IMF WORKING PAPER

WP/90/26

INTERNATIONAL MONETARY FUND

Central Banking Department

The Crisis in the Financial Sector and the Authorities' Reaction: The Case of the Philippines 1/

Prepared by Jean-Claude Nascimento

Authorized for Distribution by V. Sundararajan

March 1990

Abstract

The paper discusses the crisis in the Philippines financial sector that began on a limited scale in 1981 and culminated in a significant contraction of the financial system in 1986. The causes, manifestation and transmission mechanism of the crisis are analyzed and reactions of the authorities to the crisis are examined. The main conclusion is that weaknesses of the regulatory framework and loose banking practices provoked and exacerbated the crisis, while the political and economic climate during 1979-83 also played a key role. In the end, the authorities'interventions to contain the crisis was sucessful but costly.

JEL Classification Number:

121, 310

1/ An earlier version of this paper was presented at the Central Banking Seminar held at the Fund Headquarters on November 28-December 9, 1988. I would like to thank V. Sundararajan for his comments and editorial suggestions during the various stages of the paper. Special thanks are also due to Tomas Baliño, Linda Koenig and Douglas A. Scott for their comments, and to Carl Lindgren, for his comments and for presenting the paper at the seminar.

Table of Contents

Page No.

List of tables

List of Appendix Tables

Page No.

List of Charts

Summary

The Philippines crisis in the financial sector began in 1981 as a limited confidence crisis triggered by fraud in the commercial paper market. The crisis subsequently intensified and, by 1986, culminated in a major contraction of the financial system. Over this period, the two largest investment houses, three commercial banks, and 160 small rural and thrift banks failed. Government financial institutions acquired four private commercial banks in distress, and the two largest state-owned banks, themselves government financial institutions--the Philippines National Bank and the Development Bank of the Philippines--went bankrupt and had to be rescued. Their nonperforming assets (80 percent of their combined assets in 1985) were transferred to a newly created government agency.

This paper analyzes the causes, manifestations, and transmission mechanism of the crisis, as well as the reaction of the authorities. It concludes that weaknesses of the regulatory framework and loose banking practices triggered and exacerbated the crisis. By this mechanism the crisis was transmitted from the financial to the real sector. During 1979-83, the deteriorating macroeconomy and uncertain political climate--conducive to loose banking operations--increased the fragility of financial institutions and led, in October 1983, to a balance of payments crisis, which fed back into the financial sector.

The crisis in the financial sector originated in three sets of factors inside the financial system. First, during 1974-83, improper sequencing of financial reforms led to fraud and mismanagement by many banks. Bank supervision was not tightened. Some regulatory restrictions (e.g., activity regulation) were removed but others (e.g., selective credit) were retained. Second, the dominant bank holding companies engaged in excessive risk-taking with new and inexperienced subsidiaries. The 1981 crisis crippled these subsidiaries, and they then passed on the cost of overdue loans to customers, driving up nominal interest rates. Third, monetary management, complicated by portfolio shifts and credit rationing by banks, crowded out the private sector.

Through financial assistance and restructuring, the authorities restored the soundness of the banking sector, but at high cost to taxpayers. They provided emergency loans to banks and public corporations facing a liquidity squeeze and medium- and long-term loans to government financial institutions to assist them in rescuing troubled entities. The authorities rehabilitated two private commercial banks, initially acquired by government financial institutions, by infusing capital and seeking private partners for mergers. They also rescued the Philippine National Bank and the Development Bank of the Philippines.

I. Introduction

During 1981-86, the Philippines economy faced a major crisis in the financial sector. From 1981 to mid-1987, three commercial banks, 128 rural banks, and 32 thrift institutions failed, and two other private banks were still under intervention. In addition, the biggest commercial bank, the Philippine National Bank (PNB), and the Development Bank of Philippines (DBP), both government owned, became de facto insolvent, and were bailed out in 1986 by a transfer of their non-performing assets (about ₱ 108 billion, equivalent to 80 percent of their combined assets) to the Asset Privatization Trust (APT), specially constituted to administer problem assets. The crisis began on a limited scale during 1980/81 and intensified subsequently, culminating by the end of September 1986 in a significant contraction of the financial system (excluding the Central Bank of the Philippines (CBP). For the purpose of analysis, three distinct phases of the crisis have been identified, based on the dimensions and manifestations of the financial sector problems.

The first phase, which spanned 1981(I)-1981(IV), featured a crisis of confidence triggered by fraud in the commercial paper market. 1/ Although the initial impact of the crisis was limited, as it affected only the small part of the system outside commercial and development banks, whose combined assets accounted for 16.5 percent of total assets of the financial system in 1980, it had a lasting impact on confidence. The commercial paper market collapsed and many nonbank money market institutions were eclipsed. The two largest investment houses belonging to two major holding companies went bankrupt. This, in turn, provoked the failure of the holding companies themselves, leading to the bankruptcy or takeover of their numerous corporate subsidiaries. Wealthholders shifted funds to the highest quality paper and to more stable and conservative banks.

The loss of confidence spread to the thrift banking system. Also, the number of failures of rural banks continued to rise in 1981, following a sharp increase in the previous year. However, the assets of failed rural and thrift banks accounted for only 1.6 percent of the total assets of the banking system in 1981, and the failures among them did not pose a threat to stability, but served to reinforce the weakening of confidence.

1/ This event was known as the Dewey Dee Affair. In January 1981, Dewey Dee, an industrial magnate who had borrowed heavily in the commercial paper market, fled the country leaving behind an estimated ₱ 500 million to ₱ 800 million of debt. The news sent a wave of panic through money market investors and small depositors. The former did not renew their funding, causing commercial paper borrowers to default on a large scale. The small depositors shifted their deposits to large commercial banks, perceived as sounder financial institutions.

The second phase, which spanned 1982(I)-1983(III) featured the intensification of the Government's assistance to nonfinancial and financial institutions. This served to alleviate somewhat the growing distress among nonfinancial corporations, but widened the budget deficit. The Government increased its emergency lending and equity contributions to public corporations, arranged for the takeover of troubled private banks by government financial institutions (GFIs) 1/ in order to facilitate their restructuring and eventual disposition, and supported the takeover by the GFIs of numerous nonfinancial firms in distress. This episode reflected the Government's attempt to prevent widespread private corporate failures and banking problems, while, at the same time, stepping up public investment to offset the slump in private sector investment. This phase was also associated with widespread political uncertainties and a build up of foreign exchange difficulties, which was initially masked by swap and forward cover operations by the Central Bank as well as by irregularities in banking operations. 2/

The third phase, which spanned 1983(IV)-1986(IV), featured a sharp deepening of the crisis. This phase began in the context of widespread uncertainty in the economy, stemming from the unstable political environment of the first half of 1983, and the balance of payments crisis of October 1983. Their effects spilled over to the banking system. Indeed, in October 1983, financial panic was provoked by the authorities' announcement of a moratorium of their external debt payments to foreign commercial banks, resulting in a series of runs on the banks, this time including commercial banks. Both a flight to currency and outflows of capital occurred on a large scale. The recorded capital outflows possibly occurred even earlier, but were obscured by the banking irregularities. The disclosure or sudden loss of reserves in mid-October affected confidence and exacerbated the crisis.

By the end of this phase the hardest hit financial institutions were the two large state-owned banks--The Development Bank of the Philippines (DBP) and the Philippines National Bank (PNB). The depth of the crisis during this third phase is illustrated by: (i) a staggering decline in commercial bank credit to the private sector, which fell by 53 percent in real terms between the end of September 1983 and end of September 1986; (ii) a massive restructuring of the DBP and PNB, leading in November 1986 to a transfer of ₱ 108 billion of nonperforming assets (representing nearly 30 percent of total bank assets) to a government agency--the Asset

---

1/ Government financial institutions include the Development Bank of the Philippines (DBP), Philippine National Bank (PNB), Land Bank of Philippines (LBP), Government Service Insurance System (GSIS), Social Security System (SSS).

2/ Some of these deficiencies are discussed in Central Bank of the Philippines (1988, p. 6; and 1989, p. 15).

Privatization Trust (APT); 1/ This included the transfer of ₱ 23.4 billion of non-performing assets from the Philippine National Bank, which contributed to a decline of 20.5 percent, in real terms, in commercial bank credit to the private sector during the last quarter of 1986; (iii) continued government intervention in weak private banks, and the closing of three private commercial banks. 2/

Thus, the 1980s have been a period of turbulence in the financial system, marked by continuous concern over its soundness and stability.

Against this background, the paper examines the causes and manifestations of the financial sector crisis and the reaction of the authorities to the crisis. It focuses on the behavior of the financial system before and during the crisis, with the view to clarifying the linkages between financial reform, financial crisis, and macroeconomic performance.

The main conclusion of the paper is that factors within the financial system caused and exacerbated the crisis. While the political and economic climate of the late 1970s and early 1980s increased the fragility of the financial sector, weaknesses of the regulatory framework and loose banking practices triggered and exacerbated the crisis. In the end, the authorities' interventions prevented the banking sector from collapsing, though at a high financial cost to taxpayers.

The rest of the paper is organized as follows. Section II discusses the background to the crisis and the role of the macroeconomic and regulatory environment. Section III discusses the manifestations of the crisis with emphasis on money and credit developments. Section IV describes the measures taken to deal with the crisis. Section V contains concluding remarks, and highlights the main findings.

II. The Setting of the Crisis

Three aspects of the overall setting are examined, with a view to highlighting the relative role of factors within and outside the financial system in initiating and exacerbating the crisis. The first aspect consists of the macroeconomic setting and political climate before and during the crisis. The second consists of financial sector structure, and its

---

1/ This agency was set up in December 1986 to take over the nonperforming assets of state banks and to resell them to private investors. In 1986, the worth of these assets was estimated at ₱ 20 billions, i.e., 19 percent of their book value.

2/ The fate of one insolvent commercial bank still remained undecided as of the end of 1987 due to litigation contesting the liquidation.

liberalization initiated in 1972 and completed in 1981. The third aspect consists of prudential regulation and supervision of financial institutions, and related institutional practices.

1. Macroeconomic setting

During the 1970s the economy experienced a strong growth in real GNP, despite a low productivity of investment (see Table 1 and Chart 1). An unprecedented and demand-driven economic boom occurred reflecting the authorities' development strategy based on intensive investment growth. 1/ The financing of the investment boom resulted in a widening of external imbalances and a sharp rise in foreign savings (in percent of nominal GNP) (Table 1). Also, the growth of domestic bank credit, particularly to the private sector accelerated (see Table 2). The PNB and DBP accounted for a substantial portion of credit to the private sector; granted often on the basis of political, rather than economic, considerations.

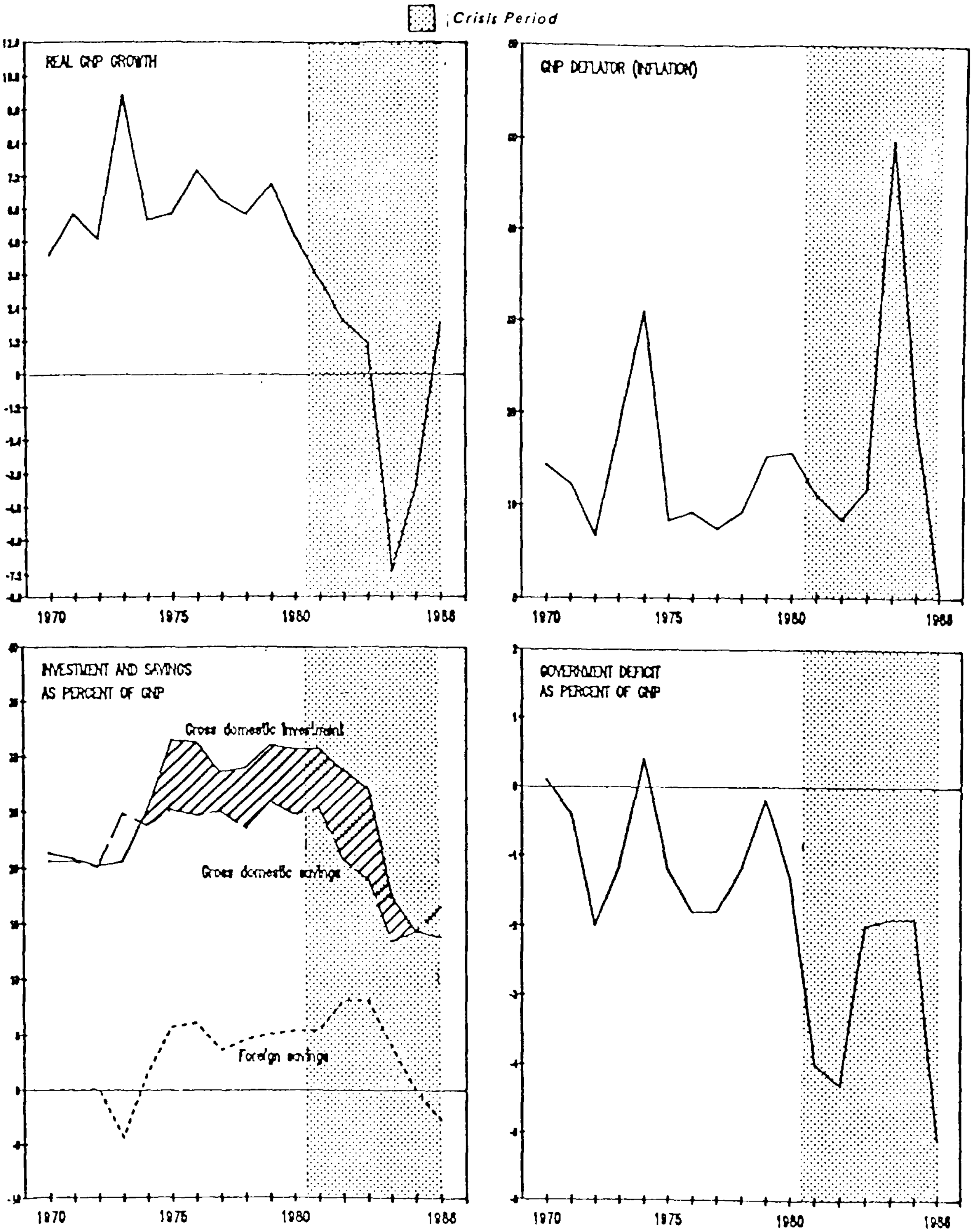
During the late 1970s and early 1980s, the deterioration in world economic conditions further weakened the external position, while the limited confidence crisis of 1981 seemed to dampen investor expectations regarding growth projections; these developments affected adversely private investments in the 1980s. 2/ By the second half of 1983, the impact of rapid expansion in earlier years, the growing uncertainty in the political climate, and unfavorable external conditions combined to cause a balance of payments crisis, which led to the announcement of a temporary moratorium on external debt repayments in October. This event triggered a run on banks, a cut-off of external financing, and some capital flight, all having significant feedback effects on the macroeconomy, particularly the balance of payments. The CBP reacted by injecting reserve money during late 1983 to meet the increase in currency demand (see Table 2). The sharp increase in reserve money during 1983 also reflected large

---

1/ In line with this strategy, the authorities carried out inward-looking and expansionary macroeconomic policies during the 1970s, namely protectionist trade policies, widespread tax incentives and preferential lending by government financial institutions to priority sectors: construction, manufactures and energy.

2/ The sharp decline of private investment (in percent of GDP) in 1980/81 is overstated due to the unreliability of investment data during the 1970-80 period. However, the magnitude of the decline and the downturn in economic growth points to a more sluggish investment in the 1980s compared to the 1970s.

CHART 1.
PHILIPPININES
SELECTED MACROECONOMIC INDICATORS, 1970-86
(IN PERCENT)



Source : IFS(1988); and Table 1.

