

## **RURAL FINANCE IN THE PHILIPPINES: LESSONS FROM THE PAST AND PROSPECTS FOR THE FUTURE**

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The paper focuses on the relationship between overall macroeconomic policy and rural finance to cover the credit gap for agricultural production. Several laudable measures have been proposed by the Agricultural Credit Policy Council (ACPC), including intensifying rural savings mobilization, using CALF to guarantee agricultural loans from the financial sector, programs to increase agricultural productivity and support for credit cooperatives. These are being undermined, however, by macroeconomic policies such as 'tight' money which restricts credit, restrictions on bank entry into rural areas, low savings deposit rates, lack of investments in rural infrastructure, stagnation in the implementation of agrarian reform, and a weak government bureaucracy in rural areas.

### **1. Three Schools of Thought**

There are now three main tendencies in the study of rural financial markets (RFM) in less developed countries (LDCs). They are what we call: 1) the traditional or farm finance approach, 2) the financial liberalization school, and 3) the surplus approach.

#### *1.1 The Traditional Approach*

The traditional approach assumes that agricultural and rural areas in LDCs are terribly depressed. This leads to the inability of the rural poor and the rural farmers to save part of their earnings. They therefore will not respond to incentives or opportunities that are geared towards the mobilization of rural savings. It is therefore believed that a "supply-side" solution of providing cheap credit to the rural poor will be the impetus for

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growth in the countryside. But, alas, cheap credit is not available to the poor farmers. Formal lenders are highly risk-averse and will not lend to them. Informal lenders, on the other hand, are monopolists and exploiters who charge usuriously high interest rates. The responsibility therefore falls on the central authorities who will have to provide subsidized and supervised loans to make sure that new technologies are adopted and major farm investments are made. The assumption mainly is that the formal system (or in some other countries, wholly state-owned banks) will be induced to follow government regulations and channel cheap credit to the poor farmers regardless of the potential losses that may be incurred in servicing risky customers. On a macro level, cheap credit is assumed to be an efficient way to offset production disincentives to the small farmers (some of which may relate to anti-agriculture policies and biases of the state). Loan quotas and supervised credit rediscounted at very low rates will be the main policy on loans to rural areas. This should be used mainly for farm production and therefore should be integrated with the packaging of inputs for the new technologies.

### *1.2 The Financial Liberalization School*

In the late seventies another school of thought arose which challenged the preceding approach. Encouraged by the widespread failures of schemes that have adopted the solution and spurred by the rise of the McKinnon-Shaw theories of financial repression, this new school has been rapidly gaining adherents in the academe (centered on Ohio State University) and in policy-making agencies, particularly the World Bank.

This view starts with the various problems and failures that are associated with policies employing the traditional approach. First, there seems to be a massive repayment problem and high default rate with farmers utilizing the subsidized and supervised credit. This, according to the new belief, is a result of providing cheap credit to non-viable borrowers who will obviously default. In order for rural financial credits to be productive, loans should be channeled to farmers who have the capacity to invest the money productively and derive returns that can be used to pay back the debt. The best way to ensure this is to liberalize and open up financial markets to allocate resources efficiently rather than intervening with it at every stage.

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Second, the credit market continues to be plagued with lack of financial resources as government resources are being drained and inflationary policies adopted in supporting subsidized credit. The policy of low interest rates, even negative real interest rates (when inflation is taken into consideration) yields financial repression wherein financial savings are being discouraged, leading to a shortage of loanable funds. This shortage inevitably leads to credit rationing and loan quotas and aggravates government's intervention in providing subsidized credit to priority areas. The financial repression and credit rationing will have a perverse effect (completely contrary to the original intent of low interest rates) of retaining loanable funds only to the more established, more powerful and larger enterprises that have closer linkages and ties with the large banks. Supervised and subsidized credit to specialized institutions becomes self-defeating and distorts the efficient, allocative power of the market. The main thing is to allow interest rates to find their equilibrium level so that financial savings will be mobilized and channeled to the more efficient and viable projects.

Obviously, this school views at least a segment of the rural and agricultural population to have much larger savings capacities than previously thought of, especially when given adequate opportunities and incentives to save. They point to numerous studies all over the world pointing to the savings capacities of even the rural poor.

Another important point on which this school differs concerns the informal lenders. Informal lenders, they claim, do not generally charge excessively high interest rates because they have to cover not only the opportunity cost of financial capital, but also high transaction costs in the rural areas and high risk premiums. When all of these are accounted for, the high interest rates charged in the informal market will not be usurious at all. In fact, the new school sees the informal lenders in a positive light since they provide funds to the small rural farmers (who may be cut off from the formal system resources) and reduce costs due to administration, transactions and risks. Borrowers may actually prefer informal loans even if interest costs are high since other non-interest characteristics may make these loans more attractive. Such special features such as the timeliness and immediate disbursement of loan funds, flexibility of loan repayment and the availability of non-cash loans answer the needs of the small farmer that will not

be met by the former banking system. Table 1 presents a summary of the differences between the traditional approach and the financial liberalization school.

**Table 1 - Differences Between the Traditional and the New Approach to Rural Financial Markets**

	Traditional	Financial Liberalization
Savings	1. Rural savings minimal.	1. Rural poor do save given proper incentives.
Financial Markets	2. Subsidized and supervised credit needed for small farmers.	2. Financial markets should be allowed to operate without intervention and interest rate ceilings.
Target Borrowers	3. Most farms.	3. Bankable and viable farms.
Purpose of Loan	4. In farm production.	4. Allow financial market to allocate among uses of loans.
Role of Informal Lenders	5. Monopolist, exploiters, usurers.	5. Efficient allocator of funds to small farmers usually not reached by formal system.
Interest Rate Structure	6. Artificially low interest rates for small farmers	6. Interest rates can be high to cover opportunity cost of money, transactions costs and risk premium.

### 1.3 Interlinked Markets

Closely connected with the new breed of financial market experts would be a growing trend which studies the phenomenon of informal credits, especially the interlinking of credit to the factor and product markets. It is tied to the "transaction costs" school that uses the works of Ronald Coase and Oliver Williamson and has developed as the study of sharecropping and its economic rationale captured the attention of many researchers. The thesis goes like this: Due to imperfect markets in the rural areas — many of the markets don't exist or are incomplete due to high transactions cost — interlinking of markets provides the

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mechanisms of answering the needs that are not being met. Thus, linking credit with the labor market provides the landlord with a means of providing credit to small farmers and at the same time screening tenants that go into sharecropping arrangements with the landlords (Braverman and Guasch, 1984). Sharecropping arrangements and credit also provide the mechanism for landlords to share risks with the tenants (Kotwal, 1985) and so on.

The theory of interlinked markets can be used either to support the informal lenders in rural credits or to attack them. In the main, the theories seem to support the fact that interlinking of markets would answer the efficiency aspects of informal lending particularly in reducing the transactions and risk costs. However, some of the studies also point out that interlinked markets are used to keep the tenants' utility at a reservation level (i.e. equivalent to that of a landless worker) (Braverman and Gausch, 1984). Most of the studies with interlinked markets are restricted to relationships between landlords and tenants. Further studies are needed to study interlinked markets with trader-lenders, farmer-lenders and other lenders, for these types of lenders predominate in the Philippines.

### *1.4 The Surplus Approach*

There is another school that can be considered nontraditional for it views the whole credit relation in agriculture as part and parcel of the relations of production and relations of exchange. Thus, the description of the relationship between the informal lenders and the farmers resembles that of the interlinked markets. But for this school, the market failure and high transactions costs are just manifestations of unequal power relations between poor farmers on one hand and their creditors on the other. The creditors have dominance and power over land (the landlords), trading and finance capital (traders, input-dealers, etc.). The poor tenant has very little bargaining strength and cannot even have the liberty to migrate due to the hold that his landlord and creditors have on him. Bharadwaj (1979) and Bhaduri (1973) exemplify some of the works done in this field.

