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Financial resources were key to the martial law regime and to Philippine cronyism. The financial vulnerability of the cronies also brought about their downfall, as domestic financial crisis led to corporate failure and then to government rescue at great cost. Financial markets and issues are the next subject to which we turn.

5 The Philippine Financial System and the Debt Crisis

Financial markets played a central role in the events leading up to the Philippine debt crisis of 1983 and the difficulties of the adjustment period that followed. A crisis in the domestic commercial paper market touched off the first round of corporate and financial institution failures, which led to fiscal rescue operations by the Philippine government. By 1984 losses within the government-owned financial institutions became a tremendous drain on fiscal resources, complicating both the achievement of external balance and the fostering of recovery in the country. This chapter examines the financial system in more detail, considering both its contribution to increasing foreign indebtedness in the Philippines and its contributions to Philippine macroeconomic difficulties in the 1980s.

5.1 Financial Institutions and Markets

The following provides a brief tour of the financial system in the Philippines. The aim here is not to be exhaustive, but to provide an introduction to the important players in the debt story.[1]

5.1.1 Capital Market

As is the case in other LDCs, the capital or securities market is not well developed in the Philippines and has provided an almost insignificant share of total funds raised for private investment. There were 184 companies listed on the Manila and Makati stock exchanges in 1983, and the total capitalized value of listed shares amounted to $800 million, or roughly 2 percent of Philippine GDP.[2] Corporate bond issues, while not unknown, have been insignificant. The size of the primary corporate security market can also be judged from the low number of public offerings, averaging roughly thirty per year (World Bank and IMF 1980, 23).

There has been a much larger volume of public securities issued, but there have been only limited private holdings and almost no secondary trading.

The Philippine government has instead opted to hold down its financing costs by selling government securities to captive purchasers—commercial banks, who can use government securities for various lending and liquidity requirements, social security institutions, and the central bank—at rates well below market rates.

There are a number of explanations for the limited development of the Philippine capital market. Perhaps most important is the fact that interest rate controls resulted in the subsidization of bank credit to prime commercial borrowers, the firms most likely to issue primary securities. Lack of government support for secondary trading in public securities also hindered the growth of the capital market. Potential investors have been discouraged by the speculative nature of most stocks in the Philippine exchanges and by the tendency of the market toward manipulation. The supply of primary securities has been limited by the tax advantages of loan financing, the reluctance of many family-owned firms to relinquish any control, and by the disclosure requirements (of interest both to investors and tax authorities) for listing on the exchanges.

The results of the stunted development of securities markets in the Philippines has been a predominance of loan financing of business activities and, as a consequence, very high debt/equity ratios. This, and the fact (taken up below) that most firms are dependent on the continued rollover of short-term loans, made the corporate sector particularly vulnerable to the unusual occurrence of recession with high interest rates in the early 1980s.

5.1.2 Financial Institutions in the Loans Market

Commercial banks are the predominant financial institutions in the Philippines, holding roughly three-fifths of total financial system assets, as is shown in table 5.1. In 1985 there were thirty commercial banks operating in the country. The government-owned Philippine National Bank (PNB) was by far the largest, with approximately 30 percent of commercial bank assets.[3] Four of the remaining banks were foreign owned, accounting for about 15 percent of bank assets.

The importance of commercial banks, while high, is not out of line with other countries in the region nor with other countries at a similar level of development. What is unusual about the Philippines is the large number of commercial banks and the relatively small size of many of them. Most of the commercial banks in operation today were established between 1950 and 1965. During this period the central bank encouraged the entry of new banking firms, and capital requirements for forming a bank were minimal. Many of the newly formed industrial groups found it in their interest to add a bank to their holdings, and a total of twenty-seven banks were incorporated during this period. The result has been a number of small and, in many cases, family-managed banks.

Table 5.1 **Philippine Financial System, 1983**

	Total Assets (billions of pesos)	Shares (percent)	Number of Institutions
Central bank	130.4	—	1
Financial system	354.6	84.8	
Banking institutions	326.0	78.0	1,122
Commercial banks	235.0	56.2	34
PNB	70.5	16.9	
Thrift banks	16.1	3.9	136
Rural banks	9.5	2.3	949
Other government banks	65.3	15.6	3
DBP	56.5	13.5	
Land Bank	8.5	2.0	
Philippine Amanah Bank	0.3	0.1	
Nonbank financial institutions	28.6	6.8	1,474
Investment houses	7.2	1.7	14
Finance companies	11.8	2.8	336
Investment companies	6.2	1.5	65
Securities dealers	0.7	0.2	124
Pawnshops	0.5	0.1	701
Fund managers	1.5	0.4	12
Nonstock SLAs	0.7	0.2	74
Other financial institutions	63.5	15.2	179
Private insurance companies	13.7	3.3	136
Special nonbanks	49.7	11.9	7
GSIS	14.7	3.5	
SSS	16.3	3.9	
Offshore banking units	4.4	—	21
Total[a]	418.0	100.0	

Source: Nomura Research Institute, "A Capital Market Study of the Philippines" (Manila: Asian Development Bank, 1984), cited in Lamberte (1985, 4).

[a]Excluding the central bank and offshore banking units.

After 1965 central bank policy changed, raising minimum capital requirements and effectively denying new bank applications. Financial reforms in the early 1970s raised capital requirements again and encouraged banks to obtain foreign equity partners to both raise capital and strengthen bank management. Several Philippine banks entered joint venture arrangements, although many of the foreign partners sold their stakes by the end of the decade.

The most important characteristic of commercial bank portfolios is the high proportion of short-term lending. Although medium- and long-term lending increased significantly during the 1970s, loans of one year or less maturity still accounted for almost 80 percent of commercial bank loans in 1980.[4]

In addition to commercial banks, there are several categories of banks with more restrictive deposit or loan portfolios. Within thrift banks, *savings and loan associations* and *mortgage banks* mobilize smaller deposits for

mortgage lending and consumer finance. Together they make up about 3 percent of financial system assets. *Rural banks* were created in 1952 to channel credit to the agricultural sector. Although there are almost one thousand rural banks, they hold only 2 percent of the assets of the financial system. They have been dependent on central bank support for funding and have recently had severe problems in arrearages.

Development banks provide longer term credit for industry. The state-owned Development Bank of the Philippines (DBP) was by far the largest of these banks, holding 14 percent of financial system assets and extending almost half of long-term credit.[5] Funding for DBP came primarily from borrowings, either from multilateral organizations (the Asian Development Bank and the World Bank), government entities (the central bank, national government, and the social security institutions), or from foreign commercial bank loans. Deposits have represented only about one-fifth of DBP's liabilities, and roughly half of these have come from deposits of the national government.

