Philippine Financial Markets Development: a Decade of Deregulation

By *Roy C. Ybañez*

This paper reviews the development of Philippine financial markets in the 1980s, covering a full decade of financial liberalization and interest rate deregulation. The extent of financial intermediation in the economy as measured by the M3/GDP ratio, hardly changed. However, there has been a shift from deposit substitutes to deposits, and an expansion of off-balance sheet activities. The long-term capital market remains relatively undeveloped, nor has universal banking produced a significant shift to long-term lending or to investments in non-allied undertakings. The positive developments include signs of an emerging long-term securities market and a revitalized stock market. Public sector borrowings have significantly increased, and interest rates have risen and become more volatile. The paper suggests the following to enhance financial markets development: greater macroeconomic stability, particularly in prices and interest rates; a regulatory structure that fosters information efficiency, competition and stability; the development of a long-term government securities market; and the encouragement of a greater supply of private securities.

Financial markets are the principal mechanism for mobilizing and allocating capital in a market economy. It is also argued that the performance of financial markets influences the rate of real saving in the economy. Policymakers therefore view the structure and operations of financial markets with much concern. The foreign debt crisis made it clear that the country needs to develop these mechanisms to promote domestic savings and efficient resource allocation.

This paper reviews the development of financial markets in the 1980s, the first decade of deregulation of financial markets. The paper focuses on developments in the non-bank sector, namely the government securities market, the money market, and the bond and equity markets. The paper has three sections: the first section outlines the role of financial markets in a market economy and briefly describes the structure of the Philippine financial system; the second section describes the pattern of financial markets development in the Philippines from the 1980s to the present. The last section summarizes the key points of the paper.

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I. THE ROLE AND STRUCTURE OF PHILIPPINE FINANCIAL MARKETS

A. The Role of Financial Markets

Chart 1 depicts the major intermediaries and instruments in Philippine financial markets. Chart 2 and Table 1 show the resource distribution and the number of institutions and branches of the Philippine financial system.

A financial system facilitates the saving-investment process by acting as a broker between savers and borrowers, providing the information and market-making services that allow both parties to match their diverse financial needs.

A financial institution also intermediates by accepting investor funds as its own liability, e.g. a time deposit, and relending these to final borrowers. (Chart 2 reflects this mode of intermediation, but not the first which are off-balance sheet activities.) This second mode is no less important than the first. Under this mode, financial institutions typically diversify both their sources and uses of funds, and produce various types of financial transformations which enhance asset accumulation and allocation. For example, depositors enjoy risk reduction via their indirect claim on the intermediary's diversified pool of assets. Borrowers benefit from term transformation. Both derive liquidity benefits. In

Table 1. Number of Financial Institutions As of March 1992

Type	Head Offices	Branches	Total
1. Commercial Banks	32	2,045	2,077
2. Thrift Banks	100	574	674
a. Savings Banks	7	286	293
b. Private Development Banks	38	170	208
c. Stock Savings & Loan Ass.	55	118	173
3. Specialized Govt. Banks	3		
a. DBP	1	66	67
b. Land Bank	1		
c. Amanah Bank	1	8	9
4. Rural Banks	786	323	1,109
5. Investment Houses	18	15	33
6. Finance Companies	119	72	191
7. Investment Companies	66		66
8. Securities Dealers/Brokers	122		122
9. Pawnshops	1,933	617	2,550
10. Fund Managers	14		14
11. Lending Investors	1,127	94	1,221
12. Non-Stock SLAs	77	27	104
13. Mutual Bldg. & Loan Ass.	6		6
14. Private Insurance Cos.	129		129
15. Government Non-Banks	4		4
16. Venture Capital Corp.	10		10
17. Money Brokers	n.d.	n.d.	0

n.d. - no data

Source : Central Bank

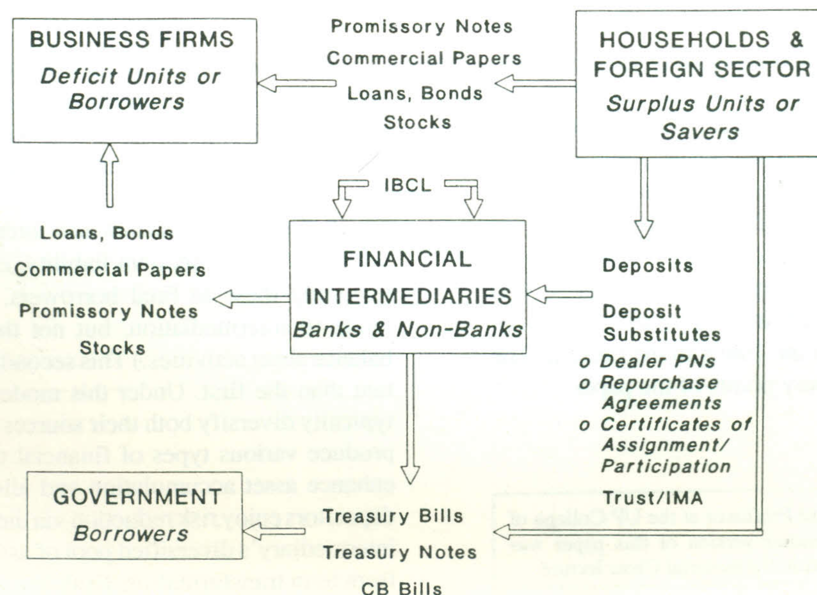
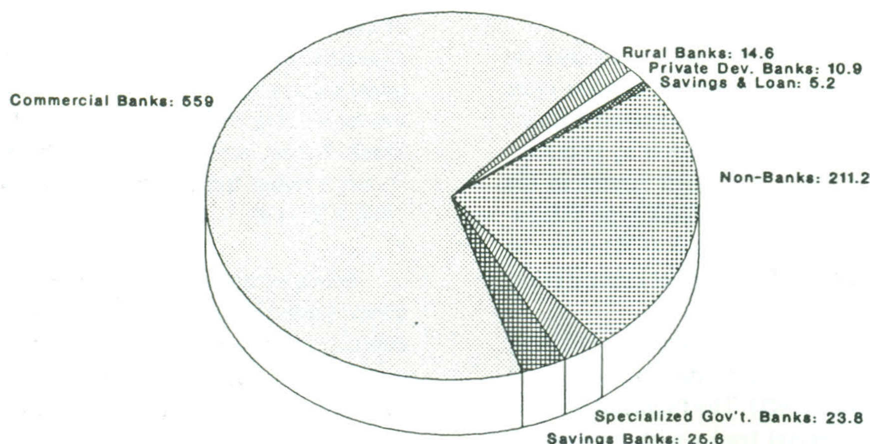


Chart 2

Total Resources of the Philippine Financial System, September 1991
₱ 850 billion (US $ 31.5 billion)



Source: Central Bank Review, December 1991

many instances, the provision of liquidity by intermediaries develop into an active secondary market with the intermediaries shifting back into the brokers' role.

