the role of external resources in lengthening capital maturities takes on even greater significance.

3. *The efficiency of overseas capital procurement*

The third function of foreign capital in Philippine economic growth was to improve the efficiency of investment capital. Overseas procurement provided access to low-interest funds in world markets as well as to a pool of resources detached from the domestic financial market in which the influence of large Philippine business groups is strong.

Active overseas borrowing took place from the mid-1970s to the early 1980s, but a review of investment results for this period leads to the conclusion that overseas funds were not invested efficiently. The reason for this is that excessive government sector participation in foreign capital procurement and allocation invited inefficiencies. As is true of other developing countries, the Philippine private sector had difficulty raising capital abroad directly. Ordinarily, foreign borrowing took place through the intervention of government financial institutions or with an official loan guarantee; therefore, the allocation of foreign capital had a strong de facto official character to it. Particularly under the ambitious Five-Year Development Plan in the late seventies and early eighties, huge amounts of foreign capital were poured into large-scale development projects. Morisawa's detailed analysis [8] shows that most of these projects produced very low earnings. Many of the industries targeted by the projects were industries in which the Philippines lacked comparative advantage. Combined with the global recession in the early eighties, this meant that Philippine exports performed poorly. The fact that these large-scale projects focused heavily on infrastructure also contributed to the low return on investment.

B. *Financial Reform and the Use of Foreign Capital*

In 1970s, the government introduced an offshore banking system, tried to attract direct foreign investment by setting up export-processing zones, abolished limitations on foreign borrowing, and simplified procedures for foreign borrowing in order to facilitate increased procurement of overseas and long-term capital and expansion of domestic investment. This set the background for financial liberalization in the early 1980s.

Financial reform exerted a restraining effect on capital flight, a positive result in terms of access to foreign funds. As shown in Section III, demand for financial assets in the Philippines is highly susceptible to changes in the interest rate. Data on movement in asset demand in Table I show that the balance of outstanding financial assets in the Philippines reacts sensitively to fluctuation in foreign interest rates, suggesting that there is a strong substitutability between domestic and overseas financial assets. The gap between Philippine and foreign interest rates gives rise to a shift in demand from domestic to foreign financial assets, making

capital flight more likely.²² The gradual removal of interest controls after 1981 led to a rise in Philippine real interest rates (Figure 2), allowing the argument that it restrained the flow of domestic capital overseas.

Nevertheless, foreign borrowing did not produce impressive results overall, in large part because it was allocated in accord with government policy rather than the market. Given that government guarantees are indispensable for overseas borrowing by developing countries, the government sector must strictly ensure the rational use of foreign funds, regardless of whether the domestic financial market is liberalized or not. In the Philippines, this condition was not met, a leading reason for the failure to realize higher gains from heavy foreign borrowing.

VII. CONCLUSION: ASSESSMENT OF PHILIPPINE FINANCIAL LIBERALIZATION POLICY

A. *Gains from Liberalization*

Continuing earlier efforts to strengthen financial market infrastructure, the Philippine government implemented a liberalization policy in the 1980s based on a World Bank/IMF-led fact-finding report. The policy consisted of two pillars, one, gradual removal of interest controls, the other, rationalization of operational restrictions mainly through the introduction of universal banking. The reform aimed to improve mobilization of savings, expand procurement of domestic long-term capital, lower intermediation costs, and realize efficient allocation of capital. It sought to achieve these objectives by introducing market determined interest rates, strengthening financial market competition and promoting development of a securities market. Although the Philippines was implementing an ambitious development plan at the time, authorities believed capital necessary for liberalization could be procured.

These reform efforts did yield some successful results. The rise in real deposit interest rates led to expansion of demand for financial assets and increased intermediation through the organized financial market. At the same time, progress was made toward financial deepening, as shown by the rise in the ratio of outstanding financial assets to GNP. In addition, the structure of maturities on bank deposits and loans lengthened from 1980 to 1984, aided by stable prices.

However, the positive results of reform were limited overall. First, the Philippine savings rate dropped and the mobilization of domestic savings worsened from the flow perspective. Second, although the volume of capital moving through the organized market expanded, the efficiency of allocation deteriorated. Further, many of the gains of reform in the early eighties were reversed in the economic turmoil a few years later. Economic recovery began in 1986 and financial liberalization resumed a year later. The current liberalization effort seeks to augment previous reform efforts by rebuilding legal and institutional infrastructure, strengthening the management of government financial institutions, and reassessing policy-directed financing.

²² Refer to Morgan Guaranty Trust Company [7].

B. *Failure of Liberalization: Causes and Lessons*

1. *Macroeconomic turmoil*

The number one reason for the limited results of financial liberalization was macroeconomic turmoil. Yet paradoxically, there exists a troubling possibility that the partial success of the liberalization policy may have heightened the instability of the economic situation.

At the start of liberalization in 1980, the Philippine economy already faced a recession, what with the global recession and the domestic fiscal and balance of payments deficits. The government hoped to avoid a recession through an expansionist fiscal policy based on its Five-Year Development Plan. While an expansionist fiscal policy would worsen the government deficit and payments balance and increase foreign debt, authorities believed that the realization of domestic asset mobilization and efficient investment through liberalization would contribute to resolving this problem. In reality, liberalization led to an expansion in the supply of domestic assets in the official market, but several unintended consequences worsened the macroeconomic situation in a way that may not have occurred without liberalization. Most crucially, as the supply of assets in the official market increased with liberalization, the resulting expanded domestic borrowing capacity allowed the continuation of unsound fiscal policy. With serious action to remedy the fiscal and trade deficits thus postponed, the objectives of economic policy became vague. The 1983 debt crisis and later economic chaos were then a natural outcome.

