EVOLUTION OF THE PHILIPPINE FINANCIAL SYSTEM

Abstract

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The Philippine financial system is coming of age. This paper looks at the evolution of the system that supplies funds for the Philippines' economic development, at the reforms of the financial system, and at the relation of the financial system to the rest of East Asia.

Review of Development Finance. After an economic collapse in 1983-85, the Philippine financial system was rehabilitated during the Aquino administration, and it has resumed growing since 1993. The development of the financial system has mirrored the performance of the economy, as may be seen in the movements of M2/GNP. Despite financial deepening, however, the Philippines still lags behind many other Asian countries, suggesting that considerable financial repression remains, and the country has relied heavily on foreign savings to finance its economic development.

The Philippines' low savings rate, a phenomenon which distinguishes it from its neighbors, is actually explained by the declining rate of household savings since the mid-1980s. Briefly the main factors that have been found to affect savings in the Philippines (particularly household savings) are income (and/or its growth), interest rates, bank availability, and the real effective exchange rate. In addition, institutions and policies, such as interest ceilings, branch opening and entry rules, the informal sector, as well as problems spawned by government intervention have also negatively influenced savings behavior in the Philippines.

Financial Reforms. The period 1950-70 may be called the infancy of the banking industry in the Philippines. The number of banking units quadrupled in response to new legislation which provided for the establishment and regulation of rural banks (1952) and development banks (1958), the secrecy of bank deposits (1955), and the establishment of deposit insurance (1963).

By the nineteen seventies, the emergence of non-bank financial institutions (investment banks, development banks, etc.) marked the growing size and sophistication of the financial community. Non-bank financial institutions began to challenge the central bank's supervisory and regulatory control and to put intense competitive pressure on banks in both the deposit and loans markets. The money market that had started to develop in the mid 1960s provided surplus units with more attractive savings instruments and borrowers with an alternative source of funds.

The 1980s gave birth to another set of major reforms. The objective, this time, was to increase competition and the availability of long term funds through indirect and direct finance and to increase the stability of the financial system. Unfortunately, a liquidity crisis spawned by crony capitalism in 1981, followed by a severe balance of payments crisis in 1983, resulted in numerous bank failures, which led to bailouts by government banks and the central bank. The Philippines' financial system was in a deep crisis.

When the Aquino government took over in 1986, it geared policy towards cleaning up and regenerating insolvent government banks and a weakened central bank, while moving towards liberalization and market-determined rates and allocation in the financial system. The 1991 Foreign Investments Act gave foreign investors greater leeway to enter the country with fewer restrictions. Full liberalization of foreign exchange holdings was implemented in 1992. The entry of foreign banks was liberalized in 1993, followed by the entry of foreign insurance firms in 1994.

Despite deregulation and liberalization, however, several negative factors still operated against the mobilization of savings. The 1984-85 depression and the slow growth thereafter had effected a drop in per capita income. Real interest rates were negative both prior to the reforms of 1981 and also in six of the eleven years after 1985. The other negative influence has been the relative peso appreciation as measured by a rising real effective exchange rate since 1988. All of these factors have not been conducive to savings formation.

Important advances have also taken place in the Philippines' capital markets, particularly the unification of the two stock exchanges into a single, computerized market in 1992. Together with the recovery of the economy, this presaged a boom in initial public offerings (IPOs), not to mention a rise in stock market capitalization from 15 percent of GNP in 1990 to 93 percent of GNP in 1996. Further development of the capital market, however, awaits reforms to increase the capitalization of brokerage houses and to establish a stronger mutual fund industry. These reforms mean addressing the problems of market underdevelopment such as a tax bias against debt instruments, the absence of an official secondary market, and the limited number of bond and long-term commercial paper issues.

Relation to East Asian Financial System. The trend has been towards greater integration of the Philippines with its Asian neighbors. This is evidenced by accelerating trade activity and more investment within the region. Financial centers in the region have assisted in the development of domestic savings; Hong Kong's financial center, in particular, has been important for trade financing and loan syndication. The environment of brisk intra-regional trade and increased intra-regional investment could have promoted the use of regional currencies for these transactions, although this has not been the case. Nevertheless, the idea of a regional currency clearing system has been under discussion since the currency turmoil that began in the summer of 1997.

Under AFTA (the ASEAN Free Trade Area) and APEC intra-regional trade and investment will accelerate further. As a clear gesture towards this end, the Philippines has unilaterally accelerated its tariff reductions. A great deal more harmonization within the region will be required, specifically the standardization of disclosures and accounting and auditing practices, communication of monitoring criteria and results, coordination of policies, and coordinated action against speculative currency attacks and in dealings with other regional groupings.

Looking toward the future, developments in economic integration, regional financial centers, the use of regional currencies, and the intra-regional institutional framework could positively impact both the Philippines' savings rate and also regional stability and economic growth.