B. The Philippine Financial System

In terms of resources, the Philippine financial system is largely a banking industry (Chart 2). Commercial banks (KB) dominate this industry. Foreign equity is restricted, and only four foreign banks operate branches. New entrants are limited to offshore banking units (OBUs). Commercial banks concentrate on deposit generation (including foreign currency deposits), short-term lending and letters of credit, funds management, transfer and payments services, and foreign exchange transactions. Thirteen of the thirty-one KBs have acquired the status of universal banks.

Savings & mortgage banks, and stock savings & loan associations primarily cater to small savers and service personal and consumer finance, e.g., housing and car finance, purchase of consumer durables, etc.

Development banks specialize in term lending and often serve as the conduit of foreign loans intended for domestic relending. Many were established with government equity financing.

Rural banks were originally conceived as unit commercial banks, allowed to operate only in rural areas, and in low urbanized areas. They developed through government support following a policy of encouraging rural and agricultural credit. When market oriented reforms led to the withdrawal of this support, many rural banks promptly collapsed or experienced financial distress.

Non-bank financial institutions include specialized services and institutions such as investment houses, financing companies, fund managers, investment companies, lending investors, securities dealers and brokers, insurance, social security and pension systems, housing finance institutions, leasing companies, pawnshops, etc. Social security and housing funds are basically compulsory saving programs covering a significant portion of the salaried workers in the country.

Financial liberalization now allows greater flexibility in types of services and geographic scope for most institutions. But the basic structure and resource distribution has not changed.

II. THE PATTERN OF FINANCIAL MARKETS DEVELOPMENT

For much of the postwar period, the types of institutions

that could be established, the financial services that could be offered, and the rates for these services were substantially restricted and controlled by law. The regulations and the financial markets development in this period have been discussed extensively in past studies [e.g. Lamberte, 1985; Licuanan, 1986; Yap, 1990]. Many now concede that this period of financial repression has stunted the growth of the financial system, particularly the long-term capital market.

Financial liberalization came in two stages : a transition period from 1974 to 1980, and deregulated interest rates from 1981 onward. The transition period involved reforms that encouraged branch and capital expansion by commercial banks, liberalized the entry of foreign equity in the banking system, reduced the number of bank type categories, expanded control of the Central Bank (CB) over the securities market, and authorized the CB to set interest rates.

The landmark reforms after the transition period were the deregulation of interest rates and the implementation of universal banking [Lamberte, 1985]. The financial reforms of the 1980s allowed commercial banks with unibanking licenses a broader scope of financial services, including investment banking functions such as underwriting and securities dealership, and equity investments in non-allied undertakings. On the premise that size fosters economies of scale and greater stability, and a larger potential for long-term lending, minimum capitalization was also increased as part of the package of reforms. The reform program is continuing - reforms in the 1990s include the deregulation of foreign currency transactions and the liberalization of bank branch expansion.

Financial liberalization hoped to develop Philippine financial markets by fostering competition and efficiency, and by encouraging financial innovation and term transformation.

The deregulated financial system was severely tested almost immediately with a financial crisis in 1981 and a balance of payments crisis which burst in 1983, the consequences of which continue to burden the economy today.

How have financial markets responded to deregulation and a highly unstable macroeconomic environment?

A. Indicators of Financial Development

Financial development has many dimensions. Two key indicators are discussed in this section, viz. a) the extent of financial intermediation and, b) the behavior of interest rates. Indicators specific to the main sub-markets are discussed in later sections.

The Degree of Financial Intermediation

A common measure of the extent of financial intermediation in the economy is the ratio of broad money (M2) to Gross Domestic Product (GDP). Broad money is composed of currency in circulation and demand, savings, and time deposit liabilities of the deposit money banks, i.e., M1 plus quasi-money. Chart 3 shows that the Philippines had the lowest level in 1989 compared with her ASEAN neighbors, South Korea, and the United States. However, the ratio shows a rising trend since 1975, and especially so since 1986 (Chart 4).

When we use a broader measure (M3) however, no clear upward trend is apparent (Table 2 and Chart 4). M3 includes deposit substitutes of deposit money banks. The rise in quasi-money (the major component of M2) is offset by a decline in deposit substitutes, resulting in virtually the same level for this measure in 1975 and in 1991.

What about financial intermediation by non-banks? Table 3[1] shows that the year-end balances of deposit substitutes issued by non-banks with quasi-banking licenses have not increased.