In addition to extending industrial loans, DBP has also guaranteed foreign loans to the private sector. At the end of 1983, DBP guarantees equalled P. 15 billion, or over 25 percent of total assets (Lamberte 1984, 20).[6] DBP also acquired equity interests in domestic firms; these investments rose rapidly during the early 1980s as the institution was used as a rescue agent for distressed industrial firms and banks. The financial crisis and the resulting slowdown in the Philippine economy have forced DBP to honor many of its guarantees, in exchange for which it took over equity interest in the distressed firms. By 1985 as much as 70 percent of its portfolio was nonperforming, presenting a major drain on fiscal resources.

Private development banks serve the same role of extending long-term credit to industry, but are much smaller than DBP, holding about 1 percent of the assets of the financial system. They have been dependent on funding from the DBP and borrowings from the World Bank and other multilateral development banks.

Two *social security* institutions, the Government Service Insurance System (GSIS) and the Social Security System (SSS) covering private workers, play an important role in funds mobilization and potentially in the provision of long-term credit. The proceeds of these institutions have largely been invested in public securities and in DBP and PNB notes. GSIS, however, has made substantial equity investments, generally in industries facing financial difficulties. Thus, GSIS owns several of the hotels that were constructed during the 1970s, as well as Philippine Airlines.

Two additional financial institutions are important for our story, largely because of their operations in the money market. *Investment houses* were originally established to provide long-term funds and underwriting services to industry. Instead their operations have centered in the money market, raising funds by borrowing in that market and extending short-term loans to

domestic firms. *Finance companies* extend credit to consumers and to businesses through discounting commercial paper, factoring, and leasing. The larger finance companies have acquired quasi-bank licenses and have been active participants in the money market.

5.1.3 The Money Market

In contrast to the relatively inactive capital market, the Philippines has developed a sophisticated and extensive market in short-term instruments. The money market provided investors with profitable opportunities for short-term funds, and the market became a major source of finance for Philippine corporations outside the first tier of borrowers.

The money market developed in the mid-1960s when a few investment houses began buying and selling short-dated obligations of banks and prime corporations. The investment houses were later joined by banks and finance companies, and this market grew rapidly in the late 1960s and early 1970s. Interbank call loans—loans made between banks to adjust reserve positions—account for the largest activity in the money market. However, markets also developed to supply investment opportunities for firms and individuals with surplus short-term funds. Termed "deposit substitutes," these consisted of promissory notes of commercial banks and other financial institutions, repurchase agreements, and certificates of assignment and participation involving other assets. Interest rates in this market were substantially above bank deposit rates; effective rates ran as high as 30 percent per year, compared to 8–11 percent for time deposits (World Bank and IMF 1980, 26). Deposit substitutes grew rapidly in volume, and by 1975 they had exceeded the total value of time and savings deposits and were equivalent to 50 percent of M2 (currency plus bank deposits).

In addition, commercial paper was traded in the money market, either directly or resold by investment houses as deposit substitutes (repurchase agreements or certificates of assignment and participation). Directly marketed commercial paper made up about 5 percent of total money market instruments, but by 1980 remarketed commercial paper formed the basis for an additional 15 percent of all deposit substitutes (Licuanan 1986, 102, 123).

While the money market provided attractive investment opportunities for individuals and firms with surplus funds, the commercial paper segment of the market and the lending activities of investment houses and finance companies offered an opportunity for smaller and less well known firms or for rapidly growing firms to obtain access to credit. The credit obtained was more expensive than bank credit, but it was available to many firms which had been closed out of bank lending or could not obtain sufficient bank funds for their activities. But, like bank loans, funds sourced from the commercial paper market and its quasi-banking institutions, were short-term funds. Only about 5 percent of money-market transactions had maturities over forty-five

days (Licuanan 1986, 9–10). Firms tapping this market did so regularly and depended on rollovers to fund continuing operations.

Commercial banks, investment houses, and finance companies with quasi-banking licenses have used the money market as a source of funds for their operations. Although commercial banks are the largest participants, money-market borrowings make up a relatively small share of their total sources of funds. In contrast, investment houses and finance companies have been heavily dependent on the market as a source of funds. Money-market borrowings accounted for about 80 percent of the funding of investment houses and from 65 to 80 percent of that of finance companies with quasi-bank licenses (Licuanan 1986, 43, 66).

The initial growth of the money market took place when the market was essentially unregulated. During the 1970s the central bank, through various measures, extended its regulation to transactions in the money market and sought to curb the growth of the market. Amendments to the Central Bank Act placed nonbank financial intermediaries under central bank regulation. Central bank circulars defined a new class of activity called quasi banking, which covered borrowing from twenty or more lenders, by issuing deposit substitutes. An interest rate ceiling of 17 percent was established on deposit substitutes in 1976, reserve requirements were established, and a transactions tax of 35 percent on deposit substitute interest payments was imposed.

The effect of these regulations was to slow, but not halt, the growth of deposit instruments in the money market, and the ratio of deposit substitutes to GNP fell from a peak of 8.5 percent of GNP in 1975 to about 4.5 percent by 1980.[7] Actions were taken by some intermediaries to sidestep and, in some cases, evade, the regulations that were in place. Institutions accepting deposits from fewer than twenty investors were not covered by quasi-banking regulation. The central bank definition of deposit substitutes covered certificates of assignment and participation issued with recourse to the intermediary. After the mid-1970s, the securities covered by these certificates were issued directly to the public without recourse, although they were accompanied by the postdated checks of the financial institutions, ostensibly in their capacity as paying agent for the issuer of the security. The volume of outstanding commercial paper also increased after regulation of deposit substitutes. Commercial paper issuances were regulated by the Securities and Exchange Commission, which proved to be lax in its oversight. Thus, the effect of the regulation was not only to slow the growth of the money market, but also to push the money market toward riskier transactions.

5.1.4 Foreign Exchange Markets

The central bank of the Philippines has exercised strict, if not always successful, control over resident foreign exchange transactions. Exporters and other recipients of current foreign exchange income are required to surrender their proceeds in exchange for pesos. Despite these restrictions, a

black market in foreign exchange has coexisted with the official market, fed by tourists, overseas workers, and exporters, and has served as a source of foreign exchange for restricted imports and for capital flight.

In 1976 the central bank moved to encourage offshore banking in foreign currencies within the Philippines. The motives were several. The first was the apparent success that Singapore had in increasing domestic financial activity with its offshore banking sector. The second was the desire to send more foreign exchange through official channels within the Philippines. A final aim was to mobilize foreign exchange resources for the Philippine economy.