Recently Floro (1987) applied a mix of the interlinked market theory and the surplus approach to study informal credits offered by trader-lenders and farmer-lenders. Agricultural credit has reached new heights as the studies of Ferrer (1986) and Floro (1987)

indicate that, whereas the landlords and storeowners were the main informal creditors before, now palay traders, rich farmers and a host of local moneylenders have arisen to take their place. Specialization is yet to be achieved since traders, storeowners and lenders are oftentimes the same people, or related to each other by blood or by business dealings.

## **2. The Philippines' Experience with Rural Credit Subsidies**

The rural credit policy in the Philippines has swung from one extreme position to the other. Marcos' ambitious Green Revolution (Masagana-99) program obviously needed much financing. The view then, which took off from the traditional approach, was that credit subsidy and loan inflow were required and should be poured into the rural sector. Although the Green Revolution did increase productivity in the rice areas, the credit program was definitely a failure in terms of repayment and led to a financial crisis, particularly for the rural banks. The failure of credit subsidies in the seventies brought about a new approach throughout the eighties which coincided with the ones espoused by the World Bank, the Ohio School and the financial liberalization school of McKinnon, which called for the stoppage of credit subsidies in order to allow financial markets to operate without intervention and interest rate ceilings.

### *2.1 An Assessment of the Masagana-99 Credit Program*

The traditional approach to rural financial markets believes that the "supply-side" solution of injecting cheap credit in the agricultural areas will spur high agricultural growth and production. Thus, special subsidized and supervised credit programs have been established by the government, particularly in the seventies. These are summarized in Table 2.

The most ambitious program was the Masagana-99 program (M-99) that was introduced in the seventies together with the land reform package and the introduction of the Green Revolution technology. The program covered around 80 percent of the total financing of the programs listed in Table 2. The amount of total subsidy borne by the government has been estimated to be anywhere between a low of P1,151 million to a high of P2,071 million. The benefits reaped have been estimated to be between P1.7 billion

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**Table 2 - Supervised Agricultural Credit Programs in the Philippines from 1973 to 1980**

Program	Commodity	Loans Granted a/ (million pesos)
1. Masagana 99	Rice	P 4,554
2. Masagayang Maisan and Masagana 77	Corn	521
3. Gulayan sa Kalusugan	Vegetables	22
4. Cotton Financing Progress	Cotton	71
5. Integrated Agricultural Financing for Virginia Tobacco b/	Tobacco	34
6. Rice-Tobacco Supervised Credit Program	Tobacco	3
7. Philippine Tobacco Administration (PTA) Farm Credit Assistant Program	Tobacco	3
8. PTA Facility Loans	Tobacco	1
9. Bakahang Barangay	Cattle	256
10. Biyayang Dagat	Fish	35
Total		P 5,500

a/ as of December 31, 1980

b/ as of 1979

Source: Unpublished files. Technical Board for Agricultural Credit, Central Bank of the Philippines.

and P4.7 billion (see TBAC, 1981). But the concept of "benefits" of course is rather vague, for it should not be measured by the increase in gross output after the program was implemented but rather the difference in output if the subsidy program were implemented with that if the subsidy program were not implemented. The latter of course is almost impossible to measure.

The extent to which Masagana-99 contributed to self-sufficiency in rice and the adoption of a more productive technology will be debated for some time to come. Some claim that adoption of the

technology started in the late sixties and would have become prevalent even without the program.

But a more realistic assessment would be that the new technology is highly capital-intensive and input-dependent and for it to be widely accepted some form of subsidy will have to be given. The main question, therefore, is whether credit subsidy had contributed its share to the goal of self-sufficiency in rice. Sacay et al. (1985) seem to suggest that direct subsidies, particularly fertilizer subsidies, might have better impact than credit subsidies.

## 2.2 M-99 Not Viable

After looking at the way the program was implemented, it seems that the long-run viability of the M-99 program is questionable. Table 3 shows the depletion over time of the number of small farmers borrowing from the program. Table 4 shows that the total number of farmer-beneficiaries of the program at its peak covered 36.4 percent of the small rice farmers and 47.2 percent of the potential

**Table 3 - Number of Borrowers of M-99, By Crop Year  
1973/74 — 1982/83**

Crop Year	Wet Season	Dry Season
1973/74	400,342	234,965
1974/75	528,747	355,716
1975/76	303,580	154,215
1976/77	142,696	89,198
1977/78	139,600	91,120
1978/79	120,404	88,188
1979/80	117,986	70,119
1980/81	82,586	72,053
1981/82	69,402	48,596
1982/83	68,822	39,600

Source: TBAC Files.



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rice farmers. By 1980, the actual coverage had fallen to 3.7 percent of the total small rice farmers and 4.8 percent of the potential farmers.

**Table 4 - The Relative Scope of the Masagana-99  
Credit Subsidy**

	No. of Small Rice Farmers	Percent to Total Small Rice Farmers	Percent to Potential Coverage
1. No. of Small Rice Farmers (< 5 ha.)	1,457,526	100.0	-
2. Potential Coverage M-99 (Small Rice Farmers)	1,126,668	77.3	100.0
3. Actual Coverage of M-99 (high) 1/	531,249	36.4	47.2
4. Actual Coverage of M-99 (low) 2/	54,250	3.7	4.8
5. Actual Coverage of M-99 (average) 3/	199,937	13.7	17.7

<sup>1</sup> Phase III (May-October 1974); the assumption here is that all those covered are small rice farmers.

<sup>2</sup> Phase XIV (November 1979-April 1980); same assumption about coverage was used.

<sup>3</sup> Average number of farmer-borrowers over fourteen phases of the program was taken; same assumption as above.

The move of farmers away from subsidized institutional credit derives mainly from high default rates that have made them ineligible for most loans from the formal credit system. Many farmers have also expressed reservations at the rigid and high transaction costs (paperwork, delay in disbursement of funds, restriction to the uses of loan funds, etc.) of such types of credit which offset partly the low-interest features of the loans. Thus we

see a shift from informal to formal sources of credit from the fifties and sixties to the mid-seventies, and a shift back to informal sources starting in the second half of the seventies.

**Table 5 - Loans for Rice Production, PNB and RBs  
As of December 31, 1982  
(million pesos)**

	3-year Period		
	1974-76	1977-79	1980-82
<b>Rural Banks</b>			
M-99	1,269.2	631.4	458.9
Regular	1,031.5	1,699.9	1,956.8
Total	2,300.7	2,331.3	2,415.7
<b>Philippine National Bank</b>			
M-99	1,347.0	562.7	444.8
Regular	508.6	57.7	244.1
Total	1,850.6	620.4	688.9
<b>Total</b>			
M-99	2,616.2	1,194.1	903.7
Regular	1,535.1	1,757.6	2,200.9
Total	4,151.3	2,951.7	3,104.6

Source: Sacay, Agabin and Tanchoco. *Small Farmer Credit Dilemma*, 1985.

The government has also found it difficult to sustain the credit subsidy program of M-99. Table 5 shows that rice production loans have shifted from the M-99 credit loans to regular agricultural loans by the early eighties. This is particularly true in the case of rural banks.

Table 6 gives us a picture of the repayment rate and past due ratios of various subsidized programs of the government including the M-99 as of the end of 1982. Although the repayment rate is still respectable at 82 percent, the fall in the volume of loans in

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**Table 6 - Volume of Arreages in Small Farmer Credit, By Program  
As of End 1982  
(in million pesos)**

Credit Program	As of December 1982				1972-1982 a/			
	Loans Granted	Loans Collected	Loans Outstanding	Loans Past Due	Repayment Rate b/ (%)	Past Due Ratio b/ (%)	Average Repayment Rate b/ (%)	Average Past Due Ratio b/ (%)
M-99	5300.2	4240.4	1059.8	885.3	82	84	81	81
M-77/ Malungana	613.7	433.3	180.3	151.1	73.8	65	75	91
GSK	31.8	20.0	11.8	8.8	67	75	72	82
IAP-Tobacco	74.8	59.4	15.4	5.6	91	36	82	65
OPP	80.1	52.8	34.3	23.5	76	68	76	36
<b>Total</b>	<b>6100.6</b>	<b>4805.9</b>	<b>1301.6</b>	<b>1074.3</b>				

a/ Average of ratios from 1977-1982 for M-77 and GSK programs period covered was from 1978 to 1982

b/ Repayment rates and past due ratio were computed as follows:

$$\text{Repayment Rate} = \frac{\text{Loans Collected}}{\text{Loans Matured}}$$

$$\text{Past Due Ratio} = \frac{\text{Loans Past Due}}{\text{Loans Outstanding}}$$

Loans for the latest phase of crop year were assumed to be all current accounts.