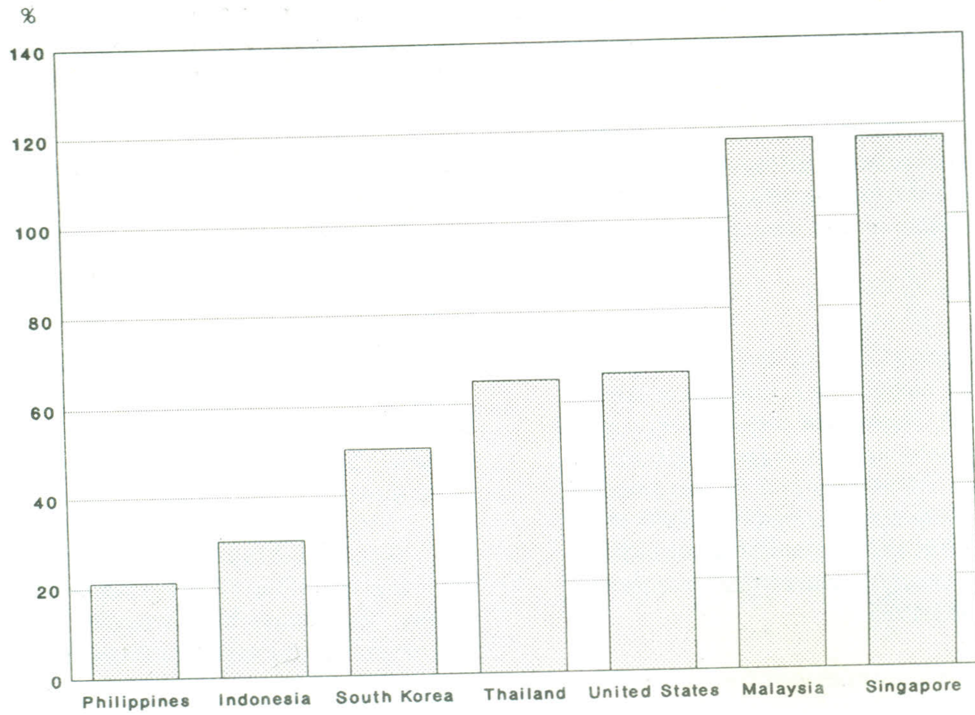
Hence, using broader measures than M2, the degree of financial intermediation would appear to have remained the same. What has clearly changed is the mode of financial intermediation from a heavy use of deposit substitutes in the 1970s, to deposits in the 1980s.

In part, the shifts were in response to regulatory changes. The unregulated deposit substitute market was brought within the regulatory umbrella of the CB in 1974, e.g., through interest rate ceilings, a 35 % tax, and minimum placement rules [Yap, et al, 1990]. In the 1980s, interest rates on deposits and deposit substitutes were deregulated, while tax rates and reserve requirements were aligned. Deposits could now offer competitive rates while enjoying the advantage of deposit insurance. On the other hand, non-bank financial institutions - which were issuing as much deposit substitutes as banks by 1980 - experienced severe financial difficulties in 1981 and loss of investor confidence.

1/ Peso values in all tables are in million pesos.

Chart 3

Money (M2) to GDP Ratio, 1989



Source: World Bank, World Development Report 1991

Chart 4

Financial Development Indicators

GS refers to outstanding government securities.
Market cap refers to market capitalization of stock market.

The above observation about M3/GDP does not necessarily indicate a stagnating demand for financial assets. As shown in Chart 4, two types of direct securities have rapidly expanded in the second half of the 80s : equities and government securities, particularly treasury bills. Nor does it suggest a decline in financial services by the banking sector - banks have been expanding off-balance sheet activities, i.e., trust and investment management services. (These sectors are discussed further in later sections.)

Interest Rate Behavior

The deregulation period thus far has generally been characterized by higher interest rates, and greater interest rate volatility (Chart 5). During the period of regulation (1975 - 1980), average monthly WAIR (weighted average interest rate) of 91-day T-Bills was 11.1 %, and standard deviation was 0.85%. With deregulation (1981-1991 data), mean WAIR rose to 17.6%, and standard deviation to 5.0%. Chart 5 also depicts very clearly the interest rate consequences of the BOP crisis in 1983-1985.

With deregulation, interest rates were free to respond to the instabilities in the macroeconomic environment in the 1980s. Chart 5 also graphically depicts the close correlation between inflation rates and interest rates. It is significant though that deregulation has made possible generally positive real rates of returns on financial investments.

Degree of Financial Intermediation and Interest Rates

Have higher interest rates fostered greater financial intermediation? Theory suggests that they should, for when nominal rates do not keep pace with inflation, savers presumably shift from financial assets to real assets. Table 2 suggests that this is the case. Up to 1986, the ratios of M2 and M3 to GDP appear to move with real interest rates. Previous studies [e.g., Ybanez, 1987] show the relationship between money (M1) and interest rates that is consistent with this behavior.

For the period 1987 to 1991 however, there is a consistent rise in the M3 to GDP ratio despite swings in the real interest rate. Clearly, there are other factors that influence this measure of the degree of financial intermediation.

Table 2. Financial Development Indicators

	Percentage to GDP			% Distribution of M3					
Year	M1	M2	M3	M1	Quasi-Money	Deposit Substitutes	Interest Rate	Inflation Rate	Real Interest Rate
1975	8.1	15.3	22.5	36.0	31.9	32.1	9.8	6.9	2.9
1976	8.0	16.1	23.7	33.6	34.6	31.8	8.9	9.7	(0.8)
1977	8.4	18.2	25.6	32.9	38.0	29.1	10.0	9.9	0.1
1978	8.5	20.1	26.4	32.3	43.6	24.1	10.9	7.1	3.9
1979	7.8	18.9	24.5	31.9	45.4	22.7	11.8	17.5	(5.7)
1980	7.3	18.2	22.6	32.4	48.2	19.4	13.1	18.2	(5.1)
1981	7.0	18.5	23.4	30.0	48.8	21.1	12.4	13.1	(0.7)
1982	6.4	20.5	25.7	25.0	54.9	20.1	13.8	10.2	3.5
1983	6.3	21.8	26.2	24.2	59.2	16.6	12.8	10.0	2.8
1984	5.9	18.2	20.9	28.0	59.2	12.7	33.7	50.3	(16.6)
1985	4.9	18.3	19.9	24.4	67.4	8.2	26.5	23.1	3.3
1986	5.7	19.5	20.7	27.8	66.4	5.8	13.7	0.8	13.0
1987	6.1	19.5	20.0	30.4	67.0	2.6	10.6	3.8	6.8
1988	6.2	20.5	20.9	29.8	68.5	1.7	13.3	8.8	4.5
1989	6.3	22.2	22.5	28.2	70.5	1.3	16.3	10.6	5.7
1990	6.6	23.7	23.9	27.7	71.3	1.0	24.7	12.4	12.3
1991	6.9	24.9	25.1	27.6	71.5	0.9	22.5	17.9	4.5

Note : 1) All money components are based on annual average of end-of-month-balances.
2) Interest rate is weighted average interest rate (WAIR) of T-Bills for all maturities.
3) Inflation rate is based on CPI (1978 = 100).
Sources : Central Bank, Business World