To develop the market, the central bank exempted offshore banking units (OBUs) from reserve requirements, local taxes, and fees, and permitted them to extend foreign currency loans to any enterprise from deposits raised outside the country. Low rates of taxation were applied to the income of OBUs. In addition, domestic commercial banks were allowed to establish foreign currency deposit units (FCDUs) with similar privileges and the ability to accept foreign currency deposits from domestic residents.

The assets of OBUs and FCDUs grew rapidly in the last years of the 1970s, and by 1980 their total nonbank placements amounted to over $4 billion (P. 32 billion), or roughly one-third of gross domestic credit of the deposit banking system. Onshore lending requires the approval of the central bank, but almost all the placements of these offshore units were made to borrowers within the Philippines.[8]

5.2 Policy and Financial Markets

5.2.1 Interest Rate Controls

Interest rate controls have been a persistent feature of Philippine monetary policy up to at least 1983. Controls have been in place for loan, deposit, and rediscount rates almost from the beginning of the postwar period. The motivation in setting interest rates has been the encouragement of investment and the channeling of funds to priority sectors. Little attention was paid to mobilization of domestic savings in financial form and, as a result, substantial excess demands for credit have been a recurring feature of the Philippines.

Ceiling rates on loans were established by the Usury Law of 1916, which set a maximum rate for secured loans of 12 percent and 14 percent for unsecured loans. No adjustments were made for the term of the loan, and these ceilings held until the middle 1970s. Deposit rates were initially set in 1956 at 2 percent, with 2.5 percent offered for one-year deposits. These rates were adjusted upward slowly; by 1970, one-year deposits yielded 7 percent.

Monetary policy during the 1950s was largely directed toward defending the exchange rate. The inflation rate was negligible during the first half of

the decade and averaged only 2.4 percent per year from 1956 to 1962, the year of decontrol. As a result, despite the low rates on deposits, a substantial degree of financial deepening took place during this period. The ratio of M2 to GNP rose from 19 to 26 percent from 1956 to 1963. The presence of excess reserves and the low level of borrowing from the central bank suggests that interest rate ceilings on loans were not binding, at least until the mid-1960s.

The loan rate ceilings became limiting after 1965, as the economy picked up during the first Marcos administration, the manufacturing sector recovered from the decontrol episode, and the government borrowed more heavily. By 1970 the inflation rate had also increased substantially to over 10 percent per year. After 1974 the central bank adjusted interest rate ceilings more rapidly and began to provide higher ceiling rates to encourage long-term loans. Real loan rates increased, as table 5.2 indicates, but real deposit rates were negative throughout the period. The persistence of disequilibrium in the credit market may be judged from the sketchy evidence

Table 5.2 Philippine Real Interest Rates

	Savings Deposits	Time Deposits	Average Money Market	Secured Short-term Loans	CPI Inflation[a]
Low interest rate period					
1956–69	0.31	−0.61		8.28	3.72
1970	−8.85	−7.85		−2.85	14.85
1971	−15.90	−14.90		−9.90	21.90
1972	−2.22	−1.22		3.78	8.22
1973	−10.50	−9.58		−4.50	16.50
Transition period					
1974	−28.16	−24.66	−16.59	−22.16	34.16
1975	−0.78	2.72	8.23	5.22	6.78
1976	−2.23	0.77	3.71	2.77	9.23
1977	−2.93	0.07	2.66	2.07	9.93
1978	−0.20	2.72	3.44	4.72	7.20
1979	−7.51	−4.51	−3.62	−2.51	16.51
1980	−8.60	−3.60	−4.33	−3.60	17.60
Average	−7.20	−3.78	−0.93	−1.93	14.49
Floating rate period					
1981	−0.79	5.02	5.02	5.42	10.58
1982	1.28	5.72	5.72	8.64	8.49
1983	−16.41	−11.76	−9.50	−4.82	26.07
1984	−38.79	−17.87	−23.19	−11.25	50.83
1985	5.14	16.28	15.11	22.56	5.66
1986	8.32	12.00	12.70	17.23	−0.30
1987	−2.92	2.38	3.51	5.67	7.45
Average	−6.32	1.68	1.34	6.21	15.54

Source: Lamberte (1985), table III.4. Data for 1985–86 from Central bank, *Philippine Financial Statistics*.
[a]For floating rate period, CPI inflation reported for December to December of each year.

on effective interest rates, which were well above legal ceilings, and by the rapid growth of the money market, where interest rates were also high.[9]

Interest rate regulation had several effects in the Philippines. The ceilings on loan rates and the excess demand for credit that developed effectively limited commercial bank credit to prime corporate borrowers or to firms affiliated with a bank. Other firms, or firms that could not obtain sufficient bank credit, were forced to go to alternative markets where funds were available at much higher interest rates. The structure of rate ceilings also discouraged long-term lending. Short-term lending was safer than lending long, and the addition of booking fees raised the effective return on short-term loans over that of long-term loans. In addition, only short-term loans could be rediscounted with the central bank. The relative incentives for short- and long-term lending were clearly reflected in bank portfolios. In the early 1970s almost 96 percent of commercial bank loans had maturities of one year or less (Lamberte 1985, 30).[10] Higher ceilings for long-term loans encouraged the growth of term lending during the remainder of the decade, but the availability of long-term finance remained a problem for industry.

Interest rate restrictions kept deposit rates well below loan rates, which provided banks with substantial margins on loan operations. The available spreads encouraged the entry of new banking operations during the two decades before 1965. After 1965, when the central bank limited entry, the spreads inherent in the interest rate restrictions generated substantial rents to the owners of banks in the Philippines. The favorable spreads were reinforced by central bank discounting policy that kept rediscount rates quite low. This encouraged banks to rely on the central bank as a source of funding. For the central bank this meant that discount policy was less a matter of monetary control than a means of allocating credit to priority sectors.

5.2.2 Credit Allocation

Credit allocation and financial specialization is the second characteristic of Philippine financial policy. In 1959 the central bank began more active intervention to channel credit to priority sectors. This credit allocation policy was approached in three ways: (1) through priority rediscounting windows with the central bank; (2) through explicit requirements for the allocation of bank funds; and (3) through the establishment of specialized financial institutions with narrowly defined lending missions.

Agricultural loans were the first beneficiaries of preferential rediscounting, followed in the 1960s by export loans and selected industrial loans. Agrarian reform loans and loans to small-scale industries were added in the 1970s, and a host of preferential rediscount windows were opened in the early 1980s. Rediscounts were limited to short-term securities until the 1980s and generally carried restrictions on the maximum rate that could be charged to the borrower.