Table 1. Philippines: Selected Macroeconomic Indicators, 1970-86

(In percent)

	1970	1975	1980	1981	1982	1983	1984	1985	1986
Growth rate of real GNP (at 1980 prices)	4.3	5.8	5.0	3.4	1.9	1.1	-7.1	-4.1	2.0
Implicit GNP deflation (at 1980 prices)	14.5	8.3	15.6	11.0	8.3	11.6	50.0	18.2	1.6
Gross domestic investment (in percent of GNP)	21.5	29.6	30.7	30.7	28.8	27.1	17.4	14.3	13.8
Of which: Private investment 1/	(19.1)	(27.0)	(27.4)	(16.2)	(16.1)	(17.6)	(14.5)	(11.4)	(10.0)
Gross national savings	20.6	25.2	24.8	25.3	20.7	19.0	13.4	14.3	16.5
Of which: Private savings	(18.6)	(21.8)	(19.4)	(21.1)	(16.5)	(14.5)	(11.9)	(13.2)	(17.8)
Foreign savings (in percent of GNP)	--	5.8	5.4	5.4	8.1	8.1	4.0	0.1	-3.3
National Government balance 2/ deficit (-) (as percent of GNP)	--	-1.1	-1.3	-4.0	-4.3	-2.0	-1.8	-1.8	-5.1
Net foreign assets (in billions of pesos)	-0.6	2.8	-21.1	-30.1	-50.5	-95.3	-125.0	-94.0	-28.5
CPI (inflation rate)	14.0	8.2	18.2	13.1	10.2	10.0	50.3	23.1	0.7
Real GNP per capita (in thousands of pesos)	3.9	4.64	5.47	5.52	5.50	5.43	5.03	4.7	4.6
External debt/GNP	...	31.3	48.9	54.4	62.8	72.7	80.6	81.7	92.9
Of which: Total short-term/GNP	(...)	(12.4)	(21.2)	(24.9)	(22.4)	(37.9)	(37.3)	(32.7)	(19.0)
(From commercial banks	(...)	(6.3)	(19.5)	(11.5)	(12.4)	(10.9)	(11.0)	(7.7)	(2.7)
Debt service ratio 3/ Exports of goods and services	29.2	16.1	20.9	25.2	38.1	38.9	44.6	48.3 4/	46.9 4/
Of which: Share of interest payment	(29.8)	(38.6)	(58.5)	(63.3)	(65.2)	(62.7)	(65.2)	(57.7)	(50.6)
Exchange rate (peso/U.S. dollar at end of period)	6.4	7.5	7.6	8.2	9.17	14.0	19.8	19.0	20.5
Terms of trade (growth rate)	17.0	-46.0	-15.9	-12.0	-2.8	4.4	-2.3	-6.6	7.5
Memorandum Item:									
Consolidated public sector balance; deficit (-) (in percent of GNP)	--	--	-3.9	-5.8	-5.3	-9.0	-8.2	-5.9	-5.4

Sources: IMF, International Financial Statistics, 1986, and staff estimates.

1/ Figures for 1970-80 are official data from the National Economic and Development Authority or NEDA; these data are overstated and thereby not comparable with the 1981-86 series, which represent Fund staff estimates.

2/ Includes losses of Government financial institutions (PNB, DBP and the CBP).

3/ Before rescheduling.

4/ Preliminary

losses on swap operations. 1/ As a result, inflation and the depreciations of the peso accelerated during 1983/84.

The subsequent tightening of monetary policy, the soaring interest rates during 1984/85, and the continued devaluations of the peso all contributed to the spread of distress among financial and nonfinancial corporations. Indeed, the high level of real interest rate and the peso devaluation aggravated the debt-servicing problems of firms with foreign currency debt. 2/

With very high interest rates, growing uncertainties, and weakening of confidence, aggregate demand dropped, leading to a deep recession. Bank credit, especially to the private sector, fell sharply in real terms.

2. Financial liberalization

To finance the development strategy based on intensive investment growth, the CBP introduced numerous reforms during the 1972-81 period. Institutional reforms included the liberalization of capital controls. Regulatory reforms included a progressive interest rate liberalization, and the introduction of "universal banks". Prudential reforms included the elimination of restrictions on the entry of foreign banks and on their equity participation in domestic banks, and the higher barriers to entry for domestic banks (e.g., higher minimum capital requirements).

a. Liberalization of foreign capital controls

The policy measures are presented below, followed by a discussion of their impact on the external debt burden and the financial structure of nongovernment entities. Evidence shows that the liberalization, together with lending practices largely influenced by political considerations, contributed to increasing the financial fragility of these entities;

1/ These losses amounted to about ₱5 billion in the last quarter representing half of the yearly increase in reserve money from end-1982 to end-1983.

2/ The share of foreign currency debt in the total debt of the non-government sector rose from an average of 44 percent during 1980-82 to 60 percent during 1983-85 (see next para.).

(1) Measures

During the 1970s, the CBP introduced the Foreign Currency Deposit (FCD) system, created Offshore Banking Units (OBUs) and eased controls on direct foreign investment. These measures aimed at attracting foreign capital, and permitting wider portfolio selection for domestic investors.

Under the FCD system, resident and nonresident nationals could hold foreign currency deposits with eligible banks. 1/ In turn, the CBP allowed FCD banks to make either foreign currency loans to domestic residents subject to prior CBP approval, or peso loans after these banks had converted their foreign currency into pesos under a swap arrangement with the CBP. 2/ Secrecy laws protected investors' deposits. Depositors were also free to withdraw their funds or transfer them abroad. Interest rates on these foreign currency deposits were unregulated. Beginning in 1978, these banks' foreign exchange operations were subject to open-position limits. 3/

Under the OBU system, both domestic banks and nonresidents were allowed to hold foreign currency deposits with OBUs. Their lending operations required prior CBP approval. However, banks operating under the FCD and OBU systems were not allowed to make loans of a maturity exceeding 360 days.

The relaxation of foreign capital controls included the following measures: (1) foreign direct cash investment made after March 1973 became freely repatriable; (2) foreign-owned companies were granted authorization to raise loans in domestic currency; (3) foreign banks were allowed to take equity participation, with minority or majority ownership, in domestic banks (see below). Though significant capital controls

---

1/ Eligibility criteria included mainly competence in the conduct of foreign exchange operations as well as the minimum unimpaired capital requirement. Liability restrictions consisted of holding a minimum foreign currency reserve ratio with the CBP. Furthermore, foreign exchange receipts from exports and most invisible transactions could not be deposited in these FCD accounts.

2/ Banks were prohibited from converting foreign currency into pesos outside swap arrangements with the CBP.

3/ Under Circular Number 547 issued in 1978, banks were required to cover, at least, 70 percent of the foreign currency liabilities with eligible assets in the same currency. This foreign currency cover included: deposits with the central bank and other Philippines-based commercial banks, deposits with foreign banks and OBUs, foreign currency loans or securities, foreign currency notes and coins, and foreign currency swapped with the central bank.

remained, the removal or relaxation of restrictions stimulated capital inflows.

(2) Overindebtedness and unsound debt structure

Reflecting the impact of these developments, and of the foreign financing of the investment boom, the external debt burden rose sharply while the maturity of this debt shortened (see Table 1). These developments invalidated the view that liberalization of capital controls would reduce foreign borrowing. 1/ Rather, they suggest that the capital flow liberalization contributed to excessive external borrowing, which permitted domestic investment to accelerate prior to the crisis. 2/

Incomplete financial reforms combined with the political climate encouraged such borrowing. Indeed, while they eased capital controls, the authorities maintained controls in other areas such as credit allocation and trade transactions. 3/ Excessive foreign borrowing and domestic protection contributed to weakening the financial position of nongovernment entities prior to the crisis.

As large foreign capital inflows exerted strong inflationary pressures during the second half of that decade, real lending rates became negative by 1980. (see Table 2). Along with high trade barriers, these negative rates created widespread misallocation of resources, and encouraged debt finance. Indeed, during the 1970s, enterprises and banks had relied heavily on debt finance, especially foreign, to expand their activities. 4/ Consequently, the total outstanding debt of the nongovernment sector (both in real terms and in percent of national income) doubled between 1972 and 1980; the share of this debt denominated in foreign currency quadrupled to 40 percent in 1980 (see Table 3). For enterprises, the changes in the level and structure of indebtedness was even more

---

1/ According to McKinnon (1973), freer capital flows would deter capital flight and boost the national saving rate, thereby reducing external borrowing.

2/ As Fry (1988) notes: "...foreign capital flow liberalization can stimulate investment more than domestic savings, causing excess indebtedness." (p. 345).

3/ For instance, banks were required to allocate 15 percent of their total deposit base for credit to the rural sector. This was known as the agri/agra requirement. Other portfolio restrictions included banks' minimum holdings of government securities. Furthermore, selective credit policies designed to allocate credit to priority sectors (e.g., exports of traditional products) were maintained. DBP was a main conduit for the channelling of these funds to the priority sectors.

4/ Individuals also resorted to domestic debt to finance their rapidly rising consumption level.

Table 2. Philippines: Monetary Conditions, 1970-86

	Reserve Money			Liquidity 1/			Bank Credit 2/		Interest Rates (in percent)		
	Total	Of which: Currency with the public	Of which: Excess reserves	Total	Of which: M1	Of which: M3	Total	Of which: To private sector	12-month treasury bill	Lending rate (one year and less)	Deposit rate (one year and less)
	(In billions of pesos)								(In nominal terms)		
1970	3.2	2.4	-0.5	9.1	4.3	9.1	10.6	8.1	13.7	12.0	6.5
1975	7.1	4.8	...	34.9	10.3	34.9	32.8	26.9	10.9	12.0	9.0
1980	17.0	10.2	0.6	79.2	22.5	79.2	94.6	79.7	12.8	14.0	14.0
1981	18.7	11.6	-0.4	87.2	23.5	82.1	114.3	97.0	13.1	16.0	15.3
1982	19.7	12.7	0.1	99.7	23.5	95.3	133.1	110.1	15.0	16.8	14.1
1983	29.1	19.6	-3.4	118.6	32.5	113.0	173.6	139.9	14.9	18.8	13.7
1984	34.9	21.8	-1.8	139.5	33.6	120.4	183.3	139.4	41.5	26.7	23.2
1985	39.9	24.1	-3.1	178.7	35.8	132.8	171.5	115.3	35.1	28.8	21.8
1986	52.3	29.3	-0.2 4/	205.9	42.6	141.4	118.9	89.2 5/	13.2	17.1	12.3
	(In billions of pesos at 1980 prices)								(In real terms) 6/		
1970	12.7	9.5	-2.0	36.9	16.9	36.9	42.5	31.6	-1.6	-3.3	-8.5
1975	12.7	8.5	...	51.7	18.4	51.7	59.8	48.3	4.1	5.2	-1.5
1980	17.0	10.2	0.6	79.2	22.5	79.2	89.9	75.8	-5.4	-4.2	-4.2
1981	16.5	10.3	-0.4	74.7	20.1	70.3	97.8	83.0	0.1	2.9	2.2
1982	15.8	10.2	0.1	78.1	18.4	74.6	104.3	86.2	4.8	6.6	3.9
1983	21.2	14.3	-2.5	78.9	17.1	73.1	115.5	93.1	-4.9	8.8	3.7
1984	16.9	10.6	-0.9	58.7	14.2	50.7	77.1	58.6	8.8	-23.6	-27.1
1985	15.7	9.5	-1.2	69.8	14.0	51.9	67.0	45.6	12.0	5.2	-1.3
1986	20.4	11.5	-0.1	80.7	16.7	51.3	46.5	35.0	14.4	16.3	11.5

Sources: IMF, International Financial Statistics, 1987; and data provided by the authorities.

1/ Starting in 1981, it includes treasury bills and central bank certificate of indebtedness (CBCIs) held outside the banking system. Thus, between 1970 and 1980, liquidity is equal to M3 which includes demand, savings and time deposits collected by the banking system.

2/ Starting in 1977, a new classification was adopted by the authorities.

3/ Between 1970-80, excess reserves were calculated by multiplying the required reserve ratio by the deposit base and subtracting the result from bank reserves. Afterward, data are from IMF (RED).

4/ End of November.

5/ After transfer of ₱23 billion of nonperforming loans from the PNB to the Government.

6/ By substracting inflation rate as measured by the CPI in Manila.

dramatic. As a result of these changes, the quality of banks' portfolios (especially of the DBP and PNB), and soundness of their liability structure had deteriorated by 1980.

The rise in the debt burden and the weakening of the liability structure of nongovernment entities accelerated until 1983, reflecting the end of the economic boom and deterioration in the political and economic climate during that period. Thereafter, a massive liquidation of debt took place as domestic and foreign creditors curtailed sharply the supply of funds (see Tables 1 and 3).

b. Interest rate liberalization

The main reforms are presented first, followed by a discussion of the behavior of interest rates following the reforms. The statistical analysis below suggests that despite a fairly open capital account, domestic monetary conditions played a significant role in explaining the behavior of interest rates after the liberalization. During 1984-86, these conditions, reflected in indicators of excess demand for real money (M3), were influenced largely by the uncertain environment, and the CBP policy efforts to bring down inflation.

(1) Reforms

During the 1970s the CBP administered the level and structure of interest rates. The CBP tried to maintain positive rates in real terms and to keep nominal interest rates aligned with foreign interest rates. In 1976, the usury law was abolished and the CBP introduced ceilings on money market rates applied to deposit substitutes. 1/

In 1981, the CBP deregulated all bank rates except short-term lending rates. Ceilings on all deposit rates were lifted in July; those on medium- and long-term lending were lifted in October. The ceiling on short-term lending rates was eliminated at the end of 1982. Meanwhile, in March 1982, both a Prime Rate and a Manila Reference Rate (MRR) began to be compiled and announced in order to enhance transparency in the credit and deposit markets. 2/

1/ This measure was aimed at curbing the flow of financial savings from bank deposits into deposit substitutes whose yield was unregulated. The ceilings on short-term deposit substitutes was set at 17 percent in 1976, and then lowered to 16 percent in 1978. These ceilings were higher than the rates on savings and short-term time deposits.

2/ Under the Prime Rate system a sample of 10 commercial banks publicized regularly the rate that they charged to their best customers on a 90-day loan. Under the MRR system, the CBP compiled an average cost of bank funds--of 30-day, 60-day and 90-day maturity--from a sample of 10

Table 3. Philippines: Indicators of Indebtedness of the Nongovernment Sectors

	1972	1980	1981	1982	1983	1984	1985
Debt, by borrowers	(In billions of pesos at 1980 prices; end of period)						
Total nongovernment 1/	104.5	246.7	255.8	281.3	320.6	245.3	185.9
Enterprises 2/	(30.2)	(117.4)	(123.7)	(134.2)	(169.1)	(133.4)	(95.3)
Commercial banks	(62.5)	(113.7)	(116.6)	(131.5)	(136.0)	(101.3)	(84.5)
Individuals	(11.8)	(15.6)	(15.5)	(15.6)	(15.5)	(10.6)	(6.1)
Denomination of the debt	(In percentage of total)						
Nongovernment							
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
In pesos	90.0	60.9	52.4	55.1	45.0	38.7	37.0
In U.S. dollars	10.0	39.1	47.6	44.9	55.5	61.3	63.0
Enterprises							
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
In pesos 3/	100.0	42.4	37.7	34.1	24.9	15.8	12.2
In U.S. dollars	--	57.6	62.3	65.9	75.1	84.2	87.8
Commercial banks							
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
In pesos	83.0	74.7	74.9	71.2	64.8	62.4	67.7
In U.S. dollars	17.0	25.3	25.1	28.8	35.2	37.6	32.3
Debt burden ratio	(In percent of nominal income of each sector)						
Nongovernment	65.7	116.9	120.5	131.9	155.9	141.6	115.3
Enterprises	20.0	55.6	58.3	63.0	82.2	77.0	59.1
Banks' debt/equity ratio							
Memorandum items:							
Enterprises foreign debt (In billions of U.S. dollars)	--	8.9	10.8	12.4	13.4	14.0	12.8
Of which: Short-term	(--)	(2.5)	(3.7)	(4.0)	(4.0)	(4.2)	(3.0)
CPI index: 1980=100	28.8	100.0	114.6	126.8	147.1	246.1	290.8
National income 4/ (at current prices)	45.8	211.0	243.2	270.4	302.4	426.2	468.8

Sources: Central Bank of the Philippines, Statistical Yearbook, 1982; Philippines Financial Statistics, 1982-1986; and IMF Recent Economic Developments, 1982-1986.

1/ Domestic and foreign debt (converted into peso at the peso/US$ rate at end of period) of the nongovernment sector composed of enterprises, commercial banks, and individuals.

2/ Composed of private and public corporations, single proprietorships, partnerships and associations, and coperatives. The overwhelming share of the debt belonged to corporations.

3/ Excludes the peso loans that were relent by the Central Bank of the Philippines or or a commercial bank. As the ultimate borrowers (i.e., enterprises) assumed the exchange rate risk, this debt was included in foreign debt contracted in U.S. dollars. These data exclude also: past due loans, items in litigation, domestic and foreign bills, "clean".

4/ Calculated by netting out indirect taxes (net of subsidies) and income plus profit taxes from nominal GNP.

(2) Determinants of interest rate levels

Following the liberalization, nominal interest rates first rose gradually, then shot up in 1984-85, before declining in 1986 (see Chart 2). Despite a fairly open capital account, foreign factors (e.g., foreign interest rates and expected exchange rate changes) were not the sole determinants of nominal interest rates after the liberalization.

Indeed, the uncovered interest arbitrage relation explained only part of the interest rate fluctuation during 1981(I)-1986(IV). Empirical equations for domestic interest rates (nominal) indicated that the estimated short- and long-run coefficients of the foreign interest rate (adjusted for ex post devaluations) were 0.1 and 0.5, respectively (see Table 4). 1/ The estimated coefficient of the dummy variable was statistically insignificant, pointing to a stable interest arbitrage relationship before and after the announcement of the moratorium. In order to test the significance of domestic factors affecting nominal interest rates, a more general relationship was estimated by including a variable reflecting monetary disequilibrium. 2/ The statistical significance of this variable (defined as the difference between actual M3 and the estimated value of the demand for money, both in real terms) was

---

commercial banks. These costs of fund were market-determined and known as the Manila Reference Rates or MRRs.