Table 3. Year-End Balances of Major Types of Financial Claims

Year-End	Savings/ Time Deposits	Deposit Substitutes			Gov't. Securities		Commercial Papers		
		DMBs	NBQB	Total	Total	T-Bills	Total	Long-Term	Short-Term
1975	8,939	9,632		19,567	1,869				
1976	12,950	10,873	5,780	16,652	22,093	1,967			
1977	17,593	11,400	5,784	17,183	25,787	2,559			
1978	23,398	11,494	6,731	18,225	29,001	2,858			
1979	26,566	11,951	8,908	20,859	31,269	2,534	23,853		23,853
1980	32,894	12,371	11,328	23,699	34,262	2,983	24,288		24,288
1981	39,285	15,923	8,598	24,521	39,467	5,470	5,087		5,087
1982	55,208	16,566	9,590	26,156	46,975	6,954	1,283		1,283
1983	63,367	17,106	8,438	25,544	50,818	7,875	739		739
1984	76,398	10,373	6,401	16,774	72,052	19,377	2,288	792	1,496
1985	88,447	8,609	5,434	14,043	89,165	31,163	2,508	1,000	1,508
1986	93,608	4,875	6,086	10,961	118,820	55,420	2,898	1,410	1,488
1987	105,899	3,553	7,885	11,438	146,856	105,908	2,630	1,410	1,220
1988	136,205	2,488	7,131	9,619	197,297	142,615	1,733	1,410	323
1989	171,639	2,832	8,810	11,642	225,246	172,543	3,727	2,300	1,427
1990	208,295	3,234	6,750	9,984	243,378	192,589	6,782	3,675	3,107
1991	242,683	3,022	9,013	12,035	333,461	213,469	n.d.	n.d.	n.d.

Note : 1) Savings and time deposits are for deposit money banks (DMBs) only.
2) NBQB refers to non-bank financial institutions with quasi-banking licenses.
3) Government securities include repurchase agreements.

n.d. - No data available

Sources : Central Bank, Securities & Exchange Commission

The Corporate Response

The response of corporate borrowers to the increase in the level and instability of interest rates may be observed from Table 4. Except for the mining and utilities sectors, corporations have lower debt-equity ratios at year-end 1991 as compared with levels in the pre-deregulation period. This is also due to reduced inflows of foreign loans following the foreign debt crisis of the 1980s, and to the related debt conversion and restructuring programs.

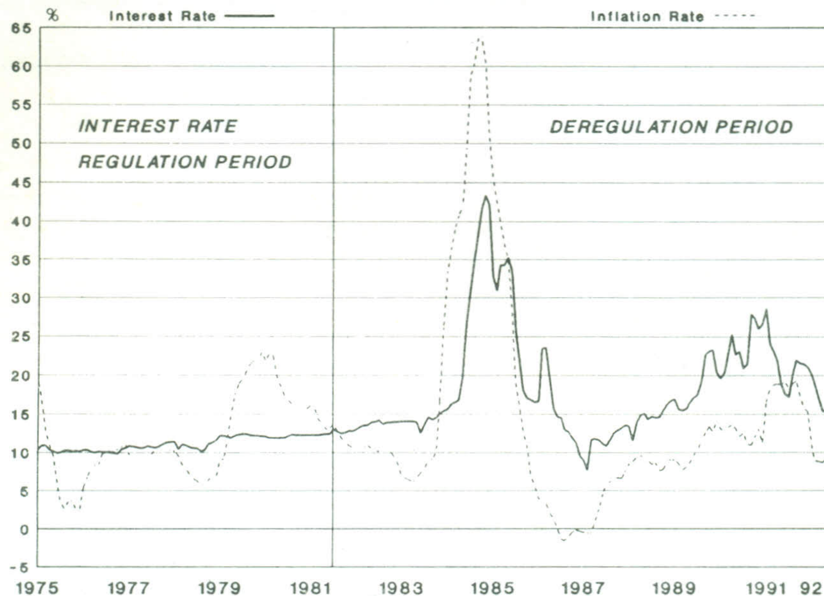
B. The Government Securities Market

A broad view of the money market is shown by Table 5. It includes the interbank call loan (IBCL), government securities, promissory note, and commercial paper sub-markets. Stock market volumes are also presented. The figures suggest the relative growth of each sub-market over time, but not necessarily their relative sizes since these are flow, rather than stock figures.

The highest growth in the short-term securities market is posted by government securities. Treasury bills constitute the bulk of government securities, trading ₱545 billion in 1991, up from ₱56 billion in 1986. Total outstanding government securities (those traded through the Central Bank) was ₱333.4 billion at year-end 1991, of which ₱213.4 billion were peso denominated treasury bills, while longer-term treasury notes amounted to ₱53.6 billion. Central Bank bills, the main open market instrument of the CB until 1987 and successor of the CBCI, were revived in 1991 (thus the sharp rise in "other government securities" traded), with a year-end balance of ₱40.7 billion.

The present size of this sub-market mirrors the large deficits of the public sector and generally tight monetary policy of the 1980s. These policies were intended to steer the economy through a delicate path of growth and stability, and to normalize the country's foreign capital flows. However, this has meant an environment of generally high interest rates, particularly in the face of persistent inflationary pressures (see Chart 5). In turn, high interest rates dampen the supply of private sector securities and real investments.

Interest Rates & Inflation Rates — **Chart 5**



Interest rate is monthly WAIR on 91-day T-Bills.

In the past, government securities could be issued despite their below market rates due to their eligibility as bank reserves, as substitutes to Agri-Agra loans, and as collateral. Treasury bills are now traded in a competitive manner. Given the size of this market, the T-Bill rate has emerged as the reference default-free interest rate on which both short- and medium-term lending rates are based (much like LIBOR). This is a positive development, as it facilitates pricing of corporate securities and enhances the development of the money and capital markets.

The government securities market is mainly short-term. Outstanding public internal debt has shifted from only 24.6% in short-term papers in 1979, to 76.9% by year-end 1991. The short-term structure of internal public debt has been criticized as a principal cause of the volatility of interest rates.