A presidential decree in 1975 directed banks to allocate 25 percent of their net loanable funds to agricultural lending, divided between agricultural production loans and loans financing the transfer of land under the agrarian reform program. As an alternative to agrarian reform lending, banks could instead purchase government securities carrying a coupon rate of 9 percent, and most banks chose securities purchase in order to meet this requirement.

Perceived credit needs of priority sectors were also addressed by creating specialized financial institutions. Rural banks, created in the early 1950s to support the agricultural sector, were followed by development banks for industry, the National Cottage Industry Bank for small-scale industry, the Philippine Amanah Bank for Moslem areas, and the Land Bank for agrarian reform. In nearly all cases these institutions were heavily dependent upon central bank deposits and credit for their funding, and in many cases had very precisely defined restrictions on whom they could lend to and for what purpose.

To support these allocative mechanisms the central bank raised reserve requirements on deposits, particularly time and savings deposits, so that by the 1970s the Philippines had the highest reserve requirement in the region. This, and the fact that rediscount rates were set well below prevailing loan rates, encouraged the dependence of Philippine financial institutions on central bank credit and the channeling of an increasing portion of total finance through the central bank or other government agencies.

Patterns of ownership and control also influence the allocation of credit. Almost all banks are owned by, or closely associated with, a family-owned industrial group in the Philippines. This reflects the historical concentration of wealth in the Philippines and the fact that most banks now in operation were formed during the period from 1946 to 1965, when the central bank actively encouraged the entry of new banking firms. The result was a financial structure in many ways similar to that of the interwar Japanese *zaibatsu*, where each of the major industrial groups owned or controlled its own bank and most banks were connected with an industrial group.[11] Ownership of a bank provided a way of mobilizing deposits and, therefore, credit in support of other group operations. As a former central bank governor put it, "the average Filipino banker is in the business not for banking profits; he uses his bank for allied businesses."[12] In a situation in which deposit and loan rates were below market clearing levels and well below rates in parallel markets, this resulted in the capture of substantial rents, and supported and perpetuated the concentration of wealth and economic power in the Philippines.

During the martial law regime government control and government influence increased substantially in the banking sector. PNB, the country's largest commercial bank, is a government-owned bank. In addition, as a result of the financial crises of the 1980s, the Marcos government acquired four commercial banks from the private sector, accounting for about 4 percent of total bank assets.[13]

Two banks, the Republican Planters Bank and the United Coconut Planters Bank (UCPB), are best described as quasi-official banks because of their involvement in the sugar and coconut industries, both heavily regulated by the government. Each was controlled by a close associate of Marcos, Roberto Benedicto in the case of Republic Planters and Eduardo Cojuangco for UCPB. Funding for both of these banks has come from export taxes on sugar and coconuts and, for coconuts, a levy on domestic production and milling.

At least five other commercial banks, including Traders Royal Bank and Allied Banking Corporation, have been termed "political banks" with close ties to the Marcos government. Although the precise extent to which they were favored by the Marcos regime is difficult to determine, several are highly dependent on central bank funds, and there is the widespread impression that their rapid growth was made possible by their government connections.[14]

The combination of the assets of PNB, DBP, and the assets of commercial banks closely tied to the Marcos government, gives a total of over half the assets of the commercial banking system (Canlas et al. 1984, 68). The sizable direct and indirect participation of the government in the Philippine financial system gave the regime a large voice in the allocation of credit within the economy, for public and, in some cases, for private purposes.[15]

The final characteristic of Philippine financial markets is their turbulent postwar history.[16] Various financial institutions have been in trouble at one time or another, including commercial banks, which have experienced several runs and occasional failures. The failure of Continental Bank in 1974 was particularly serious because it led to a run on the entire banking system, which was finally stopped when the central bank stepped in with emergency loans and assurances that it would cover liquidity problems. A more serious crisis came with the departure of Dewey Dee in 1981, since it led to the virtual collapse of one segment of the money market and runs on investment houses, finance companies, and some banks. The crisis was halted with central bank intervention, but the effects of the crisis persisted for several years. Crises have arisen not so much from lack of capital as from financing of long-term investments from short-term funds and from loans to directors and related individuals of banks (Patrick and Moreno 1985, 326–28).

5.2.3 Financial Performance

Of particular interest here is the ability of the financial system to mobilize domestic savings and make them available to investors, both over time and in comparison to other countries of similar income levels. A standard measure for LDCs, where the banking system dominates the organized financial market, is the ratio of M2—currency plus bank deposits (demand, time, and savings)—to gross domestic product (GDP). This ratio provides a rough measure of financial "depth," the extent to which financial resources are held relative to the value of domestic production.

While this is the standard measure for cross-country comparisons, its use for the Philippines is problematic. The reason is the growth of the market for deposit substitutes, which serve a function similar to time deposits, but are not counted in M2. In what follows we also use M3, defined in the Philippines as M2 plus deposit substitutes, and examine both ratios with respect to GDP.

Figure 5.1 shows the ratio of M2 to GDP for several East Asian developing countries plotted against the level of per capita GNP for 1960, 1970, and 1980. As is clear from this figure, the extent of money and bank deposit holdings is related to the level of per capita income and ordinarily increases along with per capita GNP. The Philippines is something of an anomaly in the comparison, although financial deepening is more apparent when M3 is used instead of M2. What is most striking about the Philippines is the stagnation of these ratios during the 1970s, a period in which per capita incomes were rising much faster than in the previous decade and when the savings ratio increased. In addition, Philippine financial mobilization is somewhat low for countries with similar per capita income levels.