1/ A simple uncovered interest arbitrage equation was estimated over 1981(II)-1986(IV). Since the financial market was assumed to adjust with a lag, a lagged dependent variable was introduced in the tested equation. A dummy variable (1 during 1981(II)-1983(III), and 0 for the remaining quarters) was added to detect the presence of a structural shift in the equation after the announcement of the debt moratorium. The Orcutt-Cochrane estimation procedure was used. The results, reported in Table 4, were quite satisfactory. The coefficients for the foreign interest rate (adjusted for ex post devaluation), and the lagged dependent variable were significant at a 5 percent significance level.

2/ The empirical specification builds on Edwards and Khan (1985). Domestic interest rate is related to a weighted average of the foreign interest rate adjusted for expected exchange rate changes and of domestic factors, namely, monetary disequilibrium, expected inflation and the long-term equilibrium rate of interest in real terms--a constant. Equations were estimated by Cochrane-Orcutt procedure, and two types of tests were performed. First the interest rate equation was estimated in an unrestricted form and then in a restricted form which posited that the liquidity effect was absent (i.e., monetary disequilibrium has no short-term effect on the real interest rate); a Chow test was applied to test the statistical significance of this restriction. Second, a dummy variable was used to test the stability of the slope coefficients during 1981(I)-1983(III) and 1983(IV)-1986(IV).

evidence of the strong presence of "liquidity" effect on nominal interest rates (see Table 4).

This liquidity effect was governed by both the CBP policy stance and banks' behavior. During 1982-83, expansionary policies created an excess supply of real balances which in turn put downward pressures on interest rates (see chart 2). Though the expansionary stance was maintained in the first half of 1984, a shortage of real balances emerged due to the sharp decline in the money multiplier beginning in 1984, putting a strong upward pressure on interest rate; the fall in money multiplier reflected banks' cautious lending policy in the presence of widespread economic uncertainty. The upward pressure on interest rates persisted in 1985-86, as the monetary policy stance became tight (see Chapter III).

(3) Determinants of interest rate structure

The gross margin between lending and deposit rates fluctuated around an average of 4 percentage points during 1980-84, and has risen sharply during 1985-86 (see Table 5). 1/ However, based on quarterly data, this margin was often larger and fluctuated sharply, particularly for short-term rates (see Chart 3). The larger margin for short-term rates was due to an inverted term structure of bank lending rates, the latter reflecting strong inflationary expectations in response to growing macroeconomic imbalances and large devaluations. Indeed, bankers took a cautious stance, incorporating a risk premium for inflation in their lending rates [see - Buhat (1986)]. 2/ Also, the gross margin between the short-term lending rate and the 90-day MRR rose steadily until 1983(III), reflecting a decline in the MRR soon after its introduction (see Chart 3). Fry (1988) suggested that the initial decline in the MRR pointed to oligopolistic pricing, while Buhat (1987) interpreted this decline as a move by banks to offset the increase in other elements of their costs of funds (e.g., cost of promotional campaign for deposits). Evidence supports the latter, especially in view of the low concentration ratio in the banking industry (see below) and of the evolution of the net interest margin.

1/ Using a weighted average interest rates on secured loans (lending rate) and MRRs (banks costs of funds) for a sample of 10 commercial banks; these refer to annual rates (period average).

2/ The gross interest margins (for short-term rates) was regressed on inflation, the ratio of overdue to total loans outstanding, and the Herfindahl-Hirschman ratio (a measure of concentration in the banking industry) to identify the determinants of banks' gross spread after the liberalization. Only inflation and overdue loan ratios were found statistically significant; the other coefficient had the right sign (see Appendix Table 1).

Table 4. Philippines: Estimates of Selected Financial Relationships, 1981(II)-1986(IV) 1/

Estimated Equations: 2/

Dependent Variable	Estimated Coefficients								
1. Demand for money: 3/	Constant	Dummy variable	Real GNP	Actual inflation	M_t/P_{t-1}	Rho	Rss	Adjusted R^2	DW
Real M3	-4.695	(0.076)	0.082	-0.001	0.783	-0.009	-0.002	0.998	1.989
	(-24.031)	(10.646)	(1.769)	(-10.515)	(41.968)				
2. Uncovered interest arbitrage: 4/	Constant	$(i^* + e)_t$	i_{t-1}			Rho	Rss	Adjusted R^2	h-statistic
Deposit rate (i_t)	1.165	0.097	0.726			-0.018	135.1	0.824	-0.103
	(0.860)	(3.889)	(7.704)						
3. Generalized version of interest rate equation: 5/	Constant	$(i^* + e)_t$	EMS_t	i_{t-1}		Rho	Rss	Adjusted R^2	h-statistic
Deposit rate (i_t)	0.267	0.092	-0.511	0.799		0.017	118.7	0.877	0.094
	(0.226)	(4.368)	(-1.861)	(9.495)					

1/ Quarterly average data; figures in parentheses represent the t-statistic whose critical value at 95 percent significance level is $t_c = 1.708$ for 25 observations.

2/ Their specification posits a slow market-clearing process. Thus, the estimates reported are short-term coefficients with the coefficients of (M_t/P_{t-1}) and i_{t-1} representing the adjustment lag coefficient in equations (1), (2), and (3), respectively.

3/ The demand for real money (defined as M3) was assumed to depend positively on real GDP, and negatively on inflation used as the opportunity cost variable capturing the substitution effect between money and goods. The adjustment process in the market for real money assumed that prices adjust to monetary imbalance with a time lag of such that $\ln P_t - \ln P_{t-1} = [\ln M_t - (\ln m^d/P_{t-1})]$. The estimated equation was specified in semi-log linear form. The reduced-form equation of this demand for money was tested, using an Orcutt-Cochrane procedure. The dummy variable taking a value of 1 before the announcement of the moratorium, and 0 thereafter was included to test the presence of a structural shift between these two periods.

4/ A constant was added to this regulation to assess the presence of persistent deviation between domestic and foreign rates. Following a liberalization of foreign capital flows, the constant is expected not to be significant while the long-run coefficient of $(i^* + e)$ would be close to one. Due to an adjustment lag, the short-term coefficient could be much lower than 1 within the period.

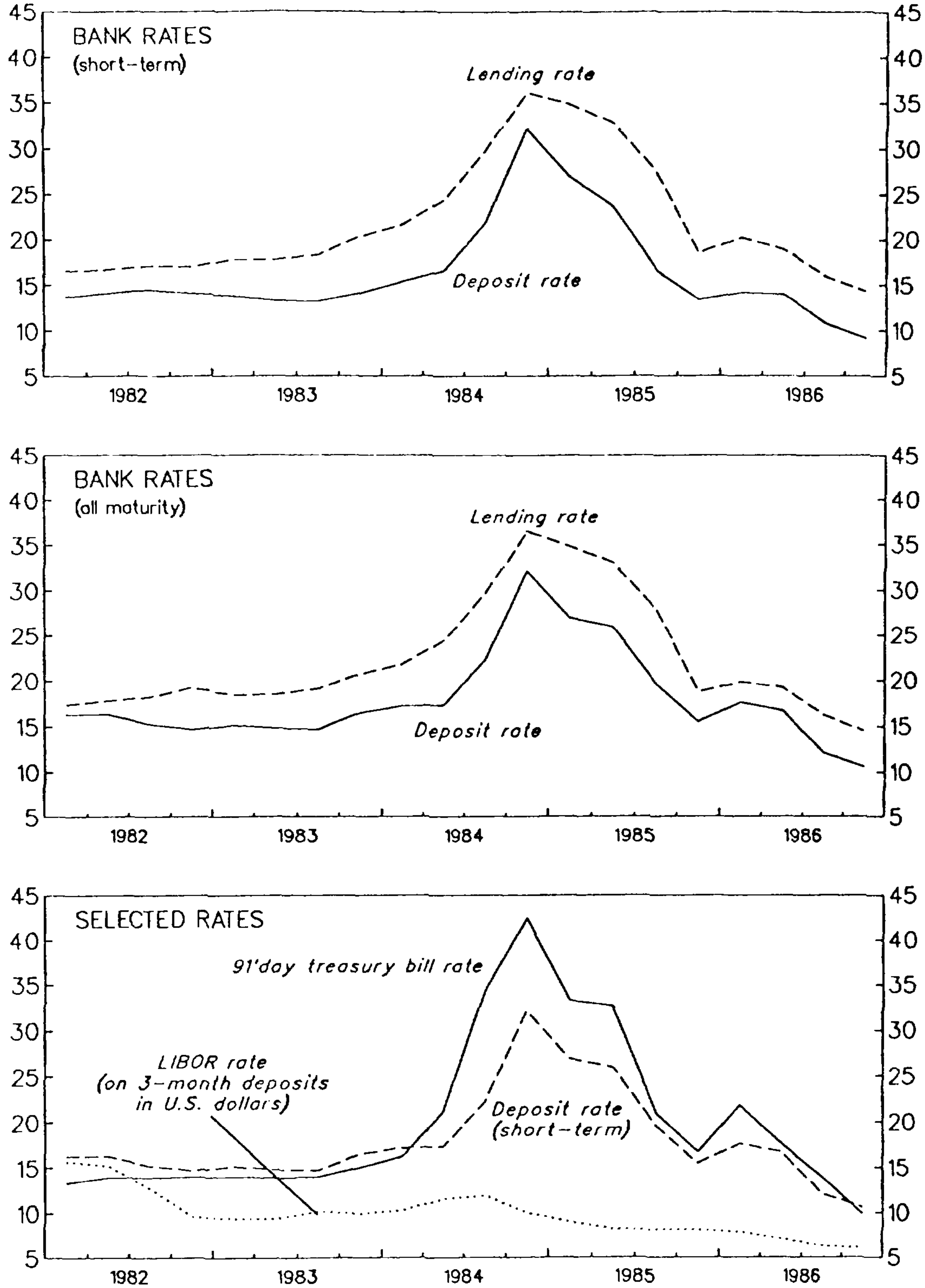
5/ In essence, this equation tests the presence of a "liquidity" effect in the uncovered interest arbitrage relationship. In the short-run, an excess supply of real money (demand) would cause the real interest rate to decrease (fall); through the Fisher equation, this would cause the nominal interest rate to fall (rise). The monetary disequilibrium variable (i.e., actual real money minus the predicted value of the estimated demand for real money--equation (1)) is negatively correlated with the interest rate.

CHART 2

PHILIPPINES

MOVEMENTS OF NOMINAL INTEREST RATES, Q1 1982–Q4 1986

(In percent per annum; period average)



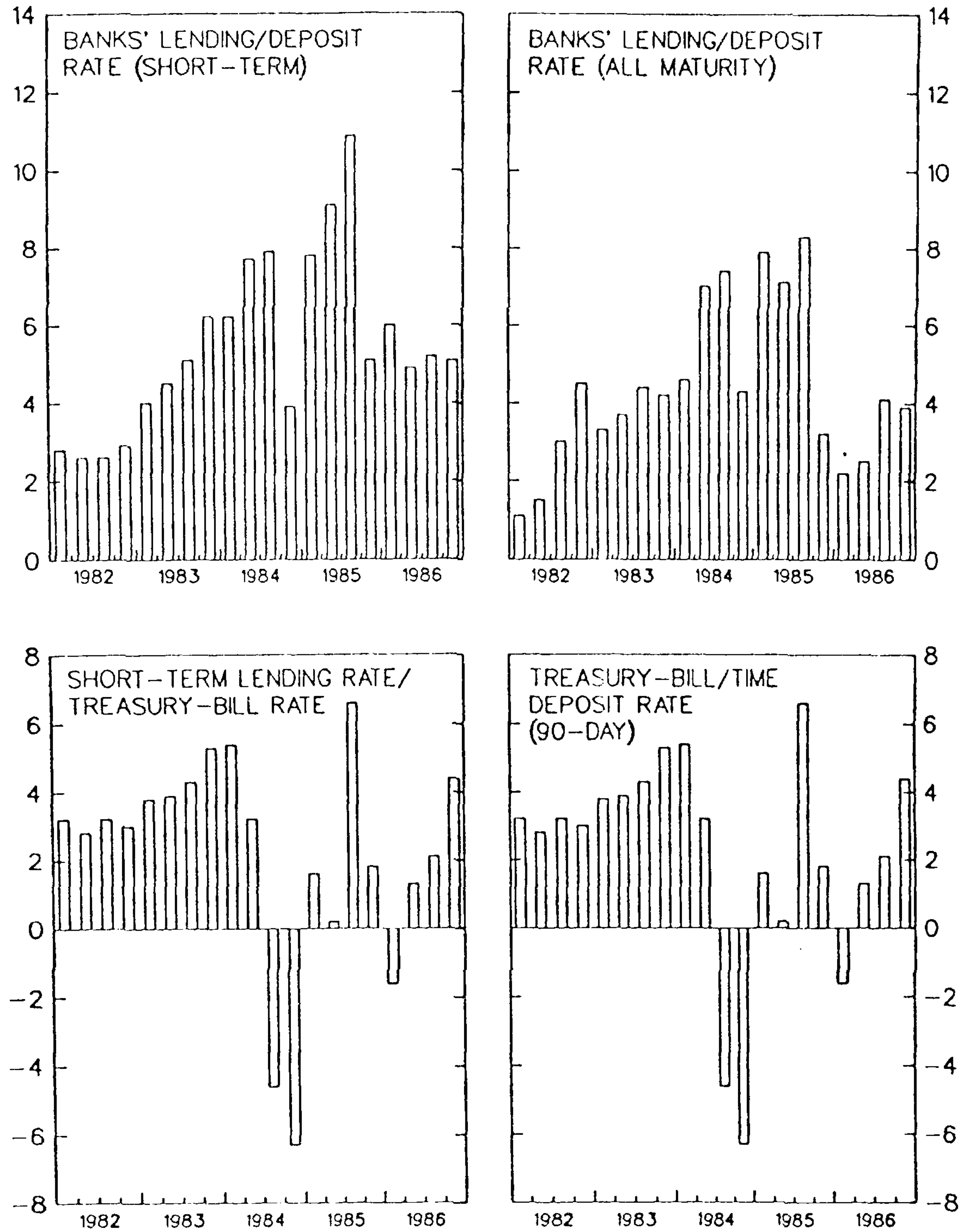
Source: Central Bank of the Philipppines, *CB Review, Vol. 38 and 39.*

CHART 3

PHILIPPINES

BANKS' GROSS INTEREST MARGINS, Q1 1982–Q4 1986

(In percent per annum; period average)



Source: Central Bank of the Philippines, *CB Review*, *Vol. 38 and 39*.

Table 5. Philippines: Banks' Interest Margins, 1970-86
(In percent; period average)

	Gross Margins	Net unitary income (i_n)						Net Margins
	$i_L - i_d$	r	i_r	i_L^n	$i_r.r$	$i_a.a(1-r)$	i_n	$(i_n - i_d)$
1970	6.8	20.0	3.0	8.88	0.60	0.00	9.48	5.18
1975	7.4	20.0	3.0	7.94	0.60	1.31	9.85	4.95
1980	4.5	20.0	3.0	8.72	0.60	1.54	10.86	1.86
1981	3.6	20.0	3.0	9.82	0.60	1.58	12.00	0.40
1982	3.0	18.0	3.0	12.05	0.54	1.85	14.44	-0.76
1983	4.3	23.0	1.0	12.00	0.23	1.72	13.95	-1.05
1984	4.5	24.0	4.0	16.38	0.96	4.73	22.07	-0.13
1985	7.1	24.0	4.0	17.31	0.96	4.00	22.27	1.17
1986	6.4	22.0	4.0	11.40	0.88	1.54	13.82	2.12

Source: Central Bank of the Philippines, CB Review, Vol. 39, February 1987.

Definitions:

$i_L - i_d$ = difference between lending (i_L) and deposit rate (i_d), as defined in footnote 1 page 14.
r = Required reserve ratio
i_r = Interest rate on required reserves deposited at the CBP.
i_L^n = Net interest rate on lending operations:

$$i_L^n = i(1 - t)(1 - a)(1 - r)$$

t = Gross tax receipts on lending operations; t = 5 percent on each unit income from lending.
a = Agri/agra required ratio; a = 15 percent of banks' loan portfolio
i_a = Interest rate on treasury bill which banks can hold to meet other agri/agra required ratio

$$i_n = i_L^n + i_r . r + i_a . a(1 - r)$$

The net interest margin--after allowing for the cost of reserve requirements and other regulatory factors 1/ --fell sharply during 1980-83 but rose during 1984-86 (see Table 5). The regulatory factors contributed about 5 percentage points to the average intermediation cost during 1983-86; their impact on the marginal intermediation cost was even higher--around 8 percent--particularly in times of inflation and high interest rates. Thus, the reserve requirements and other regulatory factors served to raise the borrowing costs of firms disproportionately, which aggravated the crisis. As noted earlier, the rising overdue loans also contributed to widening the margins--to reflect risk premiums--thereby further increasing borrowing costs. The rising loan losses, the resulting caution in lending policies by banks, served to raise lending rates, and also the gross and net margins, particularly during 1984 and 1985.

c. Monetary control reforms

The reforms of monetary policy instruments facilitated greater interest rate flexibility and rapid adjustments to major shocks, but the financial crisis itself strongly influenced the evolution of the instruments.