Table 4. Debt - Equity Ratios Of Philippine Industries

Industry	1979	1980	1981	1982	1983	1989	1990	1991
Agriculture, Fishery & Forestry	1.75	2.07	2.40	2.15	4.18	1.35	1.32	1.43
Manufacturing	2.17	2.51	2.17	2.13	2.43	1.76	1.89	1.42
Mining & Quarrying	0.88	1.14	2.09	3.47	4.26	2.10	2.01	1.84
Construction	3.00	2.98	3.49	4.15	2.40	2.35	2.31	1.93
Elec., Gas & Water	1.21	0.97	1.32	1.42	1.97	2.07	2.44	2.12
Transportation, Storage & Commun.	2.47	2.75	3.18	3.69	6.50	1.89	1.73	1.88
Wholesale & Retail Trade	3.04	3.50	3.92	3.97	3.78	5.29	3.29	2.53
Community, Social & Personal Services	2.26	1.56	1.67	1.78	1.12	1.38	1.10	0.80
Financial, etc. Services	8.16	8.30	10.46	9.86	10.36	4.36	4.24	4.19
ALL INDUSTRIES	3.64	3.96	4.65	4.56	5.83			

Sources: 1979-1983 data from Lamberte [1985];
1989-1991 data from Business World Top 1000 Corporations

Recently however, the government started issuing three-year floating rate treasury notes (FRTN) pegged to the 91-day T-Bill rate. By lengthening the average maturity of its borrowings, government should acquire better control over its cash flow. This in turn has the potential of reducing interest rate volatility.

As in the short-term market, government securities play an important role in developing the long-term or capital market. The presence of a market-determined, default-free rate greatly facilitates the pricing of private long-term securities. This argues for the introduction of longer-term government securities, longer than the present three-year maturity of treasury notes.

By the same token, there should be a long-term, market-determined **fixed-rate** government security. A variable rate financial instrument is an important risk management option in a world of volatile interest rates. But to some, the better way to cope with such risks is through a fixed-rate instrument (in part, this explains the popularity of zero coupon bonds in developed financial markets).

Consistent with the market acceptance of government securities, there has been a significant shift in their ownership structure. In general, the shares of private banks, trust funds, and the Central Bank have declined (commercial banks share have been holding steady at 23% in the past three years). In 1979, the private sector directly held only 13.5% of total securities. By year-end 1991, the private sector directly held 43%. Notably, the large shifts started in 1984 when interest rates rose to record highs. The private sector share peaked in 1988 at 60%, and has been declining since. Semi-government entities, particularly the Social Security System, increased their proportionate holdings. Via pension funds, small savers benefit from the attractive yields on government securities.

C. Short-Term Securities or Money Market

Though the traditional components of short-term financial flows are bank deposits and bank loans, this paper focuses on the securities sub-market. Commercial banks, investment houses, and financing companies constitute the principal network of this sector of the Philippine short-term market. We shall refer to this sector as the money market.

Financial institutions issue dealer promissory notes

Table 5. Volume of Money and Stock Market Transactions By Type of Instrument, 1975 - 1991

Year	Total Money Market	IBCL	T-Bills	Other Gov't.	PN	Repos	Cert. of Par/Ass.	CP	Total Stocks
1975	176,459	16,224	164	19,824	96,890	30,290	3,692	9,375	
1976	190,449	17,818	122	16,853	119,472	25,600	355	10,229	6,849
1977	210,764	17,833	119	19,944	140,611	22,715	579	8,963	2,517
1978	235,801	18,071	847	28,021	158,901	21,484	497	7,980	5,384
1979	295,489	42,268	299	52,062	151,204	39,276	616	9,764	4,976
1980	303,750	50,510	147	35,824	144,463	60,370	1,970	10,466	4,664
1981	329,621	66,969	64	28,033	189,532	20,611	486	23,926	1,292
1982	462,822	133,593	1,259	40,597	238,308	13,840	569	34,656	1,219
1983	600,562	198,101	4,899	121,695	244,043	7,557	269	23,998	5,364
1984	505,809	178,117	21,684	94,920	183,381	3,435	430	23,392	2,083
1985	505,754	226,831	38,747	49,473	156,799	14,188	0	20,166	2,059
1986	523,417	201,423	55,860	44,807	158,656	46,147	1,054	15,650	11,470
1987	460,854	172,785	96,562	38,736	131,085	2,912	237	18,537	31,523
1988	780,051	303,503	295,266	59,437	104,076	817	0	16,952	23,859
1989	904,451	360,852	361,141	81,363	80,651	11	0	20,933	53,762
1990	1,289,490	730,742	425,090	43,262	63,253	803	0	26,340	28,230
1991	1,661,192	855,071	545,818	132,429	81,415	10,476	0	35,984	39,367

Note : IBCL refers to the Interbank Call Loan market.

Source : Central Bank

(PNs), and other deposit substitutes such as repurchase agreements (RPs or Repos), certificates of assignment, and certificates of participation. The underlying assets in the latter types of deposit substitutes are either government or private corporate issues. Non-financial corporate borrowers issue PNs and commercial papers (CPs). As corporate issues, they normally carry a spread over government securities of comparable tenors.

Table 5 shows that the money market traded a total peso volume of ₱1,661 billion in 1991. Among the non-government issues, the interbank call loan (IBCL) sub-market shows the fastest growth rates. This market deals exclusively in interbank borrowings, to service liquidity and reserves needs of financial institutions. Interbank transactions slowed down in 1987, when liquidity was high and nominal interest rates were low. But interbank activity picked up with the tightening liquidity in the past four years.

Transactions in non-interbank private securities show a decline to a trading volume of only ₱128 billion in 1991, from ₱140 billion in 1975. In the past 15 years, the money market experienced fluctuating levels of activity, and negative long-term growth. The cycle varies by instrument, but the general sense is that of a no-growth market.

The figures show that practically only the PN and the commercial paper market remain of what was once a very active money market. Since 1987, the latter has been supplied exclusively by the non-financial corporate sector. The markets for repurchase agreements, certificates of participation, and certificates of assignment with private issues as the underlying asset, have virtually disappeared. (It is doubtful that certificates of participation are no longer transacted. The absence of recorded transactions may be due to non-reporting and/or misclassification). 1991 figures however show a revival of repurchase agreements in both private and government securities.

As discussed earlier, deregulation has posed greater competition on deposit substitutes from traditional deposits. And increasingly, the public sector competed with the private sector for financial resources, keeping interest rates high. We must also consider that the history of the money market is marred by two rounds of financial failures.