This experience teaches us the importance of limiting the basic objective of financial liberalization policy to realizing efficient allocation of assets. This is even clearer when we consider the limited influence of liberalization per se on economic variables. A shift in the stock of resources from real assets and the unofficial market into the official market did occur with liberalization, but a rise in the savings rate did not. A increase in the rate of savings depends mainly on predictable movement in real interest rates and on an increase the economic growth rate, and macroeconomic stability is of primary importance in realizing these.

2. *Inadequate functioning of the market mechanism*

The second reason the results of liberalization were not more positive is that infrastructure that should have been in place prior to liberalization was not. It is meaningless to rationalize controls unless you gain efficient financial markets by doing so. On the other hand, in order to have an efficient financial market structure, it is necessary to have the regulatory and institutional capacity to stop unfair transactions. Reform must be backed by legal and systemic infrastructure on the one hand and the personnel and capital to support these on the other.

These conditions were not adequately met when liberalization began in the Philippines in 1980. As a consequence, implementation of reform resulted in lower confidence in the financial market, increasingly fragile management of one group of financial institutions, and expanded economic instability. The 1981 Dewey Dee incident, arising from weak standards for commercial paper issuance,

exposed the inadequate legal infrastructure of the short-term market. Also, the large number of bank failures, including commercial banks, during the 1983–85 economic turmoil suggested unhealthy Philippine bank management and deficient oversight by banking authorities. The confused management of government financial institutions as well indicated the lack of self-regulation by financial institutions themselves, another result of insufficient official supervision.

3. *Shortcomings of the liberalization policy*

The third reason the results of liberalization were so limited is that the reform policy itself was incomplete. While a principal objective of financial liberalization was to improve the efficiency of intermediation by promoting competition, in fact inter-institutional competition remained limited. Even after liberalization, mergers and consolidations rarely took place; the number of commercial banks, for instance, decreased merely from thirty in 1980 to twenty-nine in 1988. The smaller commercial banks, at 5 per cent the size of their top-ranked counterparts, were so small as to not be able to achieve economies of scale. Despite this handicap, small banks did not consolidate.

Regardless of the stated objectives of reform, government banking administration ultimately aimed to protect the interests of banks even under liberalization. Banks themselves also adopted defensive management postures by forming cartels instead of pushing to achieve economies of scale through competition. The lesson here is the necessity of strong government leadership in introducing competition into the market.

The growth of policy-directed financing under reform provided further evidence of shortcomings in the liberalization policy. Given that the purpose of liberalization was to realize efficient allocation of capital through the market mechanism, policy-directed lending should have been limited to supplementing the market mechanism and overcoming market failures. In the Philippines, however, the scale of policy financing expanded under reform and compulsory commercial bank lending to the agricultural sector continued. This sort of unconditional supplementary financing to poorly managed public enterprises or to agricultural banks with extremely high bad debt ratios only wasted investment capital.

This experience highlights the need to define clearly the role and limitations of policy financing before liberalization is carried out. Reform seeking to improve the efficiency of the financial system must avoid the error of eliminating policy financing altogether. In developing countries where the market mechanism is not sufficiently at work, government has a limited but vital role to play in credit allocation. The error in the Philippines was to define that role so broadly as to impede rather than supplement the market. A lesson of the Philippines experience is the necessity of scrutinizing and clarifying the role of policy financing prior to the implementation of financial reform.

4. *Importance of the rational industrial policy*

A fundamental factor behind the problem of inefficient policy financing in the Philippines in the 1970s and 1980s was the lack of an appropriate, economically

rational industrial policy. The core of Philippine industrial policy in the 1970s was substantially import substitution; from the late seventies to the early eighties, the focus shifted to the promotion of heavy and chemical industries. These were both ill-advised policy choices. Import substitution repressed the development of internationally competitive export industries and ran up against its own internal limitations when the domestic market reached saturation. The large-scale infrastructure investment requirement of heavy and chemical industries makes this an extremely difficult sector for a capital starved developing country such as the Philippines to attain international competitiveness in. Moreover, heavy and chemical industries experienced global excess capacity with the onset world recession of the early 1980s, with the result that the Philippines found little market for its exports in this sector.

Flawed industrial policy invited a worsened macroeconomic situation and lower economic growth. Under both import substitution and heavy and chemical industrialization, imports of intermediate and capital goods expanded while exports lost steam; as a consequence, the balance of payments suffered and growth declined. Moreover, implementation of an active industrial policy raised government expenditure, at the same time that lower growth cut revenues, increasing the overall government budget deficit. Also, earnings on financial-sector investment capital naturally declined with the weakening economic base. Policy loans financed implementation of industrial policy, with the result that all-important long-term capital financing by government special banks was concentrated in relatively inefficient investment compared to private financial institutions.

Thus, quite apart from financial reform, the performance of the Philippine economy was fundamentally undercut by distortions in industrial policy. Without satisfactory development in the real sector, overall economic performance cannot be expected to improve even with an efficient financial sector. The most basic lesson of the Philippine experience is that financial liberalization is meaningless without an appropriate industrial policy.

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