Source: TBAC, "Agricultural Credit Plan Appraisal Reports" (Unpublished Documents), 1977-1982.

the latter part of the seventies and early eighties and farmers' difficulty in paying past due loans have increased the past due ratio to 84 percent. Since an estimated 70 to 90 percent of all borrowers have dropped out of the program, the losses of much of the past due loans represent a substantial cost to the monetary authorities.

### 2.3 Causes of Default

The single most important issue that puts in doubt the entire viability of the program is that of loan defaults. It is therefore important that we discuss the reasons for defaults and how policy can be improved to tackle this problem. Most of the studies on credit for the M-99 program (and there are many) devote their attention mainly to this point.

Most studies show in general that consistently relevant determinants of repayment are income and related variables (such as farm size, volume of produce, level of indebtedness, educational and tenurial status and household size). Furthermore, the dole-out mentality may affect depressed areas more substantially, thus leading to less repayment. Bank experience and management, loan information and collection policies as well as technical supervision may be much better in more progressive and higher income areas. It is therefore quite difficult to separate out the true causes of defaults and their magnitudes.

But it is clear that the capacity to pay is the single most important factor in explaining loan default. Any subsidized and supervised credit program will have to make sure that its target borrowers can pay back the loan. Another important factor is the incentives and motivation that are given to the farmer to pay his loan properly. The dole-out mentality and simple pragmatism may work against the viability of a subsidized credit program. One can simulate a hypothetical situation and show that a farmer who does not pay his loan will be better off than one who regularly pays his loan (assuming that the unpaid original loan is recovered through higher production and can be "rolled over" into the next periods). Bank management and experience, the efficiency in disbursement of loans and adequate collection and technical supervision policies are the next set of important variables. Studies further show that the repayment rate seems to be worse for supervised credit borrowers and borrowers without collateral compared to ordinary credit borrowers with collateral.

All of the arguments given above support the financial liberalization view that criticizes heavily the traditional approach. The former approach views reliance on credit subsidy as self-defeating because eventually it will still be the more viable farmers and the more viable enterprises that will retain their credit line. Furthermore, David (1983) points out that credit is fungible. If it is forced to be put in unprofitable activities, ways and means will be found to siphon funds off to more profitable ventures or to consumption spending, whichever yields a higher utility. Thus we may see a situation wherein the target borrowers — the small farmers — will lose access to credit and funds will be spent on items other than agricultural production, the complete antithesis of the original intent of subsidized credit.

### 2.4 *The Rigidity of Formal Credit Loans*

Some authors, notably Feder (1983), point to the "trauma" that small farmers may have experienced after the program had been "forced" upon them. The necessity of credit with technical and managerial supervision could have given many a farmer some difficulties in adjustment. The policy of the "selda system" has transformed a plan that was supposed to cultivate group support among farmers into complaints about having to shoulder somebody else's debt. This has thus given rise to "fake" seldas put together for the purpose of obtaining loans. Panganiban (1979) also points to complaints about the rigid nature of the loans (in Jaen, Nueva Ecija) wherein loan disbursements were broken down into 45 percent cash and 55 percent in seedlings, fertilizers, and pesticides. The farmers maintained that the 45 percent cash loan was not enough to pay for other farm production costs (e.g. labor and tractor cost, irrigation fees). The lack of flexibility that the farmer was given in allocating the loan fund has resulted perhaps in higher defaults and in the practice of selling part of the 55 percent share of the loan for cash. As one farmer in the study said: "Bakit binibigyan ng pautang ang bukid ngunit ang nagtatrabaho, wala"? (Why does the government give credit support only to the farm but none to tillers?)

A TBAC study (1976) also found that many farmers were willing to make partial repayment but were not allowed by rural banks. All these point to the fact that the farmers have reacted negatively to the rigid, formal impersonal transactions that dominate institutional credit.

### 2.5 *Lessons from the Masagana-99 Experience*

The issues raised above all point to the fact that to solve the rural credit dilemma, the best policies would be those that will ensure increased incomes and well-being of the majority of the peasantry. Only when the majority of farms become viable enterprises will rural credit (even without subsidies) become stable and dynamic.

This may mean that subsidies to the rural areas should be given in terms of direct subsidies to production. Government and private initiatives in infrastructure-building (irrigation seems to

be one very direct method of increasing farm yields) and in research and development for agricultural production should be continued and expanded; agricultural and price policies that do not discriminate against agriculture should be implemented immediately. The encouragement of off-farm employment and multi-cropping arrangements will spur higher income and reduce risks of default.

Perhaps more drastic structural changes will have to be implemented. Esguerra (1981) points to the fact that one big drain in income for the farmer (and which could make a difference in the viability of the farm) is land rent. We can also add the high differentials between farmgate and retail price of agricultural crops as well as possible monopoly prices of agricultural inputs. All these lead to the conclusion that a comprehensive agrarian reform program (which means not simply land redistribution but liberalization of access to marketing and credit) should be planned and executed to make the majority of farmers viable and reduce their default risks. Structural reforms may be harsh but one should not ignore them in the list of policy recommendations. The issue as to whether agrarian reform will increase productivity in the agricultural areas is a debatable issue. But the successful experiences in East Asia (Taiwan, Japan and South Korea) point to potentially significant impacts of agrarian reform on small peasants' productivity and welfare partly through a better incentive structure for the family farm unit.<sup>1</sup> Furthermore, the government's declared intent of wanting to give emphasis to small and medium farmers' access to rural credit goes beyond productivity and efficiency and leans towards improved equity. The previous discussions maintain that this bias for small and medium farmers in rural credit will be unsuccessful unless small and medium farms are turned into viable enterprises. It is the belief of this paper that agrarian reform as well as proper support services (such as rural infrastructure, research and development, marketing and credit facilities) will be the best policies to achieve this.

Structural reforms and proper policies may take time to accomplish. They definitely should be planned and implemented immediately. But there lingers one important question: What credit policies do we pursue in the short run when the majority of farmers are still considered poor and perhaps unviable?

<sup>1</sup>The shift from the commune system to more family-oriented economic units in China also provide circumstantial evidence to the potential increase in productivity and output that agrarian reform can achieve.

### 3. Financial Liberalization

#### 3.1 *The Formal Sector*

The supposed failure of the credit subsidy scheme has forced the Marcos as well as the Aquino administration to discontinue most credit subsidies and to use market mechanisms and market interest rates for rural credit. This coincided with the financial liberalization policy which began in the early eighties up to the present period. The withdrawal of the government from the credit subsidy area involves the use of market interest rates in determining agricultural production loan rates, reliance on the private sector to provide agricultural production loans, and the end of direct lending programs of non-financial government institutions.

On paper, government interventions would be restricted to direct government expenditures in the agricultural area such as building rural infrastructure and implementing an agrarian reform program. These hopefully would increase agricultural productivity and make the private financial sector more willing to lend for the purpose of agricultural production.

Table 7 shows the lack of growth in formal agricultural credit in the early eighties and the sharp drop in the mid-eighties, picking up only in 1988 and 1989, with the rehabilitation of the Philippine National Bank (PNB) and the Land Bank of the Philippines (LBP) — the latter supposedly funding agrarian reform beneficiaries. The same table also shows that neither did agricultural production lending from the private financial institutions grow in the eighties (except in 1988). Therefore, the conclusion one would make is that formal credit to agricultural production credit has, in real terms and vis-a-vis their needs, declined.

Since private financial institutions are known to lend more to large-scale agricultural production units, most small and medium farmers (as many studies have shown) are now completely dependent on the informal curb market for both production and consumption loans.