In 1981, major loan defaults (triggered by the Dewey Dee scandal) resulted in a severe liquidity crisis among investment houses and financing companies, and the closure of several institutions, including the industry leader. Tables 3 and 4 suggest that despite the financial crisis, the deposit substitute market continued to expand in 1981 and 1982. The financial crisis mainly resulted in a significant shift of financial resources from the non-bank sector to the banking sector.

In late 1983, a severe balance-of-payments crisis led to the country's declaration of a foreign debt moratorium. The restrictive economic policies and economic dislocations (reflected in the sharp rise in inflation rates, interest rates, and the peso rates of foreign exchange) resulted in the failure of more financial institutions already weakened by the 1981 financial crisis. The country's largest savings bank ceased operations, despite cash infusion from the Central Bank. Both the CB and the national government eventually absorbed a significant portion of domestic and foreign liabilities of the banking and corporate sectors. This time, not even the deposit substitute business of commercial banks was spared, as shown in Table 3. (A sharp rise in the currency to deposits ratio provides yet another evidence of the disintermediation spawned by this crisis.)

The Money Market at Present

The short-term securities market is a potential source of financial innovation. By competing with traditional bank loan and deposit markets, the money market improves the efficiency of the financial system and enhances liquidity. A well-developed money market also benefits monetary authorities - their open-market operations can be conducted more effectively [Villanueva, 1988].

Repurchase agreements allow investors to acquire liquidity and manage their maturities. Certificates of assignment provide the mechanism for trading financial claims and hence, for providing liquidity to investors. Certificates of participation on the other hand provide the mechanism for size transformation by pooling savings for relending as a single corporate loan. In addition, the intermediary provided its financial expertise and resources (as the loan originator).

The decline of the traditional money market, particularly in the non-bank sector, suggest an undesirable reduction in the modes of financial transformation with potential negative effects on the process of financial intermediation in the economy. The issue deserves further research, particularly on its effects on savings and credit allocation, and present constraints on the deposit substitute market.

One of the key lessons of the 1980s was the essential role of a well-informed investing public in ensuring efficient and stable financial markets. A credit information and rating

system has been established (though its ratings for CP issuers were regularly made public only recently). Still, the popular perception is that accurate and timely financial information is the exception rather than the rule. The improvement of financial reporting rules in the various aspects of intermediation deserves to be a priority concern of regulators and the industry [Chuppe and Atkin, 1992].

Financial markets have a key characteristic - they respond faster and with greater flexibility to new conditions than markets for real assets. The observed shift out of deposit substitutes into bank deposits exemplifies these responses. In the aftermath of the disruptive events of the 1980s and with the advent of universal banking and deregulated interest rates, banks must have seemed like safe havens to investors and borrowers.

Important innovations have also been introduced that provide alternative modes of financial transformation. In particular, commercial banks expanded trust and investment services. At year-end 1991, trust and investment management accounts were at levels equivalent to 21 % of total balance sheet resources of the commercial banking system (and as much as 46% of the assets of the leading bank in the trust business), from 7.8 % of total KB assets in 1978 and 17.0% in 1988. At year-end 1991, common trust funds accounted for 52% of such off-the-balance sheet resources of KBs, while investment management agreements accounted for another 21%. Funds mobilized in this manner now constitute the equivalent of 33% of total KB deposits [Business World, 3 February 1992].

The common trust fund (CTF) provides investors important financial benefits: opportunities for higher yields and diversification, relatively low minimum placements, liquidity, and the expertise of fund managers. Since these off-balance sheet activities involve significantly lower reserves and gross receipts tax, investors could potentially benefit from lower intermediation costs as well. There are also informational advantages - investors have greater awareness of the asset types backing the trust certificate, unlike PNs and CPs.

There are regulatory issues however. As indicated above, CTFs provide opportunities for avoidance of reserve requirements, the GRT, and balance sheet restrictions such as Agri-Agra loans. A potential source of abuse are unregulated transfers of high-risk or uncollectible accounts between trust and bank loan departments [see Zingapan, et al, 1990 for a more detailed discussion]. Finally, uninformed investors sometimes seek fixed returns which intermediaries accommodate even when underlying assets do not provide such guarantees. The significant size of this market requires investor education and adequate regulatory safeguards for both bank depositors and CTF investors.

Another significant innovation recently introduced are asset-backed securities (ABS). The ABS is a securitization mode, or a mechanism for converting illiquid bank loans into liquid assets. Like CTFs, they also provide opportunities for banks to reduce intermediation costs and enhance liquidity for the bank and for the ultimate investor.

The recent establishment (in October 1990) of an interest rate futures market with contracts for 91-day T-Bills is also significant for both money and capital markets. The availability of this derivative security should enhance the ability of both borrowers and lenders to manage interest rate volatility. (A currency futures market has also been established, which is timely given the recent FOREX deregulation.)

D. The Long-Term Capital Market

Financial reforms were intended to foster term transformation and develop the long-term capital market. The key reforms included interest rate deregulation and expanded commercial banking.

The Bank Loan Market

The financial reforms of the 1980s adopted the approach of expanding the scope KBs, the largest sector of the system, through unibanking, rather than creating new types specializing in long-term capital mobilization. Clearly however, unibanking has not yet resulted in any significant shift to long-term lending as shown by Table 6.

This is not due to an inability of the system to do term lending. A joint IMF/World Bank mission [World Bank, 1979] found that the commercial bank system's deposit base has a stable core that may be lent long-term.

The other thrust of universal banking is the promotion of equity investments, whether in allied or non-allied undertakings. Research thus far suggests that this has not been happening [Cintura, et al, 1990].

The efficiency and degree of competition in the banking industry are issues that continue to dominate discussions about the industry. The low savings deposit rate is cited as evidence of a cartel at work (monthly WAIR from 1982 to June

1992 averaged 7.2 %, lower than the average inflation rate). Others point to the spread between deposit and lending rates as evidence of inefficiency and/or abnormal profits (for the same period, the average spread between savings deposit rates and the rate on secured loans with maximum maturities of one year was 13.3%).

Banks on the other hand, point to regulation-induced intermediation costs to explain bank spreads. The more prominent are the high reserve requirement, the gross receipts and documentary stamps taxes, and loan restrictions like the Agri-Agra rule that limit asset diversification of banks.