First, during the 1970s, the CBP set a uniform legal reserve ratio of 20 percent across both institutions and instruments. In 1980, the CBP announced a plan to lower gradually the legal reserve ratio to 16 percent, beginning in January 1982. The plan was to reduce the ratio by 1 percentage point every six months. During 1982, the plan went into effect as the legal reserve ratio declined from 20 percent to 18 percent at end-1982. Due to the worsening of the crisis, the plan was frozen in 1983; in 1984, the CBP raised the legal reserve ratio to 24 percent in order to contain liquidity pressures.

Second, until 1983, the CBP actively pursued selective credit policies. Special rediscount facilities were opened as an incentive to banks, especially development banks, to extend credit to priority sectors and activities (e.g., food grain production, land irrigation, promotion of small businesses). Following the confidence crisis of 1981, the CBP opened also a special rediscount window for medium- and long-term loans, and equity investment to help government financial institutions finance the takeover and acquisition of troubled entities hit by the crisis. In November 1983, the CBP also opened a liquidity window to counter the increasing pressures on the banking system. However, during 1984-85, the

---

1/ The authorities applied a lower reserve ratio of 5 percent on long-term deposits compared to shorter time deposits which ratio is reported in Table 5. Other regulatory factors include gross receipts tax, agri-agra requirements, and the 3 percent (now 4 percent) interest paid on required reserves.

CBP modified the rediscounting policy drastically. It set access limits on the refinance facilities, raised the rediscount rates to market-related levels, unified the terms of access of these facilities, and finally reduced the number of regular rediscount windows from five to one, in November 1985.

Third, beginning in the mid-1970s, the CBP relied increasingly on open market operations based on its own securities to regulate the domestic liquidity of the banking system. Indeed, until 1981, the CBP used the Central Bank Certificates of Indebtedness or CBCIs, maturity of which was longer than 180 days. 1/ However, in 1983, the CBP stopped their issuance on an auction basis, and sold them on tap at fixed yield. 2/ In 1984, the CBP introduced central bank bills with a maturity of less than 180 days; thereafter, auctions of CB bills would become the main instrument of the dramatic tightening of monetary policy during 1985-86.

Finally, the CBP introduced swap operations in 1982. This instrument, whose importance in the CBP's tool kit increased during the 1980s, aimed at improving the CBP foreign exchange position, and providing liquidity to deposit money banks so as to smooth out short-term interest rates. Due to the fall of the peso, the CBP made huge foreign exchange losses on these swap operations.

On the whole, the above reforms had positive effects since they allowed the CBP to react promptly to the numerous monetary shocks (e.g., bank runs, portfolio shifts, increased domestic financing of budgetary deficits) buffeting the economy during 1983-86, and to transmit its policy actions to the banking system swiftly via interest rates. Through high interest rates, the CBP was able to meet its reserve money targets, and bring down inflation by 48 percentage points within two years as inflation stood at 1.8 percent in 1986. 3/ The adaptations of discount window policies served to prevent a collapse of the banking system.

However, the timing and sequencing of some measures seemed to exacerbate instability. In view of rising expectations about further devaluation of the Peso/US$ rate due to a persistent weakening of the

---

1/ Due to their unattractive features and low budgetary pressures, treasury bills played no role in the conduct of open market operations. After an unsuccessful attempt to restore the primacy of treasury bill issues in 1981, the CBP pursued until 1986, the conduct of open market operations using primarily its own securities.

2/ Treasury bill issues were also being sold on tap at that time.

3/ The management and impact of monetary policy at the height of the crisis, i.e., during 1984-86, are discussed in greater detail in Chapter III, Section 2 external position and accelerating rate of devaluation of the peso during 1979-82, the introduction of swap operations with foreign exchange guarantee seemed ill-timed; the CBP was able to finance unsustainable balance of payments deficits, but at the risk of taking large exchange losses, should the trend in the Peso depreciation continue. 1/ Furthermore, the opening of numerous special rediscount facilities in addition to the emergency facility during 1981-83 was inconsistent with the interest rate deregulation, insofar as the access to these facilities by financial institutions weakened the effectiveness of open market operations. This is because banks could obtain refinance from the central bank at below market rate, and at their initiative. As expected, these measures had inflationary effects over this 1981-83 period. The appropriate sequencing of the regulatory reforms would have required that the rediscount mechanism be modified while interest rates were deregulated, not after.

d. Banking structure

(1) Measures

Over the 1971-81 period, the CBP attempted to consolidate the domestic banking system, while promoting greater competition by allowing foreign banks to enter. In 1972, the CBP raised substantially the minimum capital requirement for all banks (see Table 6). After 1975, those banks which could not comply with this requirement were permitted to merge with other domestic and foreign banks. However, the CBP also pursued an active branching policy, encouraging banks to open branches, particularly in rural areas.

In 1980, the CBP enacted legislation permitting the establishment of "universal" banks. 2/ They also raised the minimum capital requirement again. The previous functional classification of thrift banks into savings banks, private development banks and, savings

---

1/ Actually, in 1983, the CBP had abandoned its earlier stance and indicated that the outstanding amount of swap operations at end-1982 would not be increased.

2/ Commercial banks with a capital of ₱ 500 million or more can apply to become a universal bank or "unibank" and, upon approval, are authorized to expand their activities to include investment banking services, securities transactions, credit guarantees, leasing, and equity investments in allied and nonallied undertakings. Nine commercial banks converted to unibanks, of which one (Manila Bank) was recently liquidated, and another (Philippine National Bank) was subject to major restructuring. The opportunities in near-banking activities permitted to unibanks were not pursued actively, given the unstable environment and the preoccupation with survival.

Table 6. Philippines: Selected Central Bank's Prudential Ratios, 1972-80

	1972	1980
	(In millions of pesos)	
Minimum capital requirement 1/		
Extended commercial banks (unibanks)	...	500.0
Commercial banks 2/	900.0	300.0
Thrift banks (in Manila) 3/	--	20.0
Rural banks	--	0.5
Investment houses		20.0
	(In percent)	
Limits on equity investments (by commercial banks including unibanks)		
a. In allied undertaking		
Financial		
Commercial banks	49.0	30.0
Others	49.0	100.0
Nonfinancial	100.0	100.0
b. Nonallied undertaking 3/	0.0	35.0
c. Total equity investment (in percent of net worth)		
For commercial banks	35.0	25.0
For unibanks		50.0
d. Single-equity investment	15.0	15.0
Capital-risk assets ratio	15.0	10.0
Borrowings by Directors, Officers, Stockholders, and their Related Interest (or DOSRI)	K 5/	K 5/

Source: Central Bank of the Philippines.

1/ Applies to new establishing institutions.
2/ For existing ones, it remains at ₱ 100.0 million.
3/ In other places, it is ₱ 10.0 million for new institutions and ₱ 5.0 million for existing ones.
4/ By unibanks; for commercial banks, it remains at 0.0 percent.
5/ CB Circular No. 357 dated January 22,1973. The aggregate ceiling on capital accounts (K) net of recommended valuation reserves.
N.B.: This refers to net value of capital accounts.

and loans associations was eliminated. Thrift banks were allowed to carry on all operations performed by commercial banks, except foreign exchange operations. They were also subject to lower reserve requirements giving them a cost advantage. Entry requirements for rural banks, which lend to farmers and rural entrepreneurs, were very liberal with a low capital requirement, and acceptance of limited management experience. 1/

(2) Impact

The structure of the banking industry emerging from these reforms and its role in the crisis are outlined below. The crisis itself altered the banking structure significantly. First, in terms of the volume of assets, banks increased their dominant position among financial institutions by 1980 (see Table 7). However, a tiering of the banking sector also emerged. The first tier consisted of few commercial banks and development banks whose size had increased sharply during the 1970s. The second tier consisted of a very large and growing number of rural and thrift banks, mostly small sized (see Table 8). This segment of the banking system was among the hardest hit by the crisis in terms of the number of institutions affected, and this reflected in part, the weaknesses in entry regulations and the limited subsequent supervision. At the end of 1986, the Philippines had 30 commercial banks accounting for 41 percent of the gross assets of the financial system (60 percent in 1980), and consisting of 9 unibanks, 17 domestic commercial banks, and 4 foreign banks. In addition, there were three specialized government banks (16 percent), 2/ 114 thrift banks (2.7 percent) and 877 rural banks (1 percent). During 1981-86, the relative position of banks was eroded somewhat by the growing role of the CBP in financing government budget deficits, and in supporting troubled financial institutions because of the crisis itself. 3/

Second, state-owned banks played a central role within the banking system and the concentration of risks in some of them was a

---

1/ The banking experience of management was often limited to a few weeks of training.

2/ The specialized government banks are the DBP, LBP, and the Amanah Bank which operates under Islamic principles.

3/ As the crisis worsened after 1981, the CBP granted massive financial assistance to public corporations indirectly through some government financial institutions. In turn, this allowed, these financial institutions to finance their acquisition of troubled nonfinancial entities during 1982-85. Furthermore, the CBP accumulated huge losses on foreign exchange swap operations linked to successive and massive devaluations during the first half of the 1980s.

Table 7. Philippines. Assets of the Financial Institutions, 1970-86

	Amount				Distribution			
	1970	1975	1980	1985	1970	1975	1980	1985
	(In billions of pesos at end of period)				(In percent of total)			
Central Bank	6.0	26.0	65.4	251.6	17.6	21.2	20.9	33.7
Banks	19.1	69.9	188.8	395.2	56.0	57.0	60.3	52.4
Commercial	14.1	53.2	138.4	283.3	41.3	43.3	41.6	37.6
Of which: Government	(...)	(18.1)	(34.6)	(70.3)	(n.a.)	(14.8)	(11.1)	(9.3)
Foreign	(--)	(--)	(18.7)	(45.0)	(--)	(--)	(6.0)	(6.0)
Thrift	1.0	2.11	0.6	15.1	2.9	1.7	3.4	2.0
Rural	0.7	2.8	5.6	8.8	2.1	2.3	1.8	1.2
Specialized	3.3	11.8	34.2	88.0	9.7	9.6	10.9	11.7
Of which: DBP	(...)	(9.6)	(28.0)	(74.4)	(n.a.)	(7.8)	(8.9)	(9.9)
Nonbanks	9.0	26.8	58.7	107.2	26.4	21.8	18.7	14.2
Total	34.1	122.7	313.1	754.0	100.0	100.0	100.0	100.0

Sources: Central Bank of the Philippines.

Table 8. Philippines. Number of Banking Institutions, 1975-86

	Total Offices				Head Offices			
	1975	1980	1981	1986	1975	1980	1981	1986
Total Banks	2,156	3,364	3,652	3,774	892	1,171	1,222	1,025
Commercial	996	1,503	1,732	1,716	33	32	33	30
Domestic	996	1,499	1,728	1,716	33	28	29	20
Of which: Government	n.a.	n.a.	n.a.	n.a.	(2)	(2)	(10)	(10)
Foreign	n.a.	4	4	4	n.a.	4	4	4
Thrifts 1/	259	673	631	665	88	144	140	116
Rural	834	1,096	1,167	1,293	768	985	1,040	877
Specialized Government 2/	67	92	122	100	3	3	3	2
Concentration ratio of commercial banking industry (in percent)3/	n.a.	9.99	10.03					

Sources: Central Bank of the Philippines; Private Development Banks, Annual Report, 1981.

Note: For 1975, data reproduced from World Bank (1979).

1/ Includes private development banks, savings bank and stock savings and loan associations.

2/ Includes DBP, Land Bank and starting 1980, the Philippine Amanah Bank.

3/ As measured by the Herfindahl-Hirschman Index.

critical factor in the crisis. 1/ Their share of total banks' assets averaged about 33 percent during the 1970-80 period, rising to 36 percent by end-1985. The DBP alone accounted for 29 percent of total banks' assets. Their troubles threatened the stability of the banking system, and culminated in the major restructuring and rehabilitation of two of the largest state-owned institutions that became insolvent.

Third, significant parts of the banking system were characterized by a bank-holding-company structure. Twelve holding companies had interrelated ownership and interests in private banks and nonfinancial corporations. They controlled commercial or savings banks, investment houses and insurance companies. Such was the case of the Herdis Group, 2/ which, during 1979-80, controlled Summa Savings and Mortgage Banks (savings banks), the Summa Insurance Corp. (insurance), the Equipment Credit Corp. (investment house), Interbank and Commercial Bank of Manila (commercial banks). 3/ Furthermore, most groups had a large number of interlocking directorships within the corporate business sector [see Doherty (1983)].

The number and size distribution of banks--with Herfindahl index showing a relatively low 0.10 as of December 31, 1986--suggested that the degree of concentration was not a problem. 4/ The previously noted fall in net interest margins during 1980-83 following the deregulation of interest rates also suggested a competitive banking system. The rise in net interest margins during 1984-86 was attributable to tighter monetary policies, high reserve requirements, and an increase in loan losses. Thus, oligopolistic pricing does not seem to have been a factor in interest rate developments. However, the bank-holding-company structure, together with the supervisory weaknesses discussed below, permitted excessive risk taking following deregulation, and this seems to have been a factor in causing and aggravating the crisis.

1/ State-owned banks included the PNB, DBP, LBP, the Philippines Veterans' Bank and the Amanah Bank

2/ This group effectively went out of business after the 1981 crisis and many of its companies and subsidiaries were bought out by the Government.

3/ Similar cases included the Ayala Group, which controlled 37.0 percent of the paid-up capital of the Bank of Philippines Islands (the second largest commercial bank after PNB), the Bancom Group, the Cojuango Group (United Coconut Planters Bank, the seventh largest commercial bank in 1981); the First Philippine Holding Group (Philippine Commercial and International Bank, the fifth largest bank in 1981).

4/ The number of banking institutions, including branches, is shown in Table 8.

3. Prudential supervision and related practices

The supervisory system which regulates and oversees the conduct of banks' operations is described below. The role of this system in ensuring the soundness and stability of the financial sector is discussed thereafter. A main finding is that supervisory weaknesses were conducive to loose banking practices, which later led to numerous bank failures. Also, the existence of a deposit insurance scheme did little to prevent or contain the crisis.

a. Supervisory authority

The Central Bank of the Philippines (CBP) exercises supervisory authority over the banking institutions. However, the ultimate supervisory authority is the Monetary Board (MB), the policymaking body of the CBP. 1/

The Department of Bank Supervision and Examination is the operational arm of the CBP for supervision. Supervisory procedures in the Philippines, which include reporting requirements and examination, are regular, comprehensive, and carried out thoroughly. 2/ Officers of the Department of Bank Supervision and Examination are responsible for bank examination to assess the soundness of operations, and the solvency and liquidity of the bank. Reports of these bank examinations are then transmitted to the MB, which decides what action to take should a bank be found to be in trouble.

When a bank faces protracted liquidity or solvency problems, the MB may appoint a conservator to take charge of the assets, liabilities, and management of the bank in order to protect depositors and other creditors. If the conservator is unable to restore the viability of the bank, the

---

1/ The MB is composed of the Governor acting as chief executive, the Minister of Finance, the Director General of the National Economic Development Authority, the Chairman of the Board of Investments, the Minister of the Budget, and two-part time members of the private sector.

2/ For instance, the reporting system covers every item of banks' balance sheet and information such as credit to Directors, Officers, and Shareholders and their related Interest (or DOSRI credit) are even reported daily. On-site examinations and inspections, patterned after the U.S. system, focus on the quality of banks' assets, which are classified accordingly. A rating system, so-called CAMEL (Capital Asset, Management, Earning and Liquidity), is used as a tool to assess quantitatively the soundness of a bank, completed with a questionnaire for a qualitative assessment.

bank is declared insolvent. 1/ The MB then appoints a receiver to take charge of all assets and liabilities of the bank, and forbids the bank from doing business. Within 60 days, the MB decides whether to liquidate the bank, or to reorganize it to permit the resumption of business. In the former case, the CBP appoints a liquidator to carry out the decision, provided no court challenges the decision.

The ultimate enforcement resides with the MB and the closing of a troubled bank is subject to due process, which might be lengthy, especially in case of litigation brought by owners.

b. Supervisory rules

During the 1972-82 period, the CBP also modified the main prudential regulations on commercial banks. Capital requirements, defined as a ratio of net worth to risk-assets, were lowered from 15 percent in 1972 to 10 percent in 1973 (see Table 6). After 1980, ratios as low as 6 percent became permissible with the prior approval of the MB. The authorities sought to provide banks with greater leverage to expand their asset portfolios.