Though much of the informal credit in the fifties and early sixties was provided by the landlords when share tenancy was more prevalent, the informal loans in the seventies, eighties and

Table 7 - Agricultural Production Loans Granted, By Institution: 1980-1989  
(in million pesos at current prices)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	Compounded Annual Average (1980-89) Growth Rate											
Amount: % Share	Amount: % Share	Amount: % Share	Amount: % Share	Amount: % Share	Amount: % Share	Amount: % Share	Amount: % Share	Amount: % Share	Amount: % Share	Amount: % Share	Growth Rate											
Government Banks	3,703.6	17.70	3,410.6	13.40	4,467.7	16.30	3,565.3	12.60	2,000.2	7.50	1,377.8	5.10	579.0	2.30	1,485.8	5.40	3,492.5	9.90	5,638.9	18.70	2,979.6	5.2
Phil. National Bank	3,093.3	14.77	2,605.4	10.27	3,542.8	13.33	3,267.8	11.55	1,946.8	7.19	1,315.7	4.87	574.8	2.29	702.4	2.56	2,821.4	7.46	3,394.6	10.88	1,991.3	(6.3)
Dev't. Bank of the Phil.	538.7	2.57	674.7	2.66	603.6	2.21	79.7	0.29	83.4	0.31	62.1	0.23	4.2	0.02	131.2	0.48	458.7	1.30	210.6	0.67	270.1	(9.9)
Land Bank of the Phil.	71.6	0.34	130.5	0.51	221.3	0.81	207.8	0.73	0.00	0.00	0.00	0.00	0.00	652.2	2.38	402.4	1.14	2,233.7	7.16	5,468.4	46.6	
Private Financial Institutions	17,242.8	.30	21,966.0	86.00	22,965.0	.70	24,725.8	87.40	25,039.9	92.50	25,624.3	94.90	24,535.4	97.70	25,974.2	94.60	31,797.5	90.10	25,357.0	81.30	23,828.4	4.4
Commercial Banks	13,342.6	63.70	17,430.9	68.69	17,433.5	63.78	18,915.8	65.88	21,330.1	78.80	22,479.7	83.25	20,008.8	79.67	21,007.1	76.50	23,777.0	67.38	18,558.5	59.47	15,115.7	3.7
Savings and Mortgage Banks	170.9	0.82	215.0	0.85	407.3	1.49	90.4	0.33	15.2	0.06	12.9	0.05	97.1	0.39	90.2	0.33	201.6	0.57	355.9	1.14	776.9	8.5
Development Banks	96.0	0.46	116.0	0.46	182.9	0.67	330.3	1.17	330.9	1.22	352.3	1.30	868.1	3.42	1,013.4	3.69	1,190.3	3.37	1,481.1	4.75	527.1	35.5
Rural Banks	3,257.3	15.55	3,729.9	14.70	4,307.0	15.76	4,610.3	16.30	3,261.8	12.42	2,776.9	10.29	2,948.1	11.74	3,456.4	12.59	3,854.8	10.92	4,402.7	14.11	3,056.7	3.4
Stock Savings & Loan Assoc.	376.0	1.80	474.2	1.87	534.3	1.93	779.0	2.75	1.9	0.01	0.5	0.00	623.3	2.48	407.1	1.48	2,773.8	7.86	568.8	1.82	6,060.9	4.7
TOTAL	20,946.4	100.00	25,376.6	100.00	27,332.7	100.00	28,281.1	100.00	27,002.1	100.00	27,070.1	100.00	25,114.4	100.00	27,480.0	100.00	35,290.0	100.00	31,205.9	100.00	22,100.7	4.5

Source: ACPC Year-End Credit Report



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nineties have come mainly from traders and middlemen due to increased commercialization of crops and due to the decline in share tenancy.

**Table 8 - Distribution of the Number of Operating Banks Involved in Agri Lending, By Type and By Region As of September 30, 1989**

Region	Rural Banks <sup>2</sup>	Private Commercial Banks <sup>3</sup>	Thrift Banks	Specialized Government Banks <sup>4</sup>	All Banks
I	104	84	22	23	233
II	40	23	4	20	87
III	93	108	101	28	330
IV <sup>1</sup>	160	97	147	30	434
V	60	38	12	18	128
VI	97	86	23	18	224
VII	50	97	21	16	184
VIII	38	25	4	15	82
IX	20	31	6	15	72
X	61	58	15	19	153
XI	51	80	26	19	176
XII	39	24	6	12	81
All Regions	813	751	387	233	2184

<sup>1</sup> Excluding Metro Manila.

<sup>2</sup> Excluding branches, extension offices and money shops.

<sup>3</sup> These branches of private commercial banks located outside Metro Manila excluding branches of Philippine National Bank (PNB).

<sup>4</sup> Includes branches of the Land Bank of the Philippines (LBP), Development Bank of the Philippines (DBP), Philippine National Bank (PNB), and Philippine Amanah Bank operating outside of Metro Manila.

Source of List of Banks: CB Supervisory Reports Office (SRO).

### 3.1.1 Formal Credit Supply to the Rural Areas

Table 8 gives us the distribution of the number of operating banks involved in agricultural lending by type and by regions as of September 30, 1989. In terms of number, rural banks are the most numerous, followed by private commercial banks are thrift banks and specialized commercial banks, respectively. But in terms of the total amount of agricultural production loans given (Table 7), the biggest amount was loaned out by the commercial banks (lending 60 percent or more of the total formal agricultural

production loans in the eighties). Government banks and rural banks comprise the next largest sources of agricultural production loans although the share of government banks dropped sharply during the financial crisis years 1984 to 1987. It must also be noted that, from 1981 up to 1987, agricultural production loans granted at current prices remained stagnant (which means in real terms, the value of agricultural production actually declined drastically as inflation was double-digit, except in 1986 and 1987, reaching 50 percent in 1984.) Agricultural production loans jumped in 1988 as the Philippine National Bank (PNB) resumed its lending to the agricultural sector. Although the Land Bank of the Philippines (LBP) increased its agricultural production loans in 1989, total loans still declined due to the drastic fall in agricultural production loans coming from commercial sources.

Table 9 - Ratio of Agricultural Loans Granted to Total Loan Granted, 1980-1989

Financial Institution	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	Average
<b>Specialized Government Banks</b>	<u>10.0</u>	<u>9.0</u>	<u>10.8</u>	<u>7.4</u>	<u>6.3</u>	<u>6.4</u>	<u>2.3</u>	<u>6.7</u>	<u>5.1</u>	<u>11.4</u>	<u>7.5</u>
Philippine National Bank	10.5	9.3	10.7	7.8	6.7	6.2	2.3	5.8	15.2	13.9	8.8
Development Bank of the Phil.	9.9	9.9	12.2	1.8	2.6	36.7	10.3	65.0	16.6	4.6	17.0
Land Bank of the Phil.	3.4	3.9	8.9	10.5	-	-	-	6.6	0.8	10.1	6.3
<b>Private Institutions</b>	<u>9.0</u>	<u>9.1</u>	<u>7.8</u>	<u>7.7</u>	<u>8.2</u>	<u>10.1</u>	<u>7.9</u>	<u>7.2</u>	<u>7.7</u>	<u>7.5</u>	<u>8.2</u>
Private Commercial Banks	7.4	7.7	6.3	6.8	7.3	9.2	6.9	6.4	6.6	5.4	7.0
Private Development Banks	25.7	19.2	19.8	8.5	15.3	12.0	13.8	13.5	14.7	14.4	15.7
Savings and Mortgage Banks	1.2	1.6	2.6	1.1	0.5	0.5	1.3	0.7	0.7	1.6	1.1
Rural Banks	86.2	85.0	82.8	80.6	75.9	71.4	66.0	61.2	59.2	55.2	72.4
SSLA's	32.5	29.2	25.9	10.6	16.2	19.2	13.1	17.7	28.1	24.0	21.7
<b>TOTAL</b>	<u>9.2</u>	<u>9.1</u>	<u>8.2</u>	<u>8.0</u>	<u>8.1</u>	<u>9.8</u>	<u>7.5</u>	<u>7.2</u>	<u>7.4</u>	<u>6.6</u>	<u>8.1</u>

Source: ACPC Year-End Credit Report.