Further research is needed to resolve these issues. In any case, liberalized branch banking and foreign equity rules should enhance competition and efficiency in the banking system.

The Bond Market

The Philippine bond market was virtually nonexistent until the introduction of long-term commercial papers (LTCPs) with maturities of 3 to 6 years. Thus far, only a handful of companies with high credit ratings (e.g. PLDT and SMC) have issued LTCPs.

Regulatory constraints appear to have influenced the growth of the commercial paper market. A principal motivation to go into direct issues is the single-borrower limit imposed on banks. Alternatively, corporations with large loan requirements can still tap the traditional bank loan market through syndicated loans.

Generally, LTCPs pay adjustable or variable interest rates with fixed spreads over either the 91-day or the 182-day treasury bill rate. The variable interest rate feature is an innovation introduced in response to increased interest rate volatility.

Indeed, the Philippine capital market can be credited with several recent innovations [see related article by Aragon in this issue]. In the past year, two issues of equity bonds were successfully underwritten, attesting to the willingness of investors to try out new instruments, even those with a speculative flavor. An adjustable rate preferred stock and a stock warrant have also been recently introduced and successfully listed in the exchanges. A planned issue of a convertible bond did not materialize.

Despite these developments, the long-term debt market remains a small, generally undeveloped component of financial markets. Corporate borrowers rely on limited long-term bank loans and on rolled-over short term credits. What constrains the development of this market?

Firstly, an unstable macroeconomic environment hinders capital market development. The volatility of interest

Table 6. Percentage Distribution of Loans Outstanding of Commercial Banks by Maturity

Year-End	Total	Demand/ Short-Term	Intermediate Term	Long-Term
1977	100.0	85.3	10.5	4.2
1978	100.0	82.1	10.3	7.7
1979	100.0	70.7	13.8	15.6
1980	100.0	78.1	10.0	11.9
1981	100.0	73.4	17.3	9.3
1982	100.0	69.0	18.1	12.9
1983	100.0	69.3	15.1	15.5
1984	100.0	61.0	24.3	14.8
1985	100.0	66.3	16.7	16.9
1986	100.0	69.1	18.1	12.8
1987	100.0	72.4	22.3	5.4
1988	100.0	71.4	20.8	7.8
1989	100.0	74.9	19.1	6.0
1990	100.0	80.0	16.6	3.4
1991	100.0	76.9	16.5	6.6

Source : Central Bank

rates is a significant disincentive to funds suppliers, while high interest rate levels discourage funds users. The Philippine financial market has developed modes for managing short-term interest rate risks, but a more stable financial environment through fiscal balance and price stability is the longer-term inducement. The government has had some success in addressing traditional sources of fiscal deficits, but the large public debt, particularly those of the Central Bank, poses a continuing threat.

As in the short-term market, reliable and timely financial and credit information is essential for developing the capital market. Investors in long-term securities have to be assured of fair access to relevant and reliable financial reports. Those unskilled in interpreting and analyzing such information must rely on the professional assessments of regulators and credit rating agencies.

Secondary markets must also be developed to provide liquidity to the market. Over time, many investors will find it necessary to adjust their portfolios in response to changing perceptions about economic conditions, credit risks, relative yields of competing securities, or personal cash flow needs.

Tax incentives (e.g., lower capital gains and documentary stamps taxes) may have positive effects, but it is doubtful if these will have as much effect as a reduction in credit risks. And as we argued earlier, the introduction of longer-term, fixed-rate government securities should facilitate the pricing of credit risks and thereby encourage the private debt market.

The Equity Market

Underwriters, stock brokerage firms, and the stock exchanges constitute the network of institutions in the equity market. The market is regulated by the SEC and the stock exchanges.

As of December 1991, there were 161 listed companies in the two exchanges with a market capitalization (market value of total shares outstanding of listed stocks) of ₱298 billion (see Table 7).

The stock market has a long history in the Philippines, but significant growth has occurred only in the past six years. From an annual turnover of ₱6.8 billion in 1976, the market declined to a turnover of ₱2.1 billion in 1985, then rapidly grew to a record volume of ₱53.7 billion in 1989. This growth appears due to the change in the political environment in 1986. As in equity markets elsewhere, the Philippine market is highly sensitive to economic and political uncertainties. Trading volumes fell with renewed uncertainties after 1989, but gradually climbed back to ₱39.4 billion in 1991.

The stock market has long had the image of a highly speculative market dominated by oil and mining stocks. This was certainly true in the transition period of the late 1970s. Hence, it is noteworthy that the recent growth of the market has been fueled by commercial and industrial (C-I) stocks. Of the total 161 listed companies, 96 are in the C-I sector, 41 in mining, and 24 in oils. The market is no longer a primarily oil and mining stock market as it was in the 1970s. This could reduce the volatility of the stock market.

The perception that the local stock market is a high risk market also derives from the information problems of the Philippine financial market, as repeatedly noted in this paper. Investors perceive that privileged information is being used and that in a thin market, it does not take much to manipulate stock prices.

Nonetheless, even in efficient financial markets, stocks are among the more risky forms of investment. Our research [see article in this same issue] shows that indeed, the stock market is a high return-high risk market. (The "speculative" image of oil stocks is apparently well-deserved with its greater volatility relative to the market average.)

The substantial growth of the secondary equity market has encouraged many companies to tap the equity market for funds. There have been many public offerings and new listings, both in terms of new equity and public offering of existing shares. In 1991, 9 more companies were added to the stock market.

The growth of the equity market has been particularly beneficial to the privatization program of the government. It has made possible the successful partial privatization of the Philippine National Bank. Given that more such companies are programmed to be privatized, the government has a direct interest in seeing a robust and well-functioning stock market.

The volume statistics on the stock market are deceptive however. Trading volumes and market capitalization are still accounted for by just a handful of stocks. In the first semester of 1992, the top 10 of 166 listed companies accounted for 75 % of total market capitalization and 68 % of trading volumes in the Makati Stock Exchange. Most stocks barely trade or are inactive. Thus, liquidity and diversifica-

tion opportunities are still very limited.