The CBP relaxed its rules regarding credit accommodation to Directors, Officers, Stockholders, and Related Interests (DOSRI). In 1973, DOSRI credit had an upper limit equal to a bank's total capital account, net of valuation reserves. 2/ By 1980, this limit had become less restrictive for commercial banks, since the authorities had somewhat relaxed the provisions designed to limit conflicts of interest between a bank and another financial or nonfinancial institution that were linked by interlocking directorate. 3/ In addition, regulations governing relations between a bank and its subsidiaries were eliminated.

1/ Insolvency is defined in the law as the inability of a bank to pay its liabilities as they fall due in the usual and ordinary course of business. One important limitation of this definition is that it does not apply to insolvency due to extraordinary deposit withdrawals caused by a financial panic.

2/ See CB Circular No. 357 dated January 22, 1973.

3/ See CB Circular No. 596 dated March 1, 1978 whereby the Central Bank amended CB Circular No. 357 to exclude from the maximum credit accommodation to DOSRI, among others, "the credit accommodations to a corporation in whose board of directors, a director or officer or stockholder of the lending bank seats as a representative of the bank. However, the bank representative's equity interest in the borrower corporation shall only be the minimum shares required by law, rules and regulations, or the by-laws of the corporations to quality a person as director to the corporation." (SGV, 1978, p. W15).

To restrict banks' risk exposure, the authorities established the single borrower limit of 15 percent (including loans and equity investment) of the bank's net worth; the rule had been in force during the 1970s and is still valid although exceptions have been made. For example, in 1983, the Government's takeover of the Construction and Development Company of the Philippines (CDCP) through the PNB violated this limit. After the takeover, PNB's total exposure (in equity alone) in CDCP went to 60 percent of its net worth.

In contrast to the trend toward relaxation of prudential regulations, the CBP expanded the institutional coverage of bank supervision after 1972 in order to include the nonbank quasi-banks (NBQB). The CBP also monitored the NBQB's issues of commercial paper "with recourse," and regulated its terms, conditions of rollover and physical delivery, etc.

c. Loose lending practices

This issue covers three critical areas related to CBP oversight of the quality of a bank's portfolio. Due to the political climate both before and during the crisis, the CBP failed to enforce supervisory rules regarding DOSRI credit, supervision of NBQB activities and, most importantly, the treatment of past due loans and their provisioning.

(1) DOSRI credit

The MB's failure to enforce the rules was reported to have led to substantial bank lending to DOSRI to the detriment of other legitimate borrowers. 1/ Inappropriate loans to DOSRI are cited as one major contributor to bank failures within the last decade. In reaction to the 1981 crisis, the CBP tightened the regulations on DOSRI credit in a remedial manner. 2/ The treatment of bank credit to firms with interlocking directorship/officership was tightened again (reversing the earlier stance), but the restrictions were loosened regarding institutional relationships between holding companies and subsidiaries.

1/ Bondline (1980), Op. cit.

2/ The CBP adopted new ceilings on unsecured DOSRI credit of 30 percent of total credit accommodations for each DOSRI. Total DOSRI credit was subsequently limited to 15 percent of a bank's loan portfolio or its entire capital account, whichever was lower. Also, new accounting and reporting standards for DOSRI loans have been adopted.

(2) Supervision of money market operations 1/

Prior to 1980, regulations governing the functioning of the money market were differentiated by type of participants and type of operations, each type falling under the purview of a different supervisory authority. The CBP supervised only banks and NBQBs, and monitored only transactions on a "with recourse" basis. The Securities and Exchange Commission supervised other participants, while monitoring transactions on a "without recourse" basis. Subsequently, the CBP imposed regulations on NBQBs. These regulations included: (a) the requirement that NBQBs hold 20 percent of their liabilities--deposit substitutes--in the form of deposits with the CBP; (b) a ceiling on interest rates of these institutions (the maximum rate paid for borrowing was 17 percent while the rate charged for lending was 18 percent); and (c) a minimum trading lot. Since nonbank financial institutions were not subject to such regulations by the Securities and Exchange Commission, NBQBs lost their competitiveness. In response, NBQBs started to deal in paper on a "without recourse" basis, issued mostly by subsidiaries or affiliates of "groups" to which they belonged. This allowed NBQBs not only to circumvent the CBP regulations and monitoring of their money market activities, but also to help businesses of their "group" to mobilize short-term funds by issuing less than prime commercial paper. These unsound lending practices contributed to the collapse of the commercial paper market in 1981. 2/

(3) Accounting rules

The 1980 reforms did not cover CBP rules governing the treatment of overdue loans, the provisioning for bad debt, and scrutiny of deposit transactions by CBP examiners. The inadequacies of these rules, which remained unchanged until 1986, played a significant role in the worsening

---

1/ The money market in the Philippines is characterized by a wide variety of participants which include all financial institutions, the Treasury and nonfinancial corporations, and a wide range of instruments such as promissory notes issued by banks and nonbank quasi-banks, government securities, central bank bills, certificates of participation/assignments, and commercial paper issued by corporations. Commercial paper can be issued "with or without recourse." Deposit substitutes issued by nonbank quasi-banks are also referred to as commercial paper issued by these institutions. See Lontoc, (1981), Op. cit., p.8.

2/ In reaction, the authorities modified the regulations governing money market operations. Among others, the new regulations limited the issuance of commercial paper only to prime companies; required that issuers have at their disposal a bank credit line covering 35 percent of their money market issues; and required also that all commercial papers be registered with the Securities and Exchange Commission, and be printed serially on security paper, by the Central Bank Printing Plant.

remained unchanged until 1986, played a significant role in the worsening of the financial crisis.

Regarding the definition of overdue loans, the CBP used the following rules for its own assessment of bank conditions. Demand loans were considered past due if payment was not received within six months of a written demand. For loans payable in installments, the determining factor was the number of payments in arrears, a number which varied with the repayment schedule of the loan (monthly, quarterly, semi-annually, or annually). Ten installments missed was the threshold for monthly installment loans. For the others, the period varied between one and two years. Whenever 20 percent of the outstanding balance of a loan was in arrears, the entire loan was to be considered overdue. Once a loan was classified as overdue, interest could no longer be accrued. In practice, however, banks differed considerably in their own treatment of overdue loans. Conservatively-managed banks generally placed loans on a nonaccrual status more promptly than the schedule used by the CBP, in order to avoid the tax on gross revenues; other banks followed loose practices, especially as they began facing financial distress.

Regarding provisions for bad debt, the CBP is empowered by law to establish rules, either generally or in individual cases. However, the CBP has not enforced the rules established, leaving reserving or provisioning policies to bank managements. 1/ In the supervisory process, the Central Bank does compare the reserves established by a bank with those it believes are required on the basis of its own assessment of asset quality. Under the law, banks are allowed to write off bad loans up to ₱100,000, but they must have central bank approval before writing off loans in excess of that amount. Where DOSRI loans are involved, the request for write-off approval is passed on to the MB; otherwise, it is handled by the CBP staff.

Regarding the scrutiny of deposit accounts, examiners are not allowed to investigate deposit transactions which are protected by strict secrecy rules, unless they are duly authorized by the Monetary Board (MB). The MB may only permit scrutiny of deposit transactions if it is satisfied that a bank fraud or serious irregularity has been committed and that it is necessary to look at deposit transactions to determine the facts.

1/ The policy was formalized in 1987 when the Monetary Board passed a resolution requiring all banks to set up a system for reviewing loans and other assets for the purpose of establishing appropriate and adequate reserves.

d. Negligible role of the Philippines Deposit Insurance Company (PDIC)

The PDIC played no significant role in improving depositors' confidence in the banking system during the crisis period of the 1980s. 1/ This situation was due to its severe staffing constraints and low capital base. In spite of the capital increase from ₱ 20 million to ₱ 2 billion in 1985, the PDIC's resources, human and financial, were insufficient. 2/ As a result, PDIC faced major difficulties to settle the growing claims of insured depositors of failed banks (see Table 9). 3/ Thus, the CBP was compelled to tie up most of its supervisory staff to help the PDIC settle these claims.

e. Summary

The absence of significant reforms in prudential supervision contributed to the aggravation of the banking crisis. First, the existing rules were not enforced in practice, although the MB was informed in time of the problem-bank cases. Second, some of the accounting rules themselves were not codified to ensure consistency and transparency. This situation encouraged troubled banks to book accrued interest on nonperforming loans and to distribute the book profits. Regarding the provisioning rules, the main problem arose after the crisis of 1981. The MB faced an increasing dilemma between forcing banks to provision for bad debt so as to maintain confidence in banking institutions, or being tolerant on this issue so as to "buy time" for troubled banks to overcome their financial difficulties. The MB took the second option which accelerated the deterioration of bank finances.

III. The Crisis and Its Impact

The manifestations of the crisis and its monetary impact are presented below. They relate to the loss of public trust in the banking system, and the spread of financial distress and bank failures. The crisis complicated the conduct of CBP monetary policy. A severe credit "crunch" also occurred.

1/ Deposit insurance limit was ₱ 10,000.

2/ Annual premia contribution by financial institutions amounted to ₱ 100 million.

3/ However, in the case of the largest failed bank, the PDIC settled quickly the claims of insured deposits.

Table 9. Philippines: PDIC Payments to Insured Depositors of Failed Banks, as of June 1987

	Deposit Liabilities (1)	Estimated Insured Deposits (2)	Total Payments (3)	Ratio (3)/(2)	Ratio (2)/(1)
Commercial banks	4,447.3	1,463.1	226.5	15.5	32.9
1970-80	338.7	45.2	45.2	100.0	13.3
1981-87	4,108.6	1,417.9	181.3	12.8	34.5
Savings and mortgage banks	1,015.9	815.8	771.7	94.6	80.3
1970-80	16.4	11.5	11.5	100.0	70.1
1981-85	999.5	804.3	760.2	94.5	80.5
Private development banks 1/	294.6	183.4	124.2	67.7	62.2
SSLA 1/	1,310.3	1,083.8	740.7	68.3	82.7
Total	7,068.1	3,546.1	1,863.1	52.5	50.2
1970-80	355.1	56.7	56.7	100.0	16.0
1981-87	6,713.0	3,489.5	1,806.4	51.8	52.0

Source: Philippine Deposit Insurance Corporation (PDIC).

1/ Covers the period 1981-87, as figures for the period 1970-80 amount to zero.

1. Public's loss of trust

During the crisis, financial wealthholders lost trust in the banking system, causing both runs on banks and "flight to quality." 1/ The spread of banking distress weakened the public's confidence in financial institutions, adding fears about the safety of banks' deposits.

a. Surge in demand for reserve money

As noted earlier, the Dewey Dee affair triggered a confidence crisis which provoked bank runs and capital flight in 1981. 2/ The impact of bank runs was reflected in the increase in the ratio of currency to narrow money in 1981, which was a sharp reversal of the declining trend in the ratio during the 1970s (Table 10). Evidence pointed also to the presence of capital flight (Table 10).

The level of the currency ratio continued to increase in 1982 and jumped in 1983, reflecting a major erosion of confidence in the banking system. The largest increase occurred in the last quarter of 1983 after the authorities announced in late September 1983 the suspension of repayments on external debt. Capital flight intensified in 1983 compared to 1982 (see Table 10) as the announcement of the moratorium raised concern among foreign creditors and led to the cut-off of suppliers' credit.

b. "Flight to quality"

The 1981 panic also caused a redeployment of funds, mostly to institutions perceived as sound, namely the commercial banks. As already noted, investors in the commercial paper market switched to bank deposits. Indeed, as seen in Table 11, banks' deposit accounts increased as a whole by ₱ 1.6 million. However, there was also a switch of deposits away from thrift banks. While total bank deposits increased by 11 percent in 1980-81, deposits of thrift banks fell by 9 percent, triggering failures among the thrift banks 3/ (see Table 11). This was reflected also by the switch in the number of deposit accounts from thrift and savings to commercial banks. Indeed, the latter gained 3.2 million accounts in 1981, represent-

---

1/ A "flight to quality" refers to financial wealthholders' shift from deposits to safer assets such as treasury bills or from weak banks to banks perceived to be more sound.

2/ Capital flight is defined here as "the acquisition or retention of a claim on nonresident that is motivated by the owner's concern that the value of his asset would be subject to discrete losses if his claims continued to be held domestically." See International Monetary Fund (1987).

3/ The collapse of the commercial paper market had also triggered a panic in the thrift banking sector.

Table 10. Philippines. Selected Financial Ratios, 1970-86

	"Financial Deepening" Ratios			Ratios measuring the stability of the banking sector			
P	$\frac{M1}{GNP}$	$\frac{L}{GNP}$	$\frac{M3}{GNP}$	$\frac{C^P}{M1}$	$\frac{C^P}{L}$	$\frac{K1}{D}$ 1/	$\frac{C}{D}$
			(In percent at end of period)				
1970	10.3	21.8	21.8	55.8	26.4	20.0	30.0
1975	9.0	30.5	30.5	46.6	13.8	43.9	11.4
1980	8.5	29.9	29.9	45.3	12.9	31.3	10.1
1981	7.7	28.7	27.0	49.4	13.3	-51.6	7.5
1982	7.0	29.7	28.4	54.0	12.7	-17.6	8.8
1983	8.5	31.3	29.8	60.3	16.5	-46.0	36.5
1984	6.4	26.5	22.8	64.9	15.6	6.2	10.5
1985	6.0	30.0	22.3	67.3	13.5	-33.9	5.9
1986	6.9	33.5	23.0	68.8	14.2	-52.9	19.1

Sources: Table 2, IMF, International Financial Statistics and staff estimates.

1/ Short-term capital (net) including errors and omissions (these flows represent nonmonetary capital flows); this ratio is used as a rough measure of capital flight (minus sign) including the trade credit squeeze.

Table 11. Philippines. Indicators of the Financial Crisis, 1970-87

(In percent) 1/

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987 June
Rate of bank failures 2/ (number of)	6	7	24	30	8	7	26	44	26	22
Of which: Commercial banks (number of)	(3)	(1)	(0)	(0)	(0)	(0)	(0)	(2)	(0)	(1)
Thrift	(...)	(...)	(0)	(4)	(2)	(1)	(16)	(6)	(0)	(3)
Ratio of failed bank assets to total assets 2/										
Commercial banks	1.9	1.0	0.0	0.0	0.0	0.0	0.0	1.2	0.0	4.0 [Sept.]
Thrift banks	5.2	0.0	0.0	0.4	0.3	1.3	10.8	35.4	0.0	5.0 [June]
Rural banks	0.3	0.3	1.1	1.2	0.2	0.2	0.4	1.9	1.4	1.0
Ratio of past-due to total outstanding loans	16.7	19.2	11.5	13.2	13.0	8.9	12.7	16.7	19.3	...
Of which: Commercial banks	(...)	(...)	(11.9)	(13.1)	(11.5)	(7.5)	(11.0)	(15.6)	(18.4)	(...)
Ratio of capital to outstanding loans 3/	...	...	12.1	13.6	14.4	12.9	16.7	16.1	17.7	...
Number of bank deposit accounts (in millions)	...	5.3	21.0	22.6	24.9	25.6	23.7	20.2	19.5	18.6
Of which: Commercial banks	(...)	(...)	(10.1)	(13.3)	(15.1)	(15.2)	(14.0)	(12.6)	(12.4)	(11.8)
Thrift banks	(...)	(3.3)	(7.2)	(5.1)	(5.5)	(5.8)	(5.0)	(3.1)	(2.7)	(2.5)
Broad money/Total liquidity	...	...	100.0	94.2	95.6	95.3	86.3	74.3	68.7	...
Bank deposits (in billions of pesos, at end of period)	...	27.6	90.4	100.1	116.7	140.0	152.2	167.5	166.3	159.8 [June]
Of which: Commercial banks	(...)	(20.7)	(72.6)	(79.3)	(93.2)	(116.2)	(134.5)	(143.0)	(138.0)	(132.1)
Thrift banks	(...)	(1.6)	(7.9)	(7.2)	(9.3)	(11.2)	(7.1)	(10.5)	(13.0)	(13.2) [June]

Source: Central Bank of the Philippines.

1/ Unless otherwise specified.
2/ For 1970 and 1975, data refer to cumulative amounts during 1970-74 and 1975-79, respectively. Data for the rate of bank failure excludes the five commercial banks in distress which have been acquired by GFIs; they are: Republic Planters' Bank (1978); International Corporate Bank (1982); Union Bank of the Philippines (1982); Associated Bank (1983); Philippines Bank (1979). NOTE: The nuber in parentheses refers to the year of acquisition by GFIs.
3/ Capital defined as "net worth" or unimpaired capital plus free reserves.

ing a 32 percent increase over 1980/81, while thrift and saving banks lost 2.1 million accounts, representing a decline of about 30 percent over the same period (Table 11).