Table 9 gives us the percentage of agricultural loans out of total loans granted in the eighties for the various types of banks. As expected, rural banks have allotted the greater share of loans to agricultural loans. The percentage, however, has declined from 86.2 percent in 1980 to 55.2 percent in 1989. Commercial banks also decreased their percentage particularly in 1989, consistent with what we said earlier.

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**Table 10 - Gross Value Added in Agriculture, By Commodity, 1980-89**  
(in million pesos, at current prices)

	1980		1981		1982		1983		1984		1985		1986		1987		1988		1989		Annual Growth Rate 1980-89	
	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share		
<b>CROPS</b>	36329	58.83	40386	56.26	44198	57.61	4779	66.51	83470	59.83	98819	60.80	87576	66.14	95516	55.93	106860	66.25	129980	67.34	57.60	17.00
Rice	9078	14.70	10901	15.71	11944	15.67	12225	14.46	21417	15.35	29251	18.00	21012	13.47	24028	14.07	28296	14.89	35598	15.70	15.20	19.28
Corn	3461	5.64	4044	5.83	4563	5.95	4272	5.05	7710	5.53	10687	6.58	9477	6.08	11551	6.76	11648	6.15	15833	6.98	6.20	21.01
Coconut	3036	4.92	3066	4.42	3063	3.98	5221	6.18	10975	7.87	8837	5.44	7460	4.78	8562	5.03	9654	5.03	11396	5.03	5.30	21.37
Sugar	2699	4.37	3162	4.59	4063	5.28	3286	3.89	5329	3.82	3358	2.07	3171	2.03	4030	2.36	5098	2.68	6169	2.73	3.00	13.44
Others Crops	16035	29.20	19193	27.66	20686	26.83	22775	26.94	39039	27.27	46986	28.73	46456	29.78	47325	27.71	52066	27.51	60984	26.89	27.80	15.84
<b>LIVESTOCK</b>	3838	6.21	4195	6.05	4516	6.02	5330	6.30	9435	6.76	10688	6.13	10962	7.03	11742	6.88	13792	7.28	17491	7.72	6.60	19.87
POULTRY	3642	5.91	4338	6.27	5772	7.63	7105	8.40	11441	8.20	14783	9.10	14858	9.53	16236	9.54	18938	9.99	22339	9.85	9.00	23.29
FISHERY	11199	18.13	13821	19.92	14777	19.28	16790	19.86	23116	16.57	27984	17.22	32705	20.87	35312	21.27	37227	19.59	44546	19.65	19.30	16.97
FORESTRY	6743	10.92	6151	8.86	7351	9.83	7541	8.92	12943	8.63	10855	6.69	3874	5.33	10907	5.32	13121	6.91	12342	5.44	7.20	8.77
GVA in Agri	61757	100.00	69391	100.00	76721	100.00	84546	100.00	139505	100.00	162519	100.00	155989	100.00	170770	100.00	189988	100.00	226698	100.00	100.00	16.74

Source: NEDA Statistical Year Book

The picture therefore does not look too well for formal agricultural production credit. Table 10 gives us agricultural production loans granted by commodity. It is clear that sugar, other crops (mostly other export crops such as bananas, pineapple, coffee, etc.), livestock and poultry dominate the agricultural production loans, further corroborating the fact that formal commercial loans go more to large commercial lands. It must also be pointed out that production loans for rice have been growing significantly since 1987.

Table 11 - Ratio of Loans Granted to GVA in Agriculture: 1980-1989  
(In Percent)

Commodity	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	Average
Crops	42.7	44.1	38.9	39.7	22.7	18.3	21.5	22.3	18.4	16.0	28.5
Palay	17.1	15.1	13.6	15.4	5.0	4.2	4.9	8.9	10.6	10.3	10.5
Corn	4.2	5.0	5.5	4.9	2.3	1.7	2.1	4.7	4.0	4.1	3.9
Coconut	64.1	94.6	70.5	40.9	14.3	57.8	48.0	36.4	39.2	13.4	47.9
Sugar	281.7	204.9	220.3	249.6	110.9	150.5	124.0	136.8	106.4	105.6	169.1
Others	23.6	34.2	20.7	28.8	26.4	14.4	21.6	21.2	12.6	13.9	21.7
Livestock/Poultry	37.6	38.5	39.6	34.3	18.7	9.7	9.5	8.6	10.9	11.6	21.9
Fishery	9.0	11.9	12.3	14.2	7.2	4.7	7.7	7.4	12.5	9.5	9.6
Forestry	23.8	34.3	32.2	25.6	16.0	16.9	11.0	12.8	12.8	12.2	19.8
AGRICULTURE	33.9	36.5	33.2	19.8	14.5	16.3	16.2	15.4	15.5	13.8	21.5

Source of basic data: ACPC Year-End Credit Report, NEDA Statistical Yearbook.

Table 11 shows the ratio of loans granted to gross value added for various commodities in agriculture. Based on this ratio, sugar has been most "debt-intensive" even if the ratio has fallen from 1980 to 1989. Coconut also has a relatively high ratio though this has fallen also throughout the eighties and fell to a low of 13.4 in 1989. The ratio of loans to gross value added in agriculture has fallen drastically from 33.9 in 1980 to 13.8 in 1989. This fall in the ratio is true for all commodities except fishery. Again, the picture shows an alarmingly fast decline in loans granted to agriculture with respect to gross value added. Add to this the fact that sugar gets a disproportionately larger proportion of loans — sugar being a commodity whose production should be discouraged in the long run given its long-run fall in international price — and we get a picture wherein credit is contributing less and less to

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output. The reason for this is a tight credit policy and high interest rates in the eighties. Inasmuch as agricultural credit is used mainly to purchase intermediate inputs (fertilizers and pesticides) and tractors, one may foresee some negative effects on farm productivity.

**Table 12 - Projected Agricultural Production Credit Requirement  
By Commodity, 1991-1995  
(in million pesos)**

	1991	1992	1993	1994	1995	Total 1991-95	Average % Share	Average Growth Rate
<b>CROPS</b>	30,446.1	32,798.5	35,243.1	37,856.7	40,652.9	179,341.2	78.2	7.5
Rice	2,234.5	2,420.0	2,609.6	2,820.4	3,048.8	13,133.3	5.7	8.1
Corn	458.7	505.5	557.3	614.7	680.1	2,816.3	1.2	10.3
Coconut	4,309.8	4,531.1	4,763.9	5,011.7	5,276.1	23,892.6	10.4	5.2
Sugarcane	7,055.9	8,084.8	9,270.8	10,612.2	12,109.5	47,142.2	20.6	14.5
Other Crops	17,227.7	18,441.6	19,674.6	20,945.7	16,067.4	92,357.0	40.3	(0.8)
<b>LIVESTOCK &amp; POULTRY</b>	2,852.3	3,212.7	3,684.3	4,182.0	4,827.4	18,758.7	8.2	14.1
<b>FISHERIES</b>	5,178.1	5,639.1	6,190.0	6,794.9	7,447.6	31,249.7	13.6	9.5
<b>GRAND TOTAL</b>	36,025.0	39,119.7	42,598.8	46,333.7	50,511.3	214,588.5	100.0	8.8

Source: DAP-PMS, NEDA.

**Table 13 - Projected Agricultural Production Credit Supply  
By Institution, 1991-1995  
(in million pesos)**

	1991	1992	1993	1994	1995	Average 1991-95	Average % Share	Average Growth Rate
<b>Specialized Government Banks</b>	1,086.0	1,107.8	1,129.9	1,152.5	1,175.6	5,651.8	3.8	2.0
<b>Private Financial Institutions</b>	24,935.0	28,864.6	29,252.8	29,530.0	30,071.6	142,654.0	96.2	5.0
Commercial Banks	18,531.6	22,274.7	22,858.7	23,374.7	23,795.2	110,834.9	74.7	6.7
Rural Banks	4,640.8	4,628.1	4,387.4	4,116.9	3,836.0	21,609.2	14.6	(4.6)
Savings & Mortgage Banks	176.9	203.5	215.6	228.2	241.3	1,065.5	0.7	8.1
Development Banks	926.8	1,040.3	1,065.3	1,080.9	1,222.8	5,336.1	3.6	7.3
Stocks Savings & Loans Assoc.	658.9	718.0	725.8	729.3	976.3	3,808.3	2.6	11.1
<b>Total</b>	26,021.0	29,972.4	30,382.7	30,682.5	31,247.2	148,305.8	100.0	4.8

Source: CB, ACPC Year-End Credit Report.