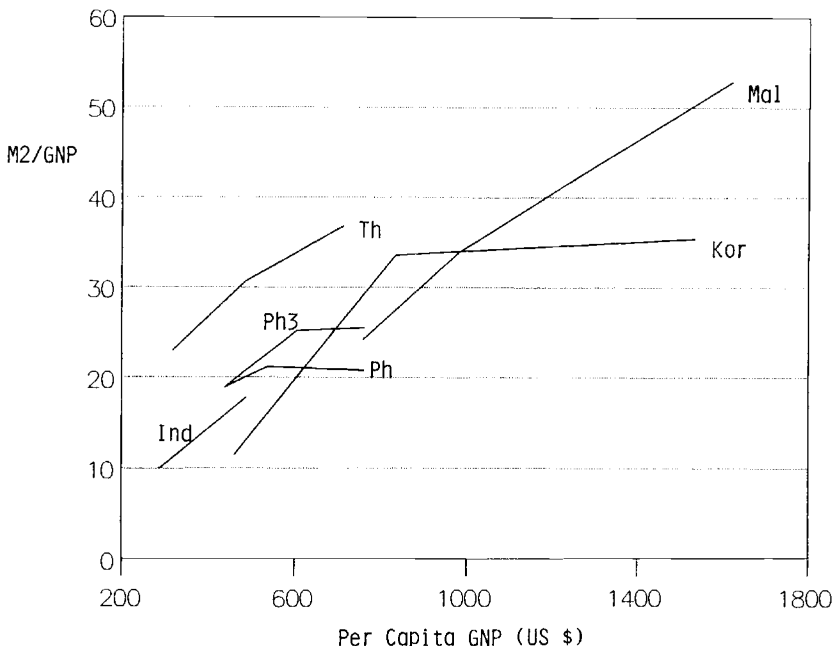

Fig. 5.1 Financial deepening in East Asian countries (1960, 1970, 1980)

Note: Ind = Indonesia (1970, 1980); Kor = Korea; Mal = Malaysia; Ph = Philippines; Ph3 = Philippines (M3); and Th = Thailand.

Source: IMF, *International Financial Statistics.*

A more detailed look at financial ratios for the Philippines in the 1970s is provided in table 5.3. Ratios of broad money to GDP increased steadily during the early 1970s, peaking in 1978. All indicators of financial asset mobilization fall in the succeeding two years, a period that coincided with the acceleration of inflation and the drop in the share of savings in GNP. What is also apparent from the table is the steady decline in narrow money to GDP, a factor that limited monetary finance of government budget deficits.

During the 1970s there was a huge increase in both private and public investment expenditures at a time when the loanable resources of the financial system were increasing only moderately. The result was a very large increase in foreign borrowing during this period, a time when the ratio of foreign debt to GNP increased most rapidly. For private firms there were two advantages of foreign currency financing. First, borrowing in foreign currency was in many instances cheaper than raising funds domestically. Assuming an external interest rate of approximately 10 percent and adding the DBP annual guarantee fee of 3 percent, foreign loans were left considerably cheaper than domestic loans whose effective rates were about 19 percent (World Bank and IMF 1980, 34).[17] In cases in which the foreign borrowing was intermediated, this lower rate was usually passed on to the ultimate borrower (Patrick and Moreno 1985, 357). The second advantage of foreign borrowing was that funds were available for longer terms than were domestic currency loans. Philippine firms required central bank approval for foreign borrowings, but export-oriented firms and firms registered with the Bureau of Industry found approval relatively easy to obtain.

Foreign currency borrowing did carry the additional risk of exchange rate changes. However, the peso had depreciated against the dollar by only 3 percent per year between 1973 and 1976 and was almost constant between 1976 and 1980. Furthermore, many firms were able to arrange swap agreements, through banks, with the central bank, that provided forward exchange at favorable rates.

Complete information on the level of outstanding swap and forward exchange cover is difficult to obtain. Figures for swap arrangements

Table 5.3 **Money Holdings in the Philippines as a Percentage of GNP, 1970–80**

	1970–72	1973–75	1976	1977	1978	1979	1980
M1	11.1	9.4	9.0	9.7	9.6	8.6	8.5
M2	21.7	17.7	18.6	21.2	22.8	20.8	21.0
M3	N.A.	24.8	26.7	28.7	29.3	26.3	25.6

Source: Central bank, *Annual Report* and *Philippine Financial Statistics*, various issues.
N.A. = not available.
M1 = currency plus demand deposits.
M2 = M1 plus time and savings deposits.
M3 = M2 plus deposit substitutes.

conducted with commercial banks for 1978 to 1980 are shown in table 5.4. Swap arrangements grew rapidly during this period, and by 1980 they rival direct borrowings from the central bank as a source of funding for Philippine commercial banks. The granting of swap arrangements was a controversial issue in the Philippines, and charges of favoritism surrounded their allocation. The central bank governor at this time, Gregorio Licaros, personally approved all swap transactions in excess of $1 million, and banks differed greatly in their use of swap transactions.

The increasing amount of medium- and long-term lending that took place during the 1970s and the access to longer term funds from foreign sources lowered the risks of debt financing, at least for those firms that had access to commercial bank credit and had hedged their foreign exchange risk. However, many firms greatly increased their reliance on debt during the decade, making them more vulnerable to economic shocks. Over the ten years from 1970 to 1980, the debt/equity ratio of the top one thousand corporations in the Philippines increased from 1.6 to 4.0.[18] In addition, the reliance of domestic firms on rollovers of short-term credit from the money market also increased, making them more vulnerable to liquidity problems. This was particularly true for the rapidly expanding firms of Marcos cronies, who borrowed heavily in this market.

5.3 Financial Markets in the 1980s

Financial markets in the Philippines were subject to a variety of strains, including market crises and substantial reversals of policy. By the midpoint of the decade the financial system was thoroughly intertwined in the country's fiscal problems, and the reluctance of the banking sector to perform its lending function had become a substantial impediment to the recovery of economic growth in the Philippines.

5.3.1 Financial Market Liberalization

During the 1980s the Philippines undertook a major financial reform that freed interest rates from administrative control and drastically reduced the

Table 5.4 **Bank Availments of Central Bank Swaps**[a]

	1978	1979	1980
Foreign exchange futures bought (millions of pesos)	7,375	13,477	20,902
(In millions of U.S. dollars)	1,000	1,818	2,750
Share of total external liabilities (%)	5.8	8.7	11.1
Memo item: Central bank credit to commercial banks (millions of pesos)	13,476	18,348	25,660

Source: Patrick and Moreno (1985), table 15.7, and Philippine central bank, Management of External Debt and Investment Accounts Department (MEDIAD). Original swap data from the central bank.

[a]Outstanding balances, December 31.

functional specialization among financial institutions. The reforms were the outgrowth of two studies of the Philippine financial system commissioned by the central bank, one by a joint World Bank–IMF mission (World Bank and IMF 1980), and the second by a former official of the Mexican central bank.

Both reports focussed on the lack of long-term funds within the Philippine financial system and the specialization and fragmentation of financial institutions that had developed. The World Bank–IMF report argued for a shift in central bank operations away from credit allocation and toward a lender of last resort facility. Both reports argued for an increase in capitalization of financial institutions and for the ability of large commercial banks to engage in underwriting and equity investments.

Almost all of these proposals were implemented over the next three years. The interest rate reform was achieved in stages. Ceilings on long-term loans and all types of deposits were lifted in July 1981, and ceilings on short-term loans were finally removed in January 1983. Specialization among types of banks was greatly reduced. With the exception of underwriting and investment in equities, each type of bank was eligible to perform all types of bank activities.