After 1983, financial investors again redeployed their funds, this time toward safe securities with high yields. Specifically, the public shifted out of deposits and into treasury and central bank bills. The ratio of M3 to total liquidity fell sharply after 1983 (Table 2), owing in part to the sharp increases in interest rates on treasury and central bank bills beginning in 1984. Banks as a group lost a large number of deposit accounts.

c. Banking distress

During 1981-85, financial difficulties of corporate businesses steadily worsened, resulting in growing distress among banking institutions. 1/ The limited data on the financial performance of top 1,000 corporations during 1980-84 showed a sharp increase in debt-equity ratios in 1982, declining profitability during 1981-83 with negative net incomes in 1982 and 1983, and a sizeable weakening of the liquidity positions of firms (as measured by the ratio of current assets to current liabilities) during 1980-84 (Appendix Table 2). The sharp increase in the debt-equity ratio and in the indebtedness of the nongovernment sector (Table 3) in 1982 and 1983 when real lending rates were at a peak seems to suggest that distress borrowing was a significant factor. These developments were reflected in the evolution of overdue loans in the banking system. Overdue loans rose from ₱ 12.5 billion (or 11.5 percent of total loans) in 1980 to ₱ 16.6 billion (or 13.2 percent) in 1981. The situation deteriorated sharply after 1983, with overdue loans rising to a record high of 19.3 percent in 1986.

Until 1983, the ratio of nonperforming loans to banks' loan portfolio remained below the critical ratio of 15 percent, perceived by bankers and the public as a threshold for individual banks' solvency. 2/ During 1981-84, banks' ratio of capital to outstanding loans remained above banks' ratio of overdue to outstanding loans. This indicates that until 1983, banks as a whole were sufficiently capitalized to provision for bad debt and absorb eventual losses due to bad loans. Beginning in 1985, this situation changed as the ratio of capital to outstanding bank loans fell below the ratio of overdue loans, indicating major solvency problems in the banking system. The size of overdue loans was contained in part by the authorities' rescue of (at least) 123 failing businesses and by the

---

1/ Official figures on business failures do not exist. In this section, partial data from nongovernment sources are relied upon to provide an idea of businesses' financial distress.

2/ See Business Day (1982), p. 139.

troubled banks' practice of keeping bad loans current by renegotiating them at maturity. 1/ In addition, the banking distress was alleviated by the Government's acquisition of six troubled commercial banks during 1981-83.

The authorities' rescue of distressed banks, contributed significantly to limit the number of liquidations among commercial banks. By the end of 1986, only three commercial banks of significant size had failed. The liquidations occurred mostly among rural and thrift banks which were numerous and small.

During 1981-83, 138 thrift and rural banks failed, i.e., 12 percent of the number of all banks existing in 1980 (Table 10). Although these failures did not threaten the stability of the banking system, they tied down the CBP supervisory staff. In addition, the Philippines Deposit Insurance Corporation met increasing difficulties in settling the growing claims of depositors of the failed banks, given its low capital base and inadequate contributions.

2. Monetary management during the crisis

a. Actions on the supply of banks' reserves

During 1981-1986, the CBP faced increasing difficulties to achieve its often conflicting objectives of monetary stability, confidence in the banking system, and credit allocation to priority sectors, as both the financial crisis and recession deepened.

During the first subperiod spanning 1981-1983, the CBP gave priority to containing the spread of financial distress and stepping up selective credit policies. As a lender of last resort, the CBP intervened appropriately by providing emergency credit during the 1981 phase of the crisis and by absorbing excess liquidity as the crisis assuaged in 1982 (see Table 12). Meanwhile, the CBP increased concessional rediscount credit to financial institutions. In 1983, the CBP also replenished the banks' loss of deposits in the aftermath of the banking panics of 1983 and, began to realize exchange losses on swap operations; these developments resulted in a 48 percent jump in reserve money between the end of 1982 and the end of 1983.

1/ Loans renegotiated doubled during 1984-85 while loans past due of over one year rose steadily from ₱ 6 billion in 1984 to ₱ 8 billion in 1986.

Table 12. Philippines: Descriptive Statistics for Reserve Money and CBP Credit During the Crisis, 1981(I)-1986(IV)

	1981(I)-1986(IV)		1981(I)-1983(III)		1983(IV)-1986(IV)	
	Mean	Coefficient 1/ of variation	Mean	Coefficient of variation	Mean	Coefficient of variation
Money and credit aggregates	(In billions of pesos, unless otherwise specified)					
Reserve money	25.8	40.6	16.1	9.6	34.1	20.4
Net domestic credit	15.8	70.3	23.3	11.4	9.5	123.0
To Public sector	12.5	42.7	8.0	13.0	16.3	27.4
Of which: Government	(11.7)	(32.8)	(8.8)	(16.1)	(14.2)	24.4
Financial institutions	3.3	460.3	15.2	17.3	-6.8	-203.2
Of which: Assistance	7.6	72.5	2.7	30.0	11.7	35.9
Rediscounting	10.3	30.5	12.1	30.0	8.8	18.4
OM operations	-14.6	-127.1	0.3	1,690.4	-27.3	58.2
Selected ratios	(In percent of reserve money)					
Net domestic credit	84.6	78.2	145.9	15.2	32.9	40.6
To Public sector	49.2	18.1	50.0	11.1	48.5	23.0
Financial institutions	35.4	184.4	95.8	21.6	-15.7	-260.3

Sources: IMF, Recent Economic Developments (1982...1988); and staff calculations.

1/ Defined as the ratio (in percent) between the standard deviation ( ) and the mean $\bar{x}$).

During the second subperiod spanning 1984-86, to offset the expansionary effects on reserve money of the earlier policies and restore monetary stability, the CBP absorbed huge amounts of liquidity from financial institutions through massive sales of its own securities and tighter access to rediscount facilities. 1/ However, these actions were mitigated by the huge financing of the public sector deficit in 1984, following the drastic cut back in foreign financing of these deficits. 2/ This policy stance led to skyrocketing inflation which went from 12 to 50 percent during 1983/84, and to a crowding out of the private sector. During 1985/86, the CBP finally brought inflation under control by maintaining a tight policy.

The CBP continued to provide extensive emergency assistance during 1984-85, reacting essentially to financial distress rather than panics as in earlier years. Through the decisions of the MB, it adopted a remedial rather than punitive approach, in order to prevent failures of financially distressed firms. This, however, raised the question of the trade-off between short-run stability and long-run cost effectiveness of rescue operations.

The negotiations over corrective actions for the rehabilitation of troubled institutions were lengthy. This might have prolonged the perception of uncertainty by the public and in the end, raised the ultimate cost of rescue operations. Also, the CBP's attempt to seek additional capital and merger partners for troubled banks proved difficult during 1983-86, when all domestic banks faced financial difficulties. As the MB was deliberating on the appropriate disposition decisions for the problem institutions, the CBP continued to extend emergency loans, overdrafts, and equity lending to prevent a banking system collapse. This policy combined with the Government's massive issues of treasury bills to finance its budget deficit exerted expansionary effects on total liquidity after 1983 in spite of the decline in the money multiplier (see Charts 4 & 5).

b. Complications due to portfolio shifts

Empirical results showed that the estimated demand for real M3 shifted downward in 1983(III) due to investors' portfolio shifts from deposit substitutes into treasury and central bank bills and subsequently

---

1/ After 1983 the CBP closed a number of special rediscount facilities and set the discount rate on the remaining ones at market-related levels.

2/ Despite the reduction in the public sector deficit (in percent of GNP) after 1983, the CBP stepped up its financing to this sector in order to offset the sharp decline in foreign financing of the public sector budgetary deficit.

caused M3 to be an unreliable indicator of monetary policy. 1/ This situation with the lender of last resort obligation contributed to the loose monetary policy and skyrocketing inflation rate observed until late 1984 since the CBP were overestimating actual M3.

The CBP then reversed its stance to bring inflation under control and shifted its operating procedures of monetary control to reserve money targeting. The CBP tightened the supply of bank reserves through massive sales of central bank bill. However, the surge in the demand for reserve money reflecting partly the currency flight led most likely such tightening to be excessive and thereby to cause the steep increases in nominal interest rates during late 1986 - mid-1986. Large increases in domestic government borrowing during that latter period contributed to adding upward pressures on nominal interest rate, and thereby to crowding out the private sector. Such increases which occurred in spite of the lightening of fiscal policy, stemmed from the drying up of foreign financing after the moratorium's announcement.

3. Credit "crunch"

After 1981, declining economic growth compounded the negative impact of rising interest rate in the demand for real credit, in particular that of the private sector. The growth in overdue loans, of which a growing share was renegotiated during 1984-86, mitigated the otherwise sharper decline in this demand. Indeed, with private investment (in percent of GNP) plummeting in 1981, the demand for new investment loans by the private sector nearly came to a halt while debt liquidation took place.

Nonetheless, banks seemed to have curtailed the supply of real credit to the private sector by more than the drop in demand, thereby resorting to credit rationing as the crisis deepened. Between 1983-86 (end-September), real credit to the private sector experienced a staggering decline of 53 percent while output fell cumulatively by 9 percent. Consistent with their prudent lending policy, uncertainty in the economic outlook and chronic shortages of reserves, banks may have preferred to stop lending rather than charging higher interest rates. Furthermore, investing their liquidity in public securities (of treasury bills and

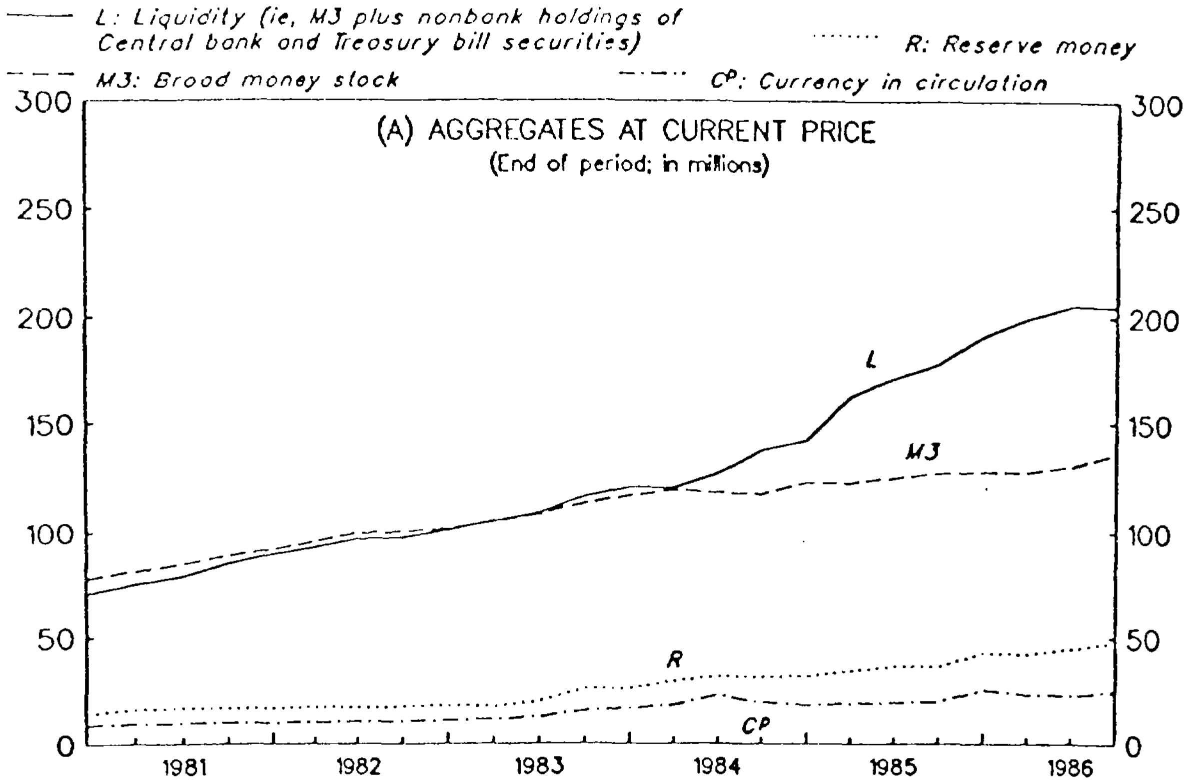
---

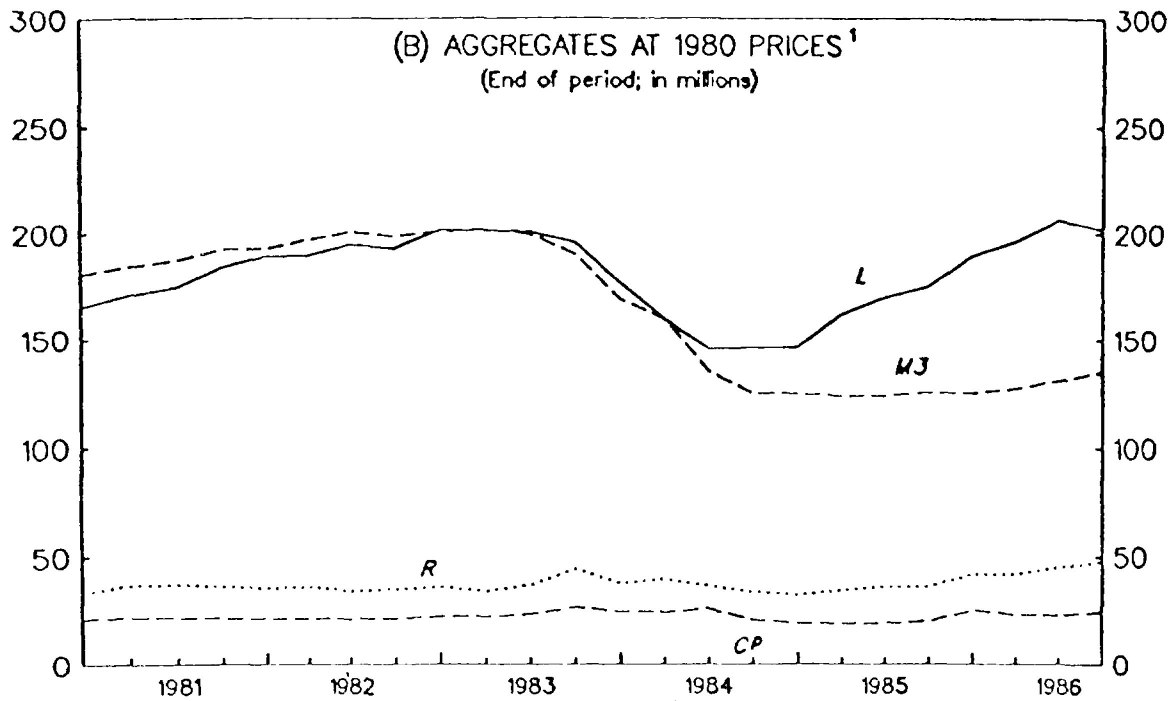
1/ M3 consists of M2 (currency, demand deposit, time and saving deposits) plus deposits substitutes. The latter are interest bearing securities issued by banks to their customers. With the economic and financial environment becoming very uncertain in late 1983, investors moved out of these securities into safer assets (see Section 1 of this chapter). A recent study [see D. Goldsborough and I. Zaidi (1989)] provides also evidence of instability in the demand for M1, an instability consistent with the currency flight taking place during the 1983(IV) - 1986(IV) period of the crisis.