Table 14 - Agricultural Production Credit Supply and Demand Gap  
1991-1995  
(in million pesos)

	1991	1992	1993	1994	1995	Total Amount 1991-1995
Credit Supply	26,021.0	29,972.4	30,382.7	30,682.4	31,247.1	148,305.7
Credit Demand	36,025.0	39,119.7	42,598.8	46,333.7	50,511.3	214,588.6
Credit Gap	(10,004.0)	(9,147.3)	(12,216.1)	(15,651.3)	(19,264.2)	(66,282.9)

The gloomy picture is further corroborated if we look at the projected agricultural credit requirement for 1991-1995 versus the projected agricultural production credit supply (Tables 12 and 13). The projections were made by the Agricultural Credit Policy Council (ACPC) assuming past trends will be continuing. The credit gap is summarized in Table 14. The gap in the next few years will average more than P10 billion. If the medium-term plan of the Philippines is to give priority to the agricultural sector, the lack of formal financial capital to support that sector will be a major obstacle to achieving that plan.

The ACPC has given some recommendations to tackle the expected shortage of formal credit. These are consistent with the overall strategy of the government to use the market as much as possible and to minimize government's role on credit subsidy.

The main strategy to achieve this is concentrated on two fronts. The first is savings deposit mobilization and second, a continuation of the guarantee funds. The first approach consists of various schemes to mobilize savings through:

1. national interest rate policies;
2. freer and more flexible bank branching regulations;
3. encouraging rural savers to put their money in the financial institutions by various means such as mobile banking, raffle prizes to depositors, incentives to bank employees to mobilize rural savings (see ACPC, 1990).

The second approach is just a continuation of the government's policy of using most of the Comprehensive Agricultural Loan Fund (CALF) as guarantee fund so that agricultural production

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loans will have less risk. This will hopefully have the positive effect of encouraging financial institutions to channel their financial resources to agricultural production. The various funds for this are:

1. the Philippine Crop Insurance Corporation (PCIC) which provides credit guarantee for production credit;
2. the Quedan Guarantee Fund Board (QGFB) which covers inventory financing; and
3. The Guarantee Fund for Small and Medium Enterprises (GFSME).

CALF funds guarantee 85 percent of the value of the loan so that the bank will still have to bear 15 percent of the cost in cases of default (the risk is still shared partly by the bank). In mid-1989 CALF funds amounted to \$12,702,000 and had provided guarantee payment of \$66,500. The number of defaulters was a low 892 (Llanto, 1989).

### 3.1.2 Rural Finance and Macro Policies

The ACPC policy recommendations are well taken. These however have been undermined by some macro policies pursued by the government as well as other structural problems in the rural sector's banking system. The high interest rate policy of the Central Bank has brought lending rate to more than 20 percent starting 1989 and reduced credit availability in the entire financial system through periodic mopping-up operations. The squeezing of credit in the economy has led to substantial credit rationing and has affected the small and medium farmer more adversely than most other sectors as loans are allocated more to the highly profitable, well-connected large establishments in both industry and agriculture.

The strong savings mobilization recommendation is also undermined by the low real interest rates that go to savings deposits. The real interest rates for savings have actually gone negative in recent years as inflation has reached double digits. Inasmuch as rural savings mobilization involves various small-sized savings in the rural areas, again, this hinders the specific policy recommendation of ACPC. The low real savings rate can be attributed to a structural feature of the financial system which

involves market segmentation and oligopolistic practices in the banking sector (see Tan, 1990).

A third problem is the inaccessibility of rural or commercial banks in many remote areas of the Philippines. The stringent policy of the Central Bank of restricting the number of new banks and branches (particularly in remote rural areas) further aggravates the situation. This not only discourages formal credit to farmers but discourages rural savings to go into the formal financial sector which is a key policy of ACPC. This topic will be discussed at length in the next section.

Finally, especially after the experience of Masagana-99, many banks have become reluctant to lend to small and medium farmers due to their "non-viability" or "non-profitability". Most agricultural production loans go to larger enterprises which make a substantial surplus or are able to provide sufficient collateral for the loan. (The guarantee schemes mentioned above are supposed to tackle partly the collateral problem but the guarantees cover only 85 percent of the loan). The rest are diverted away from the agricultural sector. ACPC realizes this and calls for increasing government expenditure in rural infrastructure, marketing facilities and technical assistance to improve productivity and profitability of small and medium farmers. But the government has a terribly tight constraint on its budget, particularly starting 1990, that one sees this option as very unlikely in the short and medium term. The slow pace of the agrarian reform program of the government and the increased uncertainty this entails also do not bode well for improving the farmers' lot.

In sum, it must be pointed out that many of the financial problems the rural sector is facing today are related to the macro and structural policies of the government. Unless these macro and structural problems are corrected, the shortage of financial funds flowing to the rural sector will not be eliminated.

### 3.1.3. The Lack of Access to Banks and Financial Institutions

One of the reasons we have given for the lack of formal credit reaching small and medium farmers is the high transactions costs that farmers have to incur in transacting a formal loan. Studies (e.g., Quinones, 1990) have shown that for the small farmer, these transactions costs discourage formal loan borrowing. Furthermore,



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a major portion of his transactions cost is actually transportation expense and opportunity cost of time consumed in the transaction. Thus, it would be very costly for a small farmer in the rural hinterlands to travel far and often in order to secure a loan. It is therefore important that banks be easily accessible to the small farmers. The picture, however, does not look very good due to the Central Bank's insistence on restricting bank entry and discouraging bank competition.

**Table 15 - Bank Growth Rates**

Region	Bank Growth Rates			
	1976-1983	1976-1986	1984-1986	1986-1989
Philippines	6.6	3.9	(2.8)	(0.45)
CR (Metro Manila)	9.8	5.8	(2.9)	1.93
Ilocos Region	5.4	2.9	(3.7)	(0.37)
Cagayan Valley	5.8	3.0	(4.7)	(0.93)
Central Luzon	3.8	2.2	(0.9)	(5.85)
Southern Tagalog	5.2	3.3	(2.2)	1.76
Bicol Region	4.4	2.4	(3.5)	(2.74)
Western Visayas	4.7	2.3	(4.2)	(0.78)
Central Visayas	6.9	4.1	(3.1)	(1.39)
Eastern Visayas	8.6	4.9	(5.1)	(7.78)
Western Mindanao	7.1	4.5	(2.0)	(1.37)
Northern Mindanao	7.4	5.0	(1.5)	(4.29)
Southern Mindanao	5.5	3.2	(2.9)	1.10
Central Mindanao	5.0	3.4	(1.2)	1.18

Table 15 shows the growth rate in the number of banks for various periods in the various regions of the country. It is clear that the number of banks grew in the period 1976 to 1983. The crisis period 1984 to 1986 included a near-financial collapse which brought about bank closures (including many rural banks) affecting all regions of the country. The recovery period 1986 to 1989 was remarkably marked by stagnancy in the number of banks in the country with most regions still experiencing negative declines. The regions experiencing moderate increases in the number of banks during the latter period were mainly the Metro Manila and Southern Tagalog areas which are the most urbanized in the country (See Table 15). Thus the bias against rural areas has become more pronounced in recent years.

**Table 16 - Number and Distribution of Banking Offices in Metro Manila and Outside Manila**

Bank Type/ Year	Outside Metro Manila <sup>a</sup>			Metro Manila			Total	
	No.	% Share	% to Total	No.	% Share	% to Total		
KBs	1986	903	36.2	52.1	830	76.2	47.9	1733
	1989	901	36.7	51.7	841	75.8	48.3	1742
TBs	1986	429	17.2	64.5	236	21.7	35.5	665
	1989	432	17.6	64.0	243	21.9	36.0	675
RBs	1986	1065	42.7	98.3	18	1.7	1.7	1083
	1989	1025	41.8	98.3	18	1.6	1.7	1043
SGBs	1986	95	3.8	95.0	5	0.5	5.0	100
	1989	97	4.0	92.4	8	0.7	7.6	105
ALL	1986	2492	100.0	69.6	1089	100.0	30.4	3581
	1989	2455	100.0	68.9	1110	100.0	31.1	3565

<sup>a</sup> Defined as all banking offices in the regions net of Metro Manila banking offices.