The market would benefit from the entry of companies which yield promise of a strong secondary market and reasonable risks. But many corporations are reluctant to go public. An SEC study cited in a news report [*Philippine Star*, 14 September 1992] found that at year-end 1991, only 173 firms (8.7 %) of the country's top 2,000 corporations are publicly held, i.e., with at least 20 shareholders . Companies listed in the country's stock exchanges constitute only 0.3 % of actively operating companies in the country. The preference to remain a closely-held company has been attributed to the fear of owners of losing control over the corporation, disclosure of sensitive information to competitors, and disclosures that could result to higher tax liabilities or to regulatory impositions [Aries Group, 1990]. These are complex concerns whose resolution would require stricter and consistent implementation of financial reporting and tax rules across the entire corporate sector.

The stock market has attracted foreign portfolio capital [see Gomez, 1990]. The Philippines offers attractive yields. Business World [August 4, 1992] cites the findings of Clemente Capital, Inc. and the International Finance Corporation that the Philippines topped the other emerging markets in terms of dollar yields over the period 1988-1991. Though it is admittedly a volatile market (the Philippines was second to South Korea in terms of price volatility over the same period), it does offer foreign investors diversification benefits. Business World [September 30, 1992], citing a study by the US investment research firm BARRA, reports a low correlation between the Philippine stock market and mature markets, e.g., the US, Japan, and UK, over the period February 1986 to March 1991. The recent FOREX deregulation has also enhanced liquidity for foreign investors.

Various proposals have been made to upgrade the operations of the stock markets. The merger of the two stock exchanges is embroiled in a debate over location, although physical merger should be a less compelling issue than conversion to electronic trading on a single board for the two exchanges. The exchanges would also benefit significantly from a more efficient stock transfer system, including the setting up of a central depository.

Table 7. Philippine Stock Market Indicators

	Peso Turnover					Cos Listed			Market Capitalization		
Year	Total	C-I	Mining	Oil	Shares Turnover	New	Total	Capital Raised	Total	% Value Turnover	% to GNP
1976	6,849	363	2,570	3,916	251,799	12		905			
1977	2,517	232	882	1,403	130,439	6		261			
1978	5,384	1,124	1,872	2,387	153,688	6		475	18,379	29.3	10.4
1979	4,976	775	1,929	2,272	130,255	4		425	17,984	27.7	8.2
1980	4,664	950	2,488	1,225	102,395	3		220	26,432	17.6	10.0
1981	1,292	303	622	367	51,828	3		690	14,255	9.1	4.7
1982	1,219	377	449	393	41,792	8		1,292	18,172	6.7	5.4
1983	5,364	3,984	1,235	146	37,113	6		946	19,445	27.6	5.1
1984	2,083	1,402	639	42	23,625	1		315	16,486	12.6	3.1
1985	2,059	1,719	294	47	11,694	4		494	12,741	16.2	2.1
1986	11,470	7,901	3,211	358	58,601	7	129	558	41,214	27.8	6.7
1987	31,523	9,639	15,251	6,633	315,703	10	137	1,707	61,108	51.6	8.7
1988	23,859	11,431	8,746	3,682	270.129	6	141	2,437	88,591	26.9	10.8
1989	53,762	32,074	12,992	8,696	456,276	7	144	4,827	260,470	20.6	27.1
1990	28,230	19,923	4,063	3,883	264,256	9	153	11,337	161,219	17.5	14.2
1991	39,367	32,107	1,295	5,965	279,158	9	161	26,003	297,743	13.2	23.7
1992*	41,260	34,990	806	5,463	214,340	5	166	12,450	436,916	18.9	

* January to June 1992; % turnover annualized (Business World, Aug. 3, 1992)

Sources : Central Bank, Makati & Manila Stock Exchanges, Sun Hung Kai Securities

E. Real Domestic Saving

It is not clear that financial reforms have had the desired effect on real saving in the country. Table 8 shows the gross domestic saving (GDP minus total consumption) as a percentage of GDP [Yap, 1991, and Philippine Statistical Yearbook, 1989].

Table 8. Gross Domestic Saving as a Percentage of GDP

1975	21.4	1983	25.9
1976	23.9	1984	20.9
1977	24.9	1985	17.4
1978	25.3	1986	18.0
1979	26.4	1987	17.0
1980	27.0	1988	17.1
1981	27.0	1989	16.7
1982	26.6	1990	7.6
		1991	15.6

The domestic saving rate was on the rise until 1981, and declined thereafter. This may be largely due to the significant decline in per capita income during the latter period. Hence, the more appropriate question is : did financial liberalization cushion the fall in the real saving rate and help reduce the cost of adjustments to the economic crisis?

III. SUMMARY AND CONCLUSIONS

The paper reviewed the development of Philippine financial markets in the 1980s, covering a full decade of financial liberalization and interest rate deregulation.

Though the deregulation period has been characterized by higher and more volatile interest rates, real rates of return on financial assets have generally remained positive.

The study finds that the extent of financial intermediation in the economy, using broad measures, remained the same from 1975 to 1991, though there was a shift from deposit substitutes to deposits. But these measures do not reflect all possible modes of intermediation. There have been an expansion of off-balance sheet activities and an increased use of direct issues by the corporate sector. Government also heavily competes with the private sector for financial resources.

The long-term capital market remains relatively undeveloped. Contrary to expectations, universal banking has not produced a significant shift to long-term lending or to investments in non-allied undertakings. The positive developments include signs of an emerging long-term securities market and a revitalized stock market.

The financial sector introduced new financial arrangements to cope with the changing environment. New mechanisms for managing increasing interest rate risk have been introduced such as adjustable interest rate instruments and a financial futures market. Rates on government securities are now market-determined, greatly facilitating the pricing of private debt instruments.

The paper points to various areas that can contribute to the development of money and capital markets. Over the long term, the development of financial markets is dependent on greater macroeconomic stability, particularly in prices and interest rates.

The government needs to fulfill its basic roles in financial markets - to design and enforce a regulatory structure that enhances competition and system stability, and assures market participants fair and timely access to relevant information. The paper also urges the introduction of longer-term government securities with varied features to facilitate the development of the capital market.

Finally, financial markets need to develop greater breadth through new issues and greater liquidity. However, these appear to involve wide-ranging reforms in the implementation of corporate and tax rules. ■

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