CHART 4

PHILIPPINES

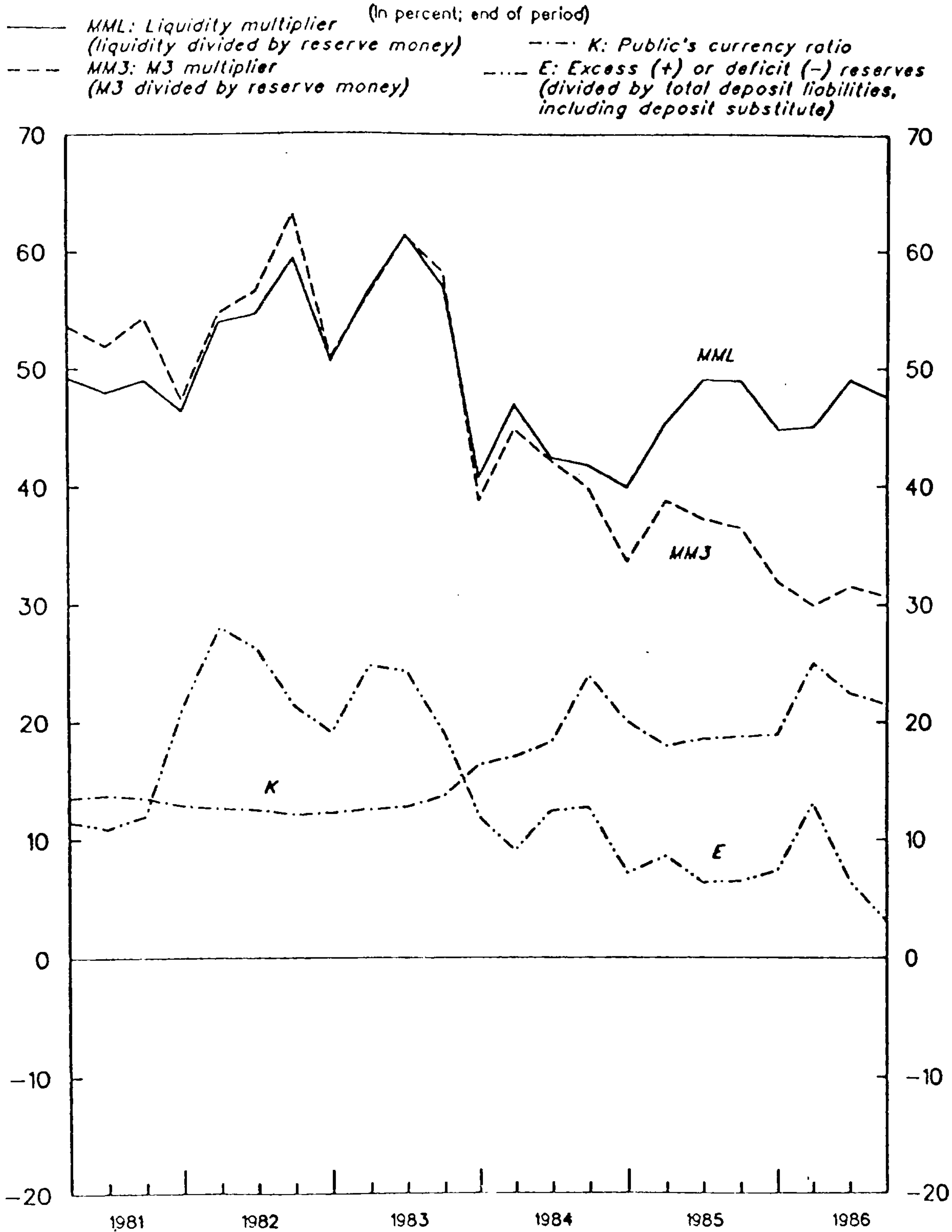
MOVEMENTS OF SEASONALLY ADJUSTED AGGREGATES, Q1 1981–Q4 1986





Source: *International Financial Statistics.*
[1] Deflated by CPI in Manila (end of period).

CHART 5
PHILIPPINES
EVOLUTION OF SELECTED MONETARY RATIOS,
Q1 1981–Q3 1986
(In percent; end of period)



Source: *International Financial Statistics.*

central bank bills) became more attractive than lending for safety reasons. Banks' holdings of public securities rose sharply during the crisis, particularly during 1984-86. 1/ Banks' shift in the allocation of funds from the private to the public sector crowded out the former sector. Therefore, while the safety of their placement became a main determinant of their behavior, banks' actions seem to have exacerbated the shortage of funds in the credit market, thereby worsening the recession.

IV. Measures

Measures to deal with the crisis included, in addition to emergency assistance and some liquidations, recapitalization through government funds, financial assistance to nonfinancial corporations, takeover of weak financial and nonfinancial firms by GFIs, and eventually a massive restructuring of some of the GFIs themselves.

1. Financial assistance

During the crisis period spanning 1981-86, the CBP and the National Government provided massive financial assistance under various schemes.

a. Schemes

When the 1981 crisis broke out, the CBP lender-of-last-resort facility did not cover quasi-banks. The CBP therefore provided emergency loans to quasi-banks through a special rediscount facility, 2/ in order to enable them to meet the demand for withdrawal of funds. However, primary issuers of commercial papers, mostly corporate businesses, continued to face liquidity problems and failed to honor their obligations falling due. At that point, quasi-banks were the major holders of this paper.

The CBP then set up the Industrial Fund supported by resources from the CBP and the National Government budget. Through the GFIs and unibanks, the Industrial Fund lent in turn these resources to troubled corporations which then settled their obligations vis-a-vis the quasi-

---

1/ During 1984-85, banks (commercial, thrift and savings banks) were the heaviest subscribers of government securities. These banks' holdings of government securities nearly doubled between 1984 and 1985. See H. Paulino, "Government Securities: A Review of 1985 Performance," Central Bank Review, Vol. 38, January 1986, p. 29.

2/ Before 1981, the CBP Law required the central bank to provide unlimited financial assistance during a crisis, but only to banks. This situation was corrected in 1982, when nonbanks became eligible for emergency assistance.

banks. 1/ The latter, in turn, repaid the CBP emergency loans. This scheme amounted to a conversion of short-term emergency loans extended through the special rediscount window into long-term CBP lending through the Industrial Fund.

In early 1982, the Industrial Fund was replaced by a CBP special rediscount window. Through the latter the CBP extended medium- and long-term loans to "universal" banks, including the PNB and DBP, to allow them to finance their acquisition of, and mergers with troubled entities [see Lamberte (1985)]. That same year, the CBP began to provide emergency loans and overdrafts to financial institutions facing unexpected liquidity shortages.

Similarly, the Government provided both emergency lending and equity contributions to nonfinancial public corporations (mostly during 1981, 1982 and until mid-1983) and to the GFIs (mostly during 1983-85). The Government's financial assistance was channelled directly through the capital budget, which recorded large deficits. Direct financial assistance to distressed public sector firms during 1981-82 aimed both at financing their operating deficits, and at stepping up public investment so as to offset the decline in private investment after 1981. Assistance to GFIs beginning in 1983 aimed mostly at financing their acquisitions and mergers of distressed entities, and facilitated the conversion of debt owed to GFIs into equity. The Government provided both loans and equity funds to government financial institutions. This allowed the government financial institutions to absorb the loan losses and at the same time assist distressed corporations by converting the bad loans into equity. As no dividends were expected from these corporations for a long time, this operation amounted to foregoing interest payments. To illustrate, the PNB lost an estimated ₱ 400 million in annual interest payments from the Construction Development Corporation of the Philippines as a result of such debt/equity conversion.

The government financial institutions took over large businesses which were virtually bankrupt. These businesses included the largest conglomerates which were hit severely by the 1981 crisis. To illustrate, the National Industrial Development Corporation--a GFI, subsidiary of the PNB--took over 9 corporations of the Construction and Development Corporation of the Philippines and 15 corporations of the Herdis Group. The DBP and PNB took over 87 and 14 corporations, respectively. 2/ SSS took over nine

---

1/ The universal banks involved in the scheme comprised mostly those which were major creditors of the troubled corporations. [See Laya (1981)].

2/ These figures are quoted from Business Day (1982), the publication of the Securities and Exchange Commission. This issue also reported that, out of the 20 biggest corporations, 8 had substantial government investments in 1981. *Op. cit.*, p. 294.

hotels since it had invested 24 percent of its investment portfolio in the hotel sector during the 1970s.

b. Volume

During the 1981-85 period, the volume of financial assistance granted by the authorities to troubled entities mirrored the intensity of the crisis over its three phases. This volume doubled during the 1981 episode, continued to rise in 1982, and doubled again during 1984/85 (Table 13). In addition, the role played by the CBP and the National Government as well as the destination of their financial assistance differed over these phases. During 1981 and in the period from late 1983 to 1985, both the CBP and the National Government provided massive financial assistance to financial corporations. During 1982/83, however, the National Government provided the bulk of financial assistance, mostly to public corporations (financial and nonfinancial).

As the crisis progressed, the main recipients of government financial assistance shifted gradually from nonfinancial to financial public corporations. Until 1982, the Government provided assistance to troubled nonfinancial forms in part to maintain overall domestic investment, and in part to finance the GFIs' takeovers and acquisition of distressed and bankrupt corporations. Beginning in 1983, the Government curtailed public investment to reduce budget deficits. As a result, financial assistance to nonfinancial corporations declined somewhat; but assistance to financial corporations accelerated.

Over the whole crisis period, government financial assistance to troubled entities contributed to worsen its budgetary position as the total amount of the government assistance (in percent of government expenditures) rose from 13.6 percent in 1980 to 20.1 percent in 1985.

c. Terms of CBP financial assistance

The terms of the CBP financial assistance rapidly shifted from penalty rates initially to subsidized rates. In 1981, for emergency loans and overdrafts of 60 days, the CBP applied a rate of interest of 24 percent, plus 2 percent for each rollover of outstanding amount. Compared to the market rate of 16 percent charged by banks on short-term borrowing, this amounted to a heavy penalty rate. Moreover, emergency loans were extended against any collateral troubled institutions could submit, even collateral previously unacceptable to the CBP. However, with the set-up of the Industrial Fund in mid-1981, the CBP provide an implicit interest subsidy. On the medium- and long-term resources provided by that fund, the CBP charged an interest rate of 16 percent compared to the long-term market rate of 21.6 percent.

Table 13. Philippines: Authorities' Financial Assistance Flows to Distressed Corporations, 1980-85

	1980	1981	1982	1983	1984	1985
			(In millions of pesos)			
To financial corporations	277	3,054	1,574	2,077	14,289	13,549
From Central Bank						
Emergency loans/overdraft facilities 1/	120	2,424	163	1,900	5,900	2,800
From National Government:						
Emergency lending and equity contribution 2/	157	630	1,408	177	8,389	10,749
To nonfinancial corporations	5,040	8,380	10,178	7,955	5,641	5,328
From National Government:						
Equity contribution and net lending	5,040	8,380	10,178	7,955	5,641	5,328
Total (1) + (2)	5,317	11,434	11,752	10,032	20,230	18,877
Memorandum items:			(In percent)			
Central Bank assistance/reserve money at end of previous period	0.8	13.6	0.8	9.6	20.3	8.0
Government assistance/total government expenditures	13.6	18.7	22.0	15.3	21.0	20.1
Flow of government assistance/budget deficit	--	31.5	17.9	-46.7	60.2	18.3
Government equity contribution (in percent of GNP)	2.0	2.7	2.8	1.5	1.8	2.4

Sources: IMF, International Financial Statistics, 1986 and staff estimates.

1/ These figures represent changes from end of period stock. They exclude ₱ 700 million of promissory notes of Union Bank's borrowers (Rancom, BBMI, and FCC) and ₱ 2.8 billion of NDC promissory notes accepted as payments to clear emergency loans of Intercom. N.B.: financed from the rediscount window. The figure for 1980 refers to commercial banks only.

2/ To GFIs only, financed from the budget.

During 1983-85, the CBP continued to accept less than first-rate collateral for its emergency loans. Furthermore, during 1984-85, the CBP provided interest rate subsidies on both emergency loans and overdrafts, as well as on medium- and long-term equity loans provided through the special rediscount window. For instance, the CBP charged a rate of interest of 27 percent (MRR + 2 percent, see Table 14), on short-term loans of 180-day maturity, which was lower than the comparable treasury bill rates. 1/ Similarly, the CBP charged 11 percent on medium- and long-term equity loans to finance mergers and acquisitions, which was well below market rates.

d. Disposition of private banks in distress

During the crisis, the authorities arranged for the takeover by the GFIs of four private commercial banks with ₱ 13.5 billion in assets in order to work out appropriate rehabilitation and decide on eventual disposition. Including the two banks acquired in the late 1970s prior to the crisis, the Government owned by the end of 1986 six formerly private banks with ₱ 20.3 billion in assets (12.7 percent of the total assets of the private banking sector). 2/ The scheme for the rehabilitation of these banks consisted of initial capital infusion from the GFI that took over each bank, placement of a central bank comptroller (if warranted) to work out restructuring, continued central bank financial assistance where needed, and arrangement of new private sector partners for mergers or acquisitions (sometimes on a "clean balance sheet basis"). 3/

The eventual disposition of these banks has varied according to the depth of their problems, and the complexity of the litigation that followed. Two of them have been successfully rehabilitated and are about to be reprivatized. Two others have been declared insolvent: one has been closed down while the liquidation of the other has been held up due to lawsuits by the owners. 4/ The fate of the remaining two banks remained undecided. The authorities intended to divest themselves and reprivatize all government-acquired banks. Change in ownership and management of

---

1/ Beginning in December 1984, the CBP applied the treasury bill rate plus 2 percent to emergency loans with 90-day maturity.

2/ Republic Planters Bank and Pilipinas Bank were acquired in the late 1970s. The private banks acquired since 1982 were International Corporate Bank, Union Bank of the Philippines, Associated Bank, and the Commercial Bank of Manila.

3/ Only one proposal for merger of an insolvent bank was on a "clean balance sheet basis". Bad loans would be taken out of the balance sheet, and the new partner would bring in funds to recapitalize the bank.

4/ These two banks and the Philippine Veterans Bank (state-owned) are the three commercial banks which were actually liquidated during the 1980s.

Table 14. Philippines. Terms of Financial Assistance to Distressed Corporations, 1981-85

Facility	Date	Circular No.	Loan Value (in percent) of bank loan	Rediscount Rate (in percent)	Maturity
Special rediscounting					
Medium- and long-term 1/	2/82	846			
For acquisition of fixed assets			75	11	10 years or less (non-renewable)
For investment in affiliates			70	14	7 years or less (non-renewable)
Lender of last resort	3/82	864.907	80 2/		
Commercial bank				MRR + 2 percent min.	90 days
Thrift bank				MRR + 2 percent min.	90 days
NGBGs				24.32 percent for loans of ₱ 150.300 million and over + 2 percent for each for each rollover	60 days
Emergency rediscounting	12/82	Section 90 RA 265/907		16 percent or MRR + 3 percent 3/	90 days
	12/83			MRR + 4 percent	180 days
	12/85			TB + 2 percent	90 days

Sources: IMF, Recent Economic Developments (1986).

1/ Medium- and long-term; also covers lending for working capital in connection with a proposed or ongoing expansion development program, and investment in high-grade securities.

2/ Or as may be provided for under a Monetary Board resolution.

3/ Whichever is higher.

Note: MRR: Manila Reference Rate
TB: treasury bill

these troubled banks was not always required. In one instance, old stockholders were even allowed to maintain their equity position.

2. Rehabilitation/restructuring of the DBP and PNB

By the end of 1985, the DBP and PNB, which together account for nearly one half of banking assets in the country, were recognized as insolvent. Their asset portfolios had deteriorated beyond repair with about 80 percent of the combined portfolio regarded as nonperforming. This deterioration reflected the politically motivated loans they granted during the 1970s and early 1980s, poor internal controls, auditing, and lending standards, the takeover of troubled corporations, the economic recession, and the massive devaluation of the peso. 1/ Their rehabilitation and restructuring began in November 1986.

a. The rehabilitation program 2/

Their rehabilitation program included a restructuring of the finances, the establishment of new charters, reorganization of staff and management, the setting up of new credit appraisal procedures, introduction of improved budgeting and planning processes, and a rationalization of branch networks.

Following an external audit to reevaluate their assets and liabilities, the bulk of their nonperforming assets 3/ was transferred to the Assets Privatization Trust (APT), resulting in a sharp reduction in the size of the two institutions. Some of the nonperforming assets were written off. The Government recapitalized the banks, and also assumed the deposit liabilities equal in amount to the book value of nonperforming assets transferred minus the capital infusion. A large part of the deposit liabilities of these banks consisted of deposits of the Government. The liabilities taken over by the Government, net of the Government's own deposits became part of public debt.

The bail-out operation involved the transfer of ₱ 107.5 billion of assets to the APT, equivalent to 27.2 percent of the total assets of the

---

1/ The special position of the DBP and PNB allowed them unlimited use of government deposits, exemptions from taxes, and access to government-guaranteed borrowing.
2/ This program was supported by World Bank resources under its Economic Recovery Loan.
3/ Nonperforming assets also included real assets and some contingent liabilities.

banking system as of end-1985 (see Table 15). 1/ The PNB accounted for ₱ 47 billion, of which ₱ 6 billion worth of nonperforming assets came from its subsidiary, the NIDC, which was also heavily involved in the rescue of failing businesses. The DBP accounted for the remaining ₱ 60.5 billion. As a result, the balance sheet of these two GFIs was scaled down sharply. Total assets of the PNB declined from ₱ 79 billion in 1985 to ₱ 26 billion in 1986 while total assets of the DBP went from ₱ 74 billion to ₱ 10 billion over the same period.

Second, management and staff were reorganized. A new management was introduced into both banks. The size of the staff was to be reduced over time. For the DBP, this involved a staff reduction from 4,147 employees in July 1985 to 1,981 employees by the end of October 1987. The number of branches and the size of the head office were also reduced. In the case of the PNB, the staff was reduced from 6,500 to 4,700 and 19 branches were closed.

The rehabilitation plan established new charters for the two banks. The DBP has been given the status of a thrift bank and hence will be subject to normal central bank regulations governing thrift banks. 2/ It will focus in its initial stages on lending for agriculture, small/medium-scale industry and housing. Expanded lending in other areas--including wholesale rather than retail lending--will be permitted only after a three-year rehabilitation period (1987-89). The PNB will continue to operate as a universal bank, but without access to special privileges or funds. The PNB will continue to serve as the principal banker for the Government and public enterprises, but within the rules prescribed for public deposits. The PNB will be privatized through public offering of stock after a two-year period of successful operation.

b. <u>The handling of nonperforming assets through the APT</u>

The Asset Privatization Trust (APT) was set up to facilitate the administration and disposition of nonperforming assets of government banks, mainly the DBP and the PNB. 3/ Four basic features related to the APT are discussed: its nature and role, the selection of nonperforming

---

1/ Bank credit to the private sector, in nominal terms, went from ₱ 153 billion at end-1983 to ₱ 96 billion (after transfer) at end-1986, compared to ₱ 114 billion before transfer at end-1986.