**Table 17 - Density Ratios: Total Number of Banking Offices to Total Municipalities and Cities Per Region**

Region	1977	1980	1983	1986	1989
I Ilocos Region	1.26	1.55	1.65	1.53	1.50
II Cagayan Valley	0.74	0.97	1.04	0.92	0.90
III Central Luzon	2.81	3.29	3.40	3.25	3.10
IV Metro Manila	41.35	54.29	69.82	64.06	65.30
IV-A Southern Tagalog	1.74	2.20	2.40	2.31	2.40
V Bicol Region	1.04	1.36	1.35	1.27	1.20
VI Western Visayas	1.68	2.02	2.14	1.95	1.90
VII Central Visayas	1.20	1.60	1.75	1.64	1.60
VIII Eastern Visayas	0.47	0.67	0.65	0.63	0.60
IX Western Mindanao	0.56	0.78	0.70	0.71	0.70
X Northern Mindanao	0.95	1.27	1.35	1.32	1.30
XI Southern Mindanao	1.86	2.29	2.17	2.12	2.10
XII Central Mindanao	0.71	0.76	0.71	0.79	0.80
Philippines	1.72	2.17	2.36	2.25	

This bias is further confirmed in Table 16 which shows that commercial banks and thrift banks are heavily concentrated in Metro Manila at the expense of other regions. Table 17 shows the density ratios of the various regions through the years. Density

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ratios are measured by the total number of banking offices to total municipalities in the region. One can see that Metro Manila is far better serviced by banks than any other region. The ratio has increased in Metro Manila tremendously from 1977 to 1983. This

**Table 18 - Density Ratios, by Bank Type and by Region  
as of December 31, 1989**

Region	Population per Bank <sup>a</sup>	Banks per Municipality
Philippines	17,245	2.2
Urban	7,184	65.3
Metro Manila <sup>b</sup>	7,184	65.3
Rural	21,795	1.6
Northern Luzon	15,955	1.5
Cagayan Valley	26,586	0.9
Central Luzon	16,599	3.1
Southern Luzon	15,586	2.4
Bicol Region	30,902	1.2
Western Visayas	22,420	1.9
Central Visayas	21,672	1.6
Eastern Visayas	40,487	0.6
Western Mindanao	44,372	0.7
Northern Mindanao	23,177	1.3
Southern Mindanao	23,553	2.1
Central Mindanao	34,212	0.8

<sup>a</sup> In the absence of actual population estimates, population projections were used.

<sup>b</sup> For Metro Manila, the estimation of the number of banks per municipality was based on the number of service areas per city/municipality.

Sources of data: CBP, 1989 *Fact Book*, Philippine Financial System (With Regional Profile of Banks); NSO, *Philippine Population Projections*.

lopsidedness is again shown in Table 18 which shows the total population served per bank. The ratio is more than double (sometimes more than six times) for areas outside Metro Manila as compared to the ratio in Metro Manila. This distribution may be partly a result of the rational behavior of banks to prefer the Metro Manila area because of the bigger market and better infrastructure there, but there are indications that policies by the Central Bank have prevented the setting up of branches and new banks in the regions (as will be discussed shortly).

This lopsidedness has remained virtually the same from 1986 to 1989 (as shown in Tables 16 and 17). All of the figures therefore point to much less inaccessibility to banks in all other regions of the country as compared to Metro Manila. In the Cagayan Valley, Eastern Visayas, Western Mindanao and Central Mindanao, there is actually less than one bank per municipality (Table 17). Furthermore the Cagayan Valley, Bicol Region, the entire Visayas and the entire Mindanao areas have more than 20,000 people per bank (Table 18). One can guess how difficult it would be for small farmers to get to the banks and secure formal loans.

Florida Chan (1988) lays the blame of much of the inaccessibility of banks to the rural populace partly on the restrictive policies of the Central Bank. In a time series regression analysis, she definitively shows that restrictive policies on bank entry and branching (measured by a binary variable with a one value for years when banking regulations were restrictive) have affected adversely service accessibility of banks (measured by number of banks per square kilometer). In all likelihood, therefore, the Central Bank's restriction of bank entry and bank competition has been a major factor for raising the transaction cost of formal loans by making access to banks more difficult for small and medium farmers.

The restrictive policies of the Central Bank consisted of:

1. the categorization of bank service areas into heavily overbranched areas, ideally branched areas, underbranched areas, and encouraged areas based on the density of banking units and trends of deposits within the area;
2. required investment in government securities; and
3. required capitalization.

In 1984, the Central Bank prohibited entry of banking units and branches into areas listed under the first three categories, although purchase and takeover of closed and failed banks were allowed. In later years, increased capitalization for all categories of banks was required.

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In September 1989, the Central Bank was supposed to have liberalized bank entry and allowed more bank competition. But new banks still had to have approval of the Monetary Board and they had to comply with required capitalization and investments in government securities. As a result, there was hardly any increase in the number of banks since September 1989.

This is quite unfortunate since there have been 147 rural banks that have failed in the period 1980 to 1987 with 87 closing down during the period 1984 to 1987 (World Bank, 1988). The rehabilitation of rural banks is currently ongoing with the rescheduling of past due obligations to the Central Bank of the Philippines over a ten-year period provided there is capital infusion equivalent to 10 percent of supervised credit arrearages or an amount equal to the capital deficiency of the bank required to achieve a minimum of 10 percent risk asset ratio.

While rural banks are recuperating, it is not wise to restrict competition in the rural areas since this is precisely the time to allow healthy competition so that efficiency will be achieved. But it seems the Central Bank and the Monetary Board have opted for an overcautious approach which discourages bank competition.

### 3.2 *The Informal Sector*

#### 3.2.1. The Distinct Nature of Credit and Segmented Market

Over and beyond the lack of accessibility to banks is the very nature of rural credit itself which gives rise to asymmetric information and segmented markets (see Llanto, 1989). Credit markets, unlike product markets wherein goods are sold at one moment in time, require information about the intention and capacity to pay of the borrower. The possibility of a borrower shirking from payment of a loan is sometimes referred to in economics as a moral hazard problem. The lending agencies (usually the banks), to counter this asymmetric information problem, use several "screening" and "sorting" procedures in order to select borrowers with higher likelihood for repayment. For the more impersonal and formal institutions, the decision will be based on proofs (usually documented) of the profitability and bankability of the project, the credit track record of the borrower and the existence

and nature of collaterals. Since the small farmers lack all these, they are at a distinct disadvantage especially in comparison with large commercial plantations. The problem immediately leads to market segmentation as most commercial banks prefer to lend to more established, highly profitable, and highly collateralized large commercial banks. Rural banks and some specialized government banks<sup>2</sup> (e.g. the Land Bank of the Philippines) will have a bigger portfolio going to small and medium farmers though this is declining in the case of rural banks as they are shifting away from agricultural production loans. Finally, the other farmers (and many of the non-profitable and non-bankable ones) are dependent on informal sources of credit. Informal loans are characterized quite differently from formal loans in the following manner:

1. In informal transactions, lenders and borrowers are usually personally known to each other, live in the same vicinity and therefore have access to information which formal banks usually do not have.
2. Much of informal loans are tied or interlinked transactions which link credit to the output, input, land and labor markets (we will expand on this later). These interlinked loans act as collateral substitutes and therefore allow most small farmers (who lack collaterals) to participate in the loan transactions.
3. Informal loans usually are more flexible in terms of loan size, repayment schedule, type of compensation (in cash or in kind) and possibility of renewal or rollover.
4. Related to the second and third points, most informal transactions usually take into consideration the specific objectives of the two parties.<sup>3</sup> Since informal loans do not necessarily have to go through a formal market, the "price" (i.e., interest rates charged), terms of payment, etc. can be unique for each transaction and therefore this allows a wide variety of possible contracts in the informal sector, and this indeed is what most researchers observe.