Minimum capital requirements were set or raised for thrift banks, rural banks, and quasi banks. In addition, a new category of commercial bank was created, an expanded commercial bank or "universal bank" (popularly known as a unibank) with a minimum capital requirement of P. 500 million, five times that of an ordinary commercial bank. Unibanks were permitted to engage in underwriting and to purchase up to 35 percent of the equity of nonallied businesses. PNB became the first unibank, followed by seven other commercial banks.

Other elements of the reform package were not as successful. Reserve requirements on deposits were reduced from 20 to 19 percent in July 1981 and were scheduled to be reduced in one-percentage-point steps to 16 percent. However, financial and balance of payments crises intervened, leading to subsequent rises in reserve requirements to 24 percent by early 1984. Under the reform program, the central bank was to assume more of a stabilization and lender of last resort role, reducing its provision of subsidized credit through priority rediscount windows. This was finally achieved, but only in 1985. In the interim, the number of rediscount windows multiplied to the point at which virtually any activity was eligible for rediscounting. The selective rediscounting policy had by this time lost its selectivity, requiring more rationing of credit through these windows.

The effects of the financial liberalization program are obscured by the financial and balance of payments crises that characterized the early 1980s. The lifting of interest rate ceilings led to moderate rises in deposit and loan rates in 1981 and 1982, apparently the result of oligopolistic coordination among the country's banks. The limited movement of interest rates continued until the central bank and Treasury began actively competing for savings in 1984, forcing banks to raise their deposit rates. The Philippines

did not liberalize the capital account at this point, so that the country did not face the inflow of speculative funds that appreciated the real exchange rate in Argentina when a similar liberalization took place.

The fall in the domestic inflation rate in 1981 and 1982 did mean higher real interest rates, and a rapid growth of bank deposits followed. Although the ratio of broad money to GNP increased during this period, much of the growth of time and savings deposits was at the expense of narrow money as indicated in table 5.5. The share of long-term loans (one-year or more maturity) in banks' portfolios also increased during this period, from 22 percent in 1980 to 31 percent by 1983.

5.3.2 The Dewey Dee Crisis and Aftermath

The first economic shock of the 1980s for the Philippines was an external one—the rise in oil prices and real interest rates—that sharply reduced the real income of the country. The second shock took place in early 1981 in Philippine financial markets. Failures of financial institutions and liquidity crises were by no means unknown; furthermore, the Philippines weathered a run on Consolidated Bank just a few days before the 1981 financial crisis. But the crisis that followed was more serious and set in train a series of events that would unhinge the budget and seriously weaken the financial system.

In January 1981 Dewey Dee, a respected Philippine-Chinese entrepreneur, disappeared from the Philippines leaving approximately P. 635 million ($80 million) in unpaid debts incurred by his textile company, Consolidated Manufacturing.[19] Dee and his companies had borrowed from several Philippine banks, including DBP, but had also run up substantial debt in the money market. The initial confusion surrounding the full extent of his obligations sparked a run on several investment houses and a general flight of capital to larger, non-Chinese banks. Investors refused to roll over existing commercial paper holdings and in many cases preterminated existing money market investments, which required the central bank to announce that it would stand behind the obligations of the affected financial

Table 5.5 **Liquidity Ratios (to GNP), 1980–87**

	1980	1981	1982	1983	1984	1985	1986	1987
M1	8.5	7.7	7.0	8.6	6.4	6.0	6.9	7.4
Time deposits	12.4	13.9	16.5	16.7	14.5	14.8	15.1	14.7
M2	21.0	21.6	23.5	25.3	20.9	20.8	22.0	22.0
Deposit substitutes	4.7	5.4	4.9	4.5	2.1	1.4	0.8	0.5
M3	25.6	27.0	28.4	29.8	23.0	22.3	22.8	22.5
Memo item: M3 + GS[a]	25.6	27.0	28.4	34.8	29.1	31.6	37.8	41.0

Source: Central bank, *Philippine Financial Statistics*.

[a]Government securities held by the nonbank public.

institutions, including investment houses and finance companies. More than forty financial institutions turned out to be exposed, and a larger number of these required central bank support.[20] The central bank advanced a little over P. 1.6 billion (about 8 percent of total loans and advances) to investment houses and finance companies during the crisis.[21] The cental bank in turn sold Certificates of Indebtedness to recapture the liquidity that had been created by the advances.

In the weeks that followed a variety of abuses came to light. The regulation of the commercial paper market by the Securities and Exchange Commission had been quite lax, and paper was issued in many instances without the approval of the SEC, sometimes by firms not licensed to deal in commercial paper. In some cases, commercial paper was printed on ordinary typing paper.

Public confidence did not return as the crisis passed and, by the end of the year, deposit substitute holdings of nonbank financial institutions had dropped by 24 percent to P. 2.7 billion. Suspicion extended beyond the financial institutions to the firms that had been active borrowers in the money market, and the commercial paper market virtually dried up. Many of the corporate borrowers turned out to be in extremely weak financial condition, and the Dewey Dee crisis brought many of them down.

The period was one well suited to financial difficulties. The Philippine economy had slowed considerably after the second oil shock, and real interest rates rose sharply in 1980 and 1981, as interest rate ceilings were raised and as inflation rates receded after the external shock. Without access to long-term funds, many corporations had borrowed short in order to fund long-term obligations, and in some cases firms had been borrowing to cover current losses.

Particularly affected were the conglomerates owned by several of the Marcos cronies. As described in the previous chapter, these firms were highly leveraged, and several were heavily involved in money-market borrowings. Herminio Disini's investment company, Atrium Capital Corporation, was in the center of the liquidity crisis. During the crisis, the central bank advanced P. 1.2 billion to Atrium. The firm was later merged with Asia Pacific Finance into International Corporate Bank (both owned by Disini) and taken over by DBP. Ricardo Silverio's Philippine Underwriters Finance Corporation (Philfinance) was also unable to meet its obligations and was later accused of wholesale violations of the securities laws.

During the crisis, the central bank had supplied funds to financial institutions at penalty rates, 24 percent for six-month money, rising by two percentage points with each rollover. But the firms that the financial institutions had lent money to were illiquid or insolvent, and collateral covering the loans were missing or vastly overstated so that the institutions, and in some cases the banks they were tied to, were unable to make repayment to the central bank.[22]

The response of the government was to undertake reorganization plans for the largest financial and nonfinancial corporations affected. For nonfinancial corporations these involved the conversion of existing government loans into equity, forcing the sale of some corporations or assets, and providing additional government funds. An industrial rescue fund was established, initially of P. 1.5 billion, but the limit was later raised to P. 5 billion. The first firms to draw on the fund were Consolidated Manufacturing (Dewey Dee's firm) and Alfa Textiles. They were followed by a host of firms owned by Cuenca, Disini, and Silverio, and also by Marinduque Mining, a non-crony firm.