2/ These regulations include limits on equity investments, limits on exposure to any one borrower, and the use of guarantees. However, the gearing ratio for the DBP will not exceed 5:1 during the rehabilitation period although a 10:1 ratio is permitted for thrifts.

3/ In principle, the APT could also receive public corporations which the Government wished to privatize.

Table 15. Philippines. Financial Restructuring of the GFIs, June 1986

(In billions of pesos)

	DBP 1/				PNB 2/				Total			
	June 1986	Adjustment	Transfer	Remaining	June 1986	Adjustment	Transfer	Remaining	June 1986	Adjustment	Transfer	Remaining
Total assets	73.9	2.8	60.4	10.7	78.5	6.0	47.0	25.5	152.4	8.8	107.4	36.2
Of which:												
Loans	39.3	0.0	33.3	6.0	38.1	1.5	23.4	13.2	77.4	1.5	56.7	19.2
Equity investment and other bonds	6.7	0.0	5.9	0.8	7.0	0.0	2.3	4.7	13.7	0.0	8.2	5.5
Total liabilities and net worth	73.9	2.8	60.4	10.7	78.5	6.0	47.0	25.5	152.4	8.8	107.4	36.2
Of which:												
Peso deposits	7.9	1.4	5.0 3/	1.5	19.6	0.0	6.2	13.4	27.5	1.4	11.2	14.9
Borrowing	52.6	0.0	49.6	3.0	39.4	0.0	38.3	1.1	92.0	0.0	87.9	4.1
Of which:												
Foreign exchange	(35.2)	(0.0)	(35.2)	(0.0)	(22.3)	(0.0)	(21.9)	(0.4)	(57.5)	(0.0)	(57.1)	(0.4)
Capital	1.6	0.2	0.6	2.5	0.03	6.29	8.45	2.5	1.63	6.49	9.05	5.0
Contingent 4/	21.5	0.0	21.3	0.2	25.4	0.0	16.7	8.7	46.9	0.0	38.0	8.9

Sources: Central Bank of the Philippines (1986).

1/ Adjustment and transfers are subtracted from outstanding stock as of June 1986 except for capital accounts, which are increased; adjustment for the DBP are before transfer.
2/ Include the operations of the subsidiary: NIDC; adjustments are made after transfer.
3/ All government deposits.
4/ Includes outstanding guarantees and unavailed guarantees.

assets transferred to the Trust, and the disposition mechanism for those assets acquired by the Trust.

The APT is a government entity acting as a trustee of the National Government for the nonperforming assets and government corporations transferred to it, and for their disposition. It has a paid-up capital of ₱ 100 million, a five-man Board of Trustees appointed by the President of the Philippines, and an expected life span of five years. 1/ The Government contributed the entire capital of the APT.

The government banks were allowed to transfer any nonperforming account with a value in excess of ₱ 10 million as well as smaller loans which had been granted by the PNB and the DBP with a government guarantee. Transfers were effected at book-value. Based on these criteria, legal titles on some 400 NPA accounts were transferred to the APT during 1986/87, of which about 75 percent constitute financial claims requiring foreclosure procedures that are expected to be long and costly. The remaining assets over which the APT had physical control were being disposed of expeditiously.

The APT would dispose of transferred assets according to a given set of principles and disposition mechanisms. These principles include, among others, the following:

(a) sales will be open to qualified buyers through competitive bidding or auction arrangements;

(b) rehabilitation prior to disposal will be undertaken only in exceptional cases, when it would lead to a justifiable increase in the assets' salability and price;

(c) as a general rule, NPAs will not be disposed of to their original owners;

(d) in the case of deferred payment, terms will be consistent among the various individual transactions.

The APT could sell the transferred assets either directly or indirectly through the use of agents or brokers. The price and terms of settlement

---

1/ The APT is supervised by the Committee on Privatization (COP), which is the first tier of the asset disposition mechanism. The COP is a five-man interministerial body with the Minister of Finance as Chairman. It is empowered to issue guidelines governing the disposition process, approve or disapprove individual disposition proposals on terms and purchasers, approve organizational and financial requirements of the APT, and monitor the overall disinvestment program.

of the sale would be decided on a case-by-case basis, upon approval by the Board of Trustees. Revenues from APT sales of NPAs would be transferred to the government budget as capital revenues.

Both the DBP and the PNB have set up loan-workout task forces selected from their staff, and charged with managing the nonperforming assets transferred to the APT. This involves preparing these assets for sale/recovery, preparing legal documentation preliminary to the sale or seizure of collateral, etc. 1/ A management contract has been signed whereby the APT reimburses all expenses related to handling of these NPAs by the task forces, including salaries of task force staff. This effective transfer of staff was done to ensure that the bank was protected from political influence during the recovery process. For NPAs retained in the DBP and PNB (i.e., less than ₱ 10 million in value per account), additional task forces have been at work to manage loan recovery with reportedly satisfactory loan recovery rates.

V. Conclusions

The paper sets forth to analyze the causes of the Philippines financial crisis, and to examine the authorities' reactions to the crisis. The Philippines crisis followed a typical boom-bust phenomena, analyzed in crisis literature. After a tremendous growth in the 1970s, both the real economy and the financial sector experienced a major contraction. The paper attempted to examine the direction of causality and the interaction between the real and financial sectors. The main conclusion of the paper is that factors endogenous to the financial system played the key role in provoking and exacerbating the crisis, and thus, a key transmission mechanism of the crisis ran from the financial sector to the real economy. This feedback from the financial to the real sector, which was strong during the 1980s, constituted the main focus of the paper.

Indeed, while the deteriorating economy, combined with the political climate and balance of payments crisis increased the financial fragility of corporate and noncorporate institutions, three sets of factors inside the financial system provoked the crisis and exacerbated its impact on real sector developments. First, improper sequencing of financial sector reforms led to widespread loose lending practices, fraud, and mismanagement by numerous banks in the presence of various macroeconomic and political shocks. In particular, these financial reforms neglected to tighten bank supervision, while removing regulatory restrictions in some areas (activity regulations, interest rate setting) and keeping them in other areas (e.g., selective credit).

1/ The names of borrowers have become public. As a result a number of them have taken action to clear their dues.

Second, the limited competition in loan markets, reflecting in part the domination by bank holding companies, played a key role although competition in deposit markets was strong, reflecting low concentration in the banking industry as a whole. Before the crisis, this structure allowed banks, belonging to these holding companies, to engage in excessive risk taking with newly created and inexperienced subsidiaries. Many of the latter would be hit by the limited crisis of 1981, bringing the entire holding group to collapse. During the crisis, this structure contributed to the upward pressure on nominal lending rates. Statistical evidence suggested that, faced with mounting overdue loans, banks passed on to customers the cost of carrying overdue loans. Thus, the portfolio quality of banks themselves contributed to higher interest rates and exacerbated the impact of tight monetary policies.

Third, evidence suggests that monetary and fiscal management was complicated by the sharp portfolio shifts in the banking and nonbanking sectors, and contributed to crowding out the private sector. After 1983, monetary management based on indirect instruments became not only vulnerable to prediction errors as M3 was no longer a reliable intermediate target, but also was faced with conflicting objectives during a crisis--namely maintaining monetary stability while preventing the collapse of the banking system. Also, in spite of a tighter stance after 1983, the fiscal authorities had to step up domestic borrowing--even though budgetary deficit (in percent of GDP) was reduced--as foreign financing had dried up. These demands on management policies in turn caused interest rate to skyrocket and to create a shortage of funds to the private sector, thereby worsening the recession.

Banks' behavior also contributed to the latter as widespread uncertainty in the economic outlook and attractive rates on central bank and government securities led them to ration private sector credit during the crisis and allocate investible funds into safe outlets. However, this issue requires further empirical scrutiny.

In reaction, the CBP and the Government took financial assistance measures to contain the crisis and long-term restructuring measures to restore the soundness of the financial system. While the various support measures to deal with problem banks helped to contain the propagation of the crisis during the difficult macroeconomic environment of 1983-86, the large accumulated losses had to be eventually assumed by the government. The institutional solutions in this regard--the specific recapitalization and restructuring measures for the banking system and the method of disposition of problem assets--seem comprehensive and well conceived; their effectiveness in terms of minimizing future problems remains to be assessed.

Table 1. Philippines: Estimation of the Determinants of Banks' Interest Margins, 1981(IV) - 1986(IV)

Dependent Variable (i_L-i_D)	Independent Variables				Summary Statistics	
	Constant	Inflation	HH Index 1/	Overdue 1/ loans	R^2 (Adj)	DW
Equation I	5.95 (0.38)	+0.07 (1.77)	-0.40 (-0.29)	0.19 (1.13)	0.20	1.14
Equation II	0.14 (0.82)	0.06 (2.54)		0.22 (1.89)	0.23	1.17

Note: (i_L - i_D) = gross interest margin on short-term bank rates.

1/ Annual data were divided by 4 and repeated for each quarter.

Table 2. Philippines: Indicators of Activity and Financial Performance of 1,000 Top Industrial Corporations, 1980-84 1/

	1980	1981	1982	1983	1984
Total assets (TA)	116.5	130.0	184.8	251.5	284.2
Current assets (CA)	58.9	62.7	69.5	82.1	96.8
Fixed assets (FA)	47.3	53.8	96.3	136.1	160.4
Other assets (OA)	10.3	13.5	19.0	33.3	27.0
Total liabilities (TL)	77.6	89.3	126.1	178.9	209.4
Current liabilities (CL)	50.7	57.4	67.8	83.8	96.7
Long-term liabilities (LL)	26.9	31.9	58.3	95.1	112.7
Equity (E)	38.7	59.2	40.7	72.6	75.0
Net income (IN)	...	0.2	-1.7	-2.0	2.6
Gross revenue (R)	...	119.2	140.9	167.9	230.0
Sales	...	114.6	137.2	163.5	223.5
			(In percent)		
Selected financial ratios					
Leverage					
TL/E	2.1	1.5	3.1	2.5	2.8
Activity					
S/CA	...	182.8	197.4	199.1	230.9
S/TA	...	88.1	74.2	65.0	78.6
Profitability					
IN/E	...	0.2	-4.2	-2.7	3.5
IN/TA	...	0.1	-0.9	-0.8	0.9
Liquidity					
CA/CL	116.2	109.2	102.5	98.0	100.1

Source: Business Day (1981-84).

1/ Consist of largest corporations in construction; electricity, gas, and water; manufacturing; mining and quarrying sectors.

Table 3. Philippines: Evolution of Nongovernment Sector Debt In Nominal Terms, by Borrowers and Origin

(In billions of pesos at current prices; end of period)

	1972	1978	1980	1981	1982	1983	1984	1985
Nongovernment 1/								
Total	30.1	179.7	246.7	293.2	356.7	471.6	603.5	540.5
Domestic	27.1	104.4	150.3	153.6	196.5	214.4	233.3	200.1
Foreign	3.0	75.3	96.4	121.8	160.2	257.2	370.2	322.8
Enterprises 2/								
Total	8.7	90.8	117.4	141.8	170.2	248.7	328.3	277.1
Domestic	8.7	33.2	49.8	53.5	58.0	61.9	51.9	33.7
Foreign	...	57.7	67.6	88.3	112.2	186.8	276.4	243.4
Commercial banks								
Total	18.0	76.5	113.7	133.6	166.7	200.1	249.3	245.8
Domestic	15.0	58.9	84.9	100.1	118.7	129.7	155.5	166.4
Foreign	3.3	17.6	28.8	33.5	48.0	70.4	93.8	79.4
Individuals								
Total	3.4	12.4	15.6	17.8	19.8	22.8	25.9	17.6
Memorandum items:								
Enterprises' foreign debt			(In billions of U.S. dollars)					
Total	--	7.8	8.9	10.8	12.4	13.4	14.0	12.8
Of which: Short-term	(--)	(1.4)	(2.5)	(3.7)	(4.0)	(4.0)	(4.2)	(3.0)
				(In billions of pesos)				
Net national income 4/	45.8	157.5	211.0	243.2	270.4	302.4	426.2	468.8

Sources: Central Bank of the Philippines, Annual Report, 1983; and Philippines Financial Statistics, 1984-86, and IMF, "Recent Economic Developments," 1987-88.

1/ Sum of debt contracted by enterprise, commercial banks, and individuals.

2/ Composed of business corporations (private and public), single proprietorships, partnerships and associations, and cooperatives. Over 80 percent of the debt was attributed to corporations.

3/ Contracted in local currency from domestic commercial banks. The debt contracted in local currency but onlent by the Central Bank of the Philippines or commercial banks (including the DBP) is netted out. Such debt is included in the foreign currency debt since, as ultimate borrowers, the exchange risk was assumed by these firms.

4/ Includes foreign debt relent to enterprises.

Bibliography

Buhat, V., "Trends in Peso Deposits and Secured Loans of Commercial Banks (1981-1985)" CB Review, Vol. 38, No. 6, June 1986.

________________, "Movements in the Manila Reference Rates and Lending Rates of Commercial Banks (1982-1986)" CB Review, Vol. 39, No. 2, February 1987.

Business Day, "100 Top Corporations in the Philippines" (in cooperation with the Securities and Exchange Commission), Vols. 15 and 17, Manila, 1982 and 1984.

Capie F. and Woods E.G. (eds.), Financial Crisis and The World Banking System (New York: St. Martin Press, 1986).

Central Bank of the Philippines, Annual Report 1983, Statistical Bulletin, 1983.

________________, Banking Laws. Manila: Central Bank of the Philippines, 1983.

________________, "Governor's Report"; CB Review, February 1988.

________________, "The Philippines External Debt Monitoring System"; CB Review, January 1989.

________________, Philippines Financial Statistics, 1983-85.

________________, "Rationale and Expanded Dimensions of Universal Banking in the Philippines," Bondline, (Second Quarter, 1980).

De Dios, Emmanuel S., An Analysis of the Philippine Economic Crisis. Manila: University of the Philippines Press, 1984.

Doherty, John F., "Who Controls the Philippine Economy: Some Need Not Try as Hard as Others," in Cronies and Enemies: The Current Philippine Scene, by Belinda A. Aquino (Editor), Philippine Studies Occasional Paper No. 5, (Honolulu: Center for Asian and Pacific Studies, University of Hawaii, August 1982), pp. 7-35.

Edwards, S. and Khan M., "Interest Rate Determination in Developing Countries," IMF, Staff Papers, Vol. 32, No. 3, September 1985.

Fry, M., Money, Interest and Banking in Economic Development, (Baltimore: The Johns Hopkins University Press, 1988).

International Monetary Fund, Capital Flight: "Concepts, Measurements and Issues", by The Research Department, SM/87/24, January 1987.

McKinnen, I.R., Money and Capital in Economic Development (Washington, D.C.: The Brookings Institution, 1973).

Lamberte, Mario B., "Financial Liberalization: What Have We Learned?" Journal of Philippine Development, Vol. 12, No. 2.

Laya, Jaime C., A Crisis of Confidence (Manila: Central Bank of the Philippines, 1982).

_______________, Gearing Toward Recovery (Manila: Central Bank of the Philippines, 1983).

Licaros, G.S., "Regulations in the Financial System," Bondline, Vol. 23, No. 3 (Manila: Central Bank of the Philippines, 1979). pp.1-3.

Lirio, Ricardo P., "The Philippine Banking Industry: A Historical Perspective," Bondline, Vol. 24 (Manila: Central Bank of the Philippines, April-June 1985), pp. 4-13.

Lontoc, Francisco L., "A Time of Crisis and Reform," Bondline (Manila: Central Bank of the Philippines, November 1981), pp. 7-13.

Robledo, Catalina T., "Deficit Financing of Government Corporations, 1973-83." Central Bank Review (Manila: Central Bank of the Philippines, May 1984), pp. 12-15.

Saldana, Cesar G., "The Philippine Commercial Banking System: Structure, Performance, and the Impact of the Capital Buildup Program of 1972," The Philippine Review of Economics and Business, Vols. 3 and 4, pp. 145-164.

Shaw, E., Financial Deepening in Economic Development (London: Oxford University Press, 1973)

Sicat, Gerardo P., "A Historical and Current Perspective of the Philippine Economic Problems," The Philippine Economic Journal, Vol. 24, No. 1, pp. 24-63.

Sycip, Gorres, Velayo, and Co., "A Study of Commercial Banks in the Philippines." Manila, December 1972, 1978, 1983, and 1986.

Teodoro, Procesa L., "Non-Bank Financial Intermediaries--A Decade of Performance," Central Bank Review (Manila: Central Bank of the Philippines, September 1985), pp. 16-20.