Reaction Paper on Ybañez's "Philippine Financial Markets Development: a Decade of Deregulation"

By *Manuel Q. Bengson*

The paper reviews the Philippine financial markets in the past decade. It gives useful information (with lots of good tables and charts) and interesting analyses about how well (or poorly) our markets have fared in this first decade of deregulation and interest-rate liberalization. It also identifies outstanding problems that still need to be addressed by our policymakers and, as I see it, areas of opportunity for entrepreneurs and finance practitioners.

It's a good reading material for all, especially for finance executives who wish to give themselves a quick update of recent Philippine financial history. It gives many interesting insights and leads on what to expect in the future. While the paper is not intended, I think, to be an in-depth analysis of the issues and problems raised, it offers the readers the raw material and initial platform for doing a more detailed research of these issues later on.

In particular,what I found most interesting were the following:

Expansion of "Off Balance Sheet" Activities of Banks and Increased Use of Direct Issues by the Corporate Sector.

With interest rates moving up to almost prohibitive levels and characterized by extreme volatility, the effect on the market was as expected. Market players, intimidated by such high and volatile rates, reduced or avoided debt altogether, replacing it with equity or simply shriveling their balance sheet. They looked for various ways to alleviate the heavy burden of high interest rates by availing of needed finance outside the balance sheet of banks. The incentive to find innovative ways is so compelling because intermediation costs could rise, as they did, to as much as 4% to 8% per annum.

Notwithstanding the regulatory implications, the market would always look for cost alleviations which are legally defensible. With the liberalization of foreign exchange rules, more cost-alleviation possibilities and entrepreneurial opportunities have developed. Now, the possibilities go beyond being able to secure finance outside the balance sheets of banks. They now include possibilities outside our currency and country.

The danger of course is when these new possibilities go out of control and result in abuses and losses to the general public as was experienced in the early '80s. Not only do these abuses invite regulation, they also lead to a rapid erosion of investor confidence quickly followed by a contraction of financing outside the balance sheet of banks.

Why the Long Term Debt and Capital Market Did Not Develop Enough During the Period

It is probably another market phenomenon that market players are generally easily intimidated by high and volatile rates. This is obvious in borrowers' preference for short-term borrowings in order to avoid locking themselves in to high costing loans for long periods. Funds providers also develop a strong bias for short tenors because they maintain the hope that a higher yield awaits them at each rollover date. The dealers are also easily affected by the mindset of these borrowers and lenders, and they really don't have a choice.

Since it is also not advisable to allow the bunching of maturities in the short term because of the risk involved in doing so, the market again responded logically by discovering longer-term loans with frequent interest-repricing features as a way of avoiding or minimizing interest rate risk.

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While the stock market is becoming increasingly attractive to savers/investors (as common stocks provided the highest after-tax rates of return and risk in Philippine financial markets), the Philippine capital market is still far from being fully developed. In terms of size, the Philippine market is still one of the smallest in Asia: only 161 listed companies with a total market capitalization of US$17 billion (even lower than Indonesia's US$20 billion) and an average daily turnover of US$25 million (Figures as of end June, 1992).

In an address delivered by Mr. Kimimasa Tarumizu, President of the Asian Development Bank, he cited two reasons why the financial markets in developing countries have remained underdeveloped: a) the legal framework in these countries are discouraging the participation of both local and foreign investors in the securities market; b) the institutional weaknesses in capital markets. He also suggested that developing countries, in order to mobilize capital, should: a) improve their credit-worthiness, thus increasing their access to international financial markets, and b) increase their ability to mobilize domestic resources development.

The Thing to Watch: The Huge and Ever-increasing Government Debt and Budget Deficit

The single most important problem at present is the huge government debt and fiscal deficits (including the still-to-be-resolved and still-increasing Central Bank deficit). To keep inflation in check and ensure a healthy balance in the monetary and foreign exchange aggregates, it seems that our financial system has to have high peso interest rates (high enough to ensure a positive rate to savers after providing for inflation).

Because of the huge deficits of government-owned corporations, which officially are not part of the reported fiscal deficits, the pressure for even higher interest rates is obvious. Likewise, because of the high deficit condition of the Central Bank, we seem to have found it almost mandatory and convenient to keep a high 25% reserve requirement. This is a record high in our banking history and is considered among the highest in Asia and the world. Along with the 5% Gross Receipts Tax imposed on banks' interest and other income, the 25% reserve requirement increases the cost of funds of banks by as much as 4% to 8% per annum, depending on market conditions.

Note that the size of government debt as of the end of 1991 was ₱333 billion versus only ₱242 billion for savings and time deposits of the financial system. At the rate government debt is growing every year, it could eclipse the private sector and dominate the financial and credit markets in no time. One could only guess what interest rates might be like at that time, especially when the private sector demand for loans starts rising during a period of economic recovery.

Foreign Investments and Capital Market Initiatives

With the recent liberalization of foreign exchange and the substantial inflows which occurred before and after the actual lifting of forex rules combined with the very successful primary and secondary offerings of shares and debt instruments in recent months, we have good reasons to believe that the trend towards more securitization and financial intermediation outside the balance sheet of banks would now gain speed. With more and better options becoming available to corporate users of funds, we have reason to be optimistic about lower and more stable interest rates and improved functioning of our financial markets. This should provide a strong underpinning for our much awaited economic recovery and growth. ■