The two large investment firms that had closed in July 1981 were merged with related commercial banks—Atrium, as described above, with Interbank, and Bancom with Union Bank. Both banks were taken over by the government. Two additional banks were taken over in early 1982, bringing to six the number of private banks the government had acquired.[23] These acquired banks held just 8 percent of bank assets, but their share of central bank credit rose from 11.5 percent in 1980 to 24.3 percent in 1983. Even this is an underestimate, since the central bank replenished the funds that had been supplied by DBP. By the end of 1984, the government's exposure to these banks was P. 6.7 billion ($330 million), as detailed in table 5.6.

This episode in the early 1980s was not the first time that the government had rescued ailing corporations. After the boom of hotel construction for the 1975 IMF–World Bank meetings, DBP and GSIS had taken over ownership of a number of hotels that were losing money. In 1978 GSIS took over majority ownership of Philippine Airlines. But the rescue operations mounted in 1981 and 1982 were far more extensive. By 1983, PNB had P. 2 billion in equity holdings and DBP had P. 7 billion in equity in 122 corporations (Montelibano 1983).

5.4 Portfolio Deterioration of Government Financial Institutions

As explained above, the Philippine government has long played a prominent role in the financial sector, in contrast to its limited participation in other sectors of the economy. The financial sector has also been an area of

Table 5.6 Government Support to Acquired Commercial Banks (end of 1984, in millions of pesos)

Government equity	1,808
Government deposits	1,221
Parent advances	1,199
Central bank advances	2,429
Total	6,657

Source: Philippine government, "Report A: Role of Government Financial Institutions," 4 July 1985, p. 50.

political patronage—access to cheap credit was seen as one of the spoils of winning elections in the Philippines. Thus the element of political influence in the allocation of credit by government financial institutions during the late 1970s and early 1980s was not a new phenomenon in the Philippines, nor in fact is it unusual among state-owned financial institutions in other countries. What was striking about the Philippines in the 1980s was the massive deterioration of portfolios of government financial institutions and the tremendous drain they placed both on the budget and on economic recovery.

The two major public financial institutions with greatly deteriorated portfolios were PNB, including its subsidiary, the National Investment and Development Corporation (NIDC), and DBP. In addition, weak or insolvent assets characterized the investment portfolios of the two social insurance institutions, SSS and GSIS. The remaining institution was the Philippine Export and Foreign Loan Guarantee Corporation (PhilGuarantee), which primarily guaranteed loans made by foreign banks, but also extended guarantees to loans made by Philippine institutions.

Neither PNB nor DBP had been very successful in deposit mobilization. PNB did better, with its extensive network of branches that covered most of the country, but private deposits made up only about 25 percent of PNB's liabilities (government deposits have accounted for an additional 18 percent) compared to about 54 percent for private commercial banks (Tan 1984, 66). DBP generated less than 10 percent of its funds from private domestic sources, and instead relied almost entirely on government deposits, investments of the social security institutions, central bank credit, and foreign loans. By 1982 foreign loans made up almost 40 percent of its liabilities. In addition, as a result of guarantees extended, DBP had contingent liabilities of $847 million in foreign currency, or 18 percent of total assets.[24] All government-owned banks have been heavily reliant on central bank rediscounting as sources of funds, and that dependence increased markedly during the early 1980s (table 5.7).

The problems that DBP had in the 1980s came from several sources. Much of the bank's loan portfolio was in large-scale, capital-intensive industry—mining, cement, textiles, metals, synthetic materials—that had been built up during the 1970s and was hit by low commodity prices, high

Table 5.7 **The Use of Central Bank Credit by Government Banks (as percentage of credit to all commercial banks)**

	1960	1970	1980	1983	1984
Government chartered	19.8	6.0	35.7	31.6	27.2
PNB			20.4	10.5	7.7
DBP			11.3	18.9	17.6
Government acquired	0.0	0.0	11.5	24.3	12.3

Source: Presidential Commission on Government Reorganization (1985a, 34), table 12.

energy costs, high interest rates, and the real depreciation of the currency in 1983. A prominent example was Marinduque Mining, to which DBP had a P. 6.3 billion exposure in 1983 (including guarantees), or 11 percent of total assets.

Political influence was an important determinant in many of these loans, as DBP lent heavily to projects organized by favored individuals of the martial law regime. Possibilities for corruption abounded in such arrangements, particularly if foreign loans and loan guarantees were involved. A borrower would contract for imported equipment at inflated prices (or in some instances would purchase used equipment invoiced as new), and in return the equipment supplier would make a kickback to a foreign bank account owned by the borrower.[25] In such a situation, the borrower might have little interest in the ultimate profitability of the investment; the money was made by the investment going forward.

Later, in the early 1980s, when many of the firms to which loans and guarantees had been made were failing, these loans were converted to equity and additional funds were extended through DBP and other government financial institutions. From 1981 to 1984 the assets acquired by DBP from firms unable to service their loans rose from P. 1.3 billion to P. 8.3 billion.[26] A memorandum from the central bank governor to President Marcos in August 1983 described 87 problem accounts of P. 5 billion or more. Of these, 44 accounts amounting to P. 28.2 billion ($2 billion) were classified as "behest" accounts, financed at the request of the government (Laya 1983).

Under the weight of its deteriorating portfolio, DBP's income fell steadily. Loan and guarantee payments as a percent of total outstanding loans fell from 16.6 percent in 1980 to 6.7 percent in 1983 (Lamberte 1984, 22). By the end of 1983 DBP was insolvent (Laya 1983, 1). In order to hide this fact from foreign creditors, DBP apparently doctored its financial statements by listing noncash income as profits.[27]

Less information is available about the operations of PNB. PNB had lent extensively to the sugar industry during the 1960s and 1970s for the construction of sugar mills. However, the price of sugar fell sharply from its 1974 peak, and the number of sugar mills constructed greatly exceeded the requirements of the industry. PNB acquired many of these mills in the late 1970s. At this time PNB's subsidiary, NIDC, was set up to manage these acquired assets.

In addition to DBP, PNB also had a large exposure to Marinduque Mining. And, like DBP, PNB had extended loans to a number of favored associates of the martial law regime and participated in rescue operations in the early 1980s. Major beneficiaries were Delta Motors (Ricardo Silverio) and the Construction and Development Corporation of the Philippines (Rodolfo Cuenca). PNB also acquired majority ownership of Pilipinas Bank in 1980 when that bank failed. Total earnings as a proportion of assets for PNB averaged 10.6 percent from 1980 to 1983, well below the prevailing loan rate of over 18 percent (Tan 1984, 67–68). And by 1984 the government's

Commission on Audit estimated PNB's overdue loans at P. 21.9 billion, 42 percent of all loans outstanding (1985, 2).

The portfolios of the two government social security institutions had also become heavily entwined in these troubled assets. Total assets of the two institutions were P. 28.5 billion in 1983, or 7.5 percent of GNP. More than 65 percent of these assets were invested in PNB and DBP. In addition, the government employees insurance system, GSIS, made direct investments in Philippine Airlines, two hotels, CDCP, and Philippine Cellophane Film (Disini), as well as loans without interest to the Human Settlements Development Corporation. Of its P. 3.9 billion (23 percent of its assets) invested in securities, most have never paid dividends.[28] The private sector retirement institution, SSS, had less invested directly in troubled companies, but did have part ownership (along with the government's Land Bank) in Union Bank.

The portfolio problems of government financial institutions continued to mount during the adjustment period. By 1986 the total exposure of government financial institutions to nonperforming assets reached P. 113 billion, or a value equivalent to almost 20 percent of GNP. Estimates of the distribution of nonperforming assets are shown in table 5.8. Of the P. 113 billion total exposure, slightly over 30 billion came from additional outlays of the institutions to maintain or rehabilitate acquired assets.[29]

Although the national government made equity contributions to PNB and DBP during the early 1980s, much of the support for these institutions came from the central bank and was outside the budget. Central bank contributions were cut off under the 1984 IMF program, and the budgetary drain resulting from the financial institution losses began to soar. By 1986, capital infusions into the financial institutions accounted for 17 percent of government expenditures and 3 percent of GNP (table 5.9).

5.5 Financial Markets and the Debt Crisis

Philippine financial markets played several important contributing roles in the development of a debt crisis in the Philippines.[30] Interest rate controls

Table 5.8 **Nonperforming Assets of Government Financial Institutions, 1986 (in billions of pesos)**

	Total Exposure	Total Claims[a]
DBP	60.5	72.4
PNB	40.9	51.9
NIDC	6.0	13.0
PhilGuarantee	5.9	5.9
Total	113.3	143.2

Source: Ministry of Finance, cited in *Business Day,* 8 September 1986, p. 2.

[a]Total exposure plus unbooked interest and other charges.

Table 5.9 **Budgetary Contributions to Government Financial Institutions (in billions of pesos)**

	1984	1985	1986
Amount	8	10	19
Percentage of government expenditure	12	13	17
Percentage of GNP	1.5	1.7	3.1

Source: Philippines, Government Corporate Monitoring Committee.

discouraged financial mobilization in the period of rapid economic growth, limiting the ability of the economy to generate savings and make them available to borrowers through the banking system.[31] In addition to the low interest rates offered to depositors, Philippine financial regulation increased the cost of bank intermediation, resulting in high effective rates to borrowers. Reserve requirements were high, and the requirement to loan to agriculture in fact resulted in the channeling of low interest rate funds to the public sector. Both reduced the yield on a large portion of bank portfolios, raising the cost of supplying funds to other borrowers. As a result of these two policies and other efforts to direct credit to priority sectors, effective rates of interest on commercial bank loans were substantial and exceeded the cost of foreign borrowing through much of the 1970s.

Controlled interest rates and high effective loan rates were characteristics that the Philippines shared with many less developed countries. What the Philippines added was innovative, as well as reckless, domestic financial institutions that made the financial system more unstable and vulnerable to a tightening of credit or downturn in the domestic economy. An active market in deposit substitutes developed at the initiative of several investment houses, offering better rates to depositors and access to credit to many smaller borrowers. Attempts by the central bank to impose reserve requirements led this market to evolve in ways that made it more unstable.

The way in which the banking system developed, with many small banks serving the interests of their industrial or family group, the tendency to lend to directors, stockholders, and related individuals, and relatively lax banking and securities regulation led to substantial abuse. Add to this the rapid growth of several conglomerates based on their proximity to the martial law government and high financial leveraging, and one had a highly volatile mixture waiting for an event like the departure of Dewey Dee.

The large degree of government involvement in financial markets, through ownership of major financial institutions, extensive regulations channeling credit to priority sectors, and the leverage that the government had over nominally independent banks, encouraged the flow of funds at low cost to politically favored, and ultimately very low return, investments. The effective control of the government over the flow of financial resources was

increased by the large use of foreign borrowing and the preference of external lenders for government entities and government guarantees.

Heavy state involvement in the financial sector encouraged the government to use public financial institutions for fiscal purposes. The corporate rescue operations of the early 1980s were conducted primarily through PNB, DBP, GSIS, and indirectly through the central bank. This had the effect of hiding the true cost of the rescue operations, as well as substantially weakening the portfolios of the major financial institutions. By 1985 and 1986 the fiscal problem would be primarily a public financial institution problem, as we will explain in detail in chapter 7.

Philippine financial markets contributed to the debt crisis; they also made adjustment to the crisis more difficult, as government demands for financial resources nearly starved the private sector in the adjustment episode. In chapter 7 we take up the adjustment period in detail, but before that we examine the one remaining piece of the Philippine debt crisis story, the accumulation and management of the external debt.

6 External Debt and Debt Management

The 1970s opened with an external debt crisis in the Philippines that was in some ways similar to the current crisis. Expansionary policy during the first Marcos administration, coupled with heavy external borrowing on short term, led to the crisis. The debt/GNP ratio for the Philippines rose from 10 percent in 1965 to 22 percent by 1969, and debt maturing within the next year amounted to one quarter of total external debt. In tandem with an IMF stabilization program and a float of the peso, the Philippines negotiated longer maturities for much of the outstanding short-term debt of the public sector.

The crisis led to a number of changes in external debt policy. Republic Act 6142 (November 1970) established a comprehensive system of control and information for foreign borrowing. Under the system all external borrowing by the public or the private sector, except short-term borrowing by the commercial banking sector, required prior approval of the Monetary Board.[1] The Management of External Debts and Investment Accounts Department (MEDIAD) was set up within the central bank to screen applications for external borrowing. Applicants were required to submit information on the proposed project and its likely returns, as well as details of the financing involved. The central bank could, and did, set minimum requirements for