<sup>2</sup> Rediscounted credits to target farmer borrowers as previously discussed is of course an artificial (i.e. non-market) type of segmentation.

<sup>3</sup> Many studies model interlinked informal loans as something akin to the principal-agent problem (See Geron (1989), Esquerria and Fabella (1990)).

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To counter the lack of information, uncertainty and high transactions costs that accompany formal loans, many lenders and borrowers go to the informal market where personal contracts and interlinked transactions remove much of the uncertainty and high transactions costs.

The lenders in the informal credit market are varied, ranging from landlords — mainly in share tenancy relations — to traders, input dealers, millers, medium and rich farmers, even rural folk whose finance capital is derived from relatives' remittances from abroad.

### 3.2.2 Market Interlinkages

While some informal loans may be similar to formal loans in the sense that the main "price" of the transaction is the interest rate<sup>4</sup> and while there may be "altruistic" loans with no interest or other strings attached (mainly from relatives), the informal credit mode dominating the more regular type of loans actually consists of interlinked or tied loans which do not involve the credit market alone. In some of the hinterlands where share tenancy still abounds, landlords may provide credit to their tenants in order to make them more productive and give them incentive not to shirk from their work (Braverman and Srinivasan, 1981; Kotwal, 1985). In this arrangement the deal is called interlinked since the credit transaction is not inseparable from the share tenancy arrangement. But whereas this was the main source of informal credit when share tenancy was prevalent in most areas, the last few decades have seen the rise of lenders which are traders, millers, import dealers, rich and medium farmers and a host of other lenders as leasehold and amortizing owner arrangement arose (especially in rice and corn areas) and as commercialization increased in most of the crop areas. Thus the interlinked transactions with the traders — the single biggest source of informal credit in some crop areas such as rice — usually consist of loan transactions and a

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<sup>4</sup> Although there is still the difference that the lender and borrower in the informal transaction live in the same locality and have personal contact and thus have more access to information and subject to less chances of default.

transaction which involves the farmer selling his crop output at a previously arranged price. The transaction involves not just the credit market but also the product market. The pricing and terms for the credit and product market deals are interlinked and inseparable. The trader-lender is interested in the accumulation of merchant capital and therefore acts as a typical market lender preferring more bankable farmers (with higher income and lower default risk). With higher output and productivity, effective interest rates are much higher for poor farmers due to high default risks. The stipulation that farmers should buy inputs from these traders (at higher than market price) and/or sell their output to them (at a lower rate than market price) is a clear use of interlinked markets to ensure the sources and market for their traded products. This power of the trader-lender is enhanced since he owns transaction-specific assets such as warehouses which the poor farmer does not have.

Farmer-lenders, according to Floro (1987), have a different motivation in lending (constrained of course by their liquidity needs as they are oftentimes net borrowers themselves). Collateralized loans (particularly those with land collaterals) are their primary concern. They are therefore more willing to lend to lower land-sized and lower-income farmers as long as their land is used as collaterals. Floro shows that such loans arise because the land market is imperfect. Credit thus becomes a means of expanding one's land or one's access to the fruits of another person's land. Thus many of these loans include the surrendering of cultivation rights by the borrower to the farmer-lender. Oftentimes, his interest rate structure is opposite to that of the trader-lender. Farmer-lender loans are found to be the most flexible, accommodating requests at any time of the production period, and allowing rollovers and rescheduling of loans. These easy terms, however, may lead to small farmers accumulating enough debt so that eventually the farmer-lender may force a land mortgage or a takeover of cultivation rights.

Land as primary motive of the farmer-lender is not as conclusive. Ferrer's anthropological work points to other benefits the farmer-lender may get from lending to desperate farmers. New "feudal" ties seem to be in the making as farmers are made to render household and farm services (although often with compensation) to the farmer-lender as well as to oversee his land. The development of what Ferrer calls "the debt nexus" in the agricultural area (particularly in rice production) focuses on the



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need to study the agricultural credit system in conjunction with the overall technological changes, product and factor markets in the rural areas as well as the shifting relations of production and exchange.

This interlinkage of transactions is caused by market failure in many rural markets. The credit market, for one, is highly underdeveloped. As explained earlier, the formal system is wary of lending to small farmers whom they perceive to be unbankable and bereft of any marketable collateral. Small-sized loans to the small farmer also have the disadvantage of entailing high transactions cost and high risk of default. Thus if left alone, and untied, informal credit will also be afflicted with the same problem as the formal system, and may become an unprofitable enterprise.

Other markets too are quite underdeveloped. There is hardly a competitive land market to speak of mainly due to sharecropping arrangements, depressed agricultural incomes and insecurity brought about by the unstable agrarian reform program. The labor market is also not operating competitively again due to share cropping arrangements and the prevalence of owner-cultivator farming. The lack of a strong futures market and crop insurance scheme mark much of the trading of agricultural crops. Imperfect markets, market failures and missing markets call for very high transactions cost to retrieve proper information flows and monitoring. They also entail high risks on uninsured and uncollateralized transactions. The result is an "internalization" (or creation) of particular institutions and arrangements to meet these unmet needs. It is indeed a fact that even with the rise of the CALF (guarantee funds), the informal market still dominates inasmuch as it answers more efficiently the market failures in the rural market.

### 3.2.3. Policies for the Informal Sector

It has been said that the interlinking in the informal market increases efficiency in the economy since it reduces transactions costs and answers the need of market failures and imperfect markets. If this is so, shouldn't the government then try to channel formal loans to the informal sector?

The controversy that rages here is important. The Ohio financial liberalization school usually pushes for channeling funds

to informal lenders because they are more efficient and use interlinked markets to reduce transaction and risk costs. Furthermore, there are signs that there has been a lowering of interest rates in the informal sector after the introduction of the Green Revolution technology (see Sacay et al., 1985). The fall in informal interest rates can be explained (as earlier mentioned) by the increase of suppliers of loans such as the rural banks, traders, input dealers, farmer-lenders, rice millers, storeowners, etc. who responded to the increased demand for loans due to the high input-content of the new technology. This is further verified as studies show that interest rates are lower in areas where the Green Revolution technology has been applied most.

For the more isolated areas, however, finance capital may be concentrated in one or a few traders or landlord. Thus even if the transaction is interlinked, monopoly power still exists. Some studies (e.g. Quinones, 1978) have shown interest rates to be higher in more isolated and backward areas and repayment higher due to the monopoly power of the creditor.

But perhaps an equally important issue is the issue raised by the surplus school, particularly the work of Floro. For here it is pointed out that efficiency and equity are two different objectives. Informal lenders may be efficient and use interlinked markets for this purpose. But, to use the jargon of the transactions school in Industrial Organization, the informal lenders also own specific assets, such as warehouses, access to capital markets and implicit franchises to the industrial inputs to agriculture. Because of this, the resulting agreement between lender and borrower usually puts the borrower in a very weak bargaining position, and thus a great portion of his welfare and even his precious land may be lost in the process. In fact, the process of vertical integration wherein the creditor goes into the area of trading, milling, and selling is very similar to the transaction costs school's explanation of the vertical integration process of large multinational firms (Williamson, 1985).

Another unexplored area, therefore, in both the theoretical and empirical field, is the establishment of credit (and marketing) cooperatives to answer the imperfect markets in the rural areas. Just like the informal lenders, credit cooperatives can interlink markets, particularly the product, credit and factor markets. Efficiency may be achieved (just as in the interlinking of markets by the landlords and traders). But the added feature is that the

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small farmers themselves own the cooperatives, thereby increasing their access to institutional capital, financial and trading markets.

The history of government-inspired credit and marketing cooperatives has been a dismal failure so far. But there are various instances of private initiatives in credit unions and cooperatives that have worked. The story of cooperatives in Japan, South Korea, Taiwan and Bangladesh are far rosier and more encouraging than our experience. In the main, it seems that the essential variables that affect credit cooperatives' ability to succeed are:

1. the level of education and organizing that is done to instill in the farmer a sense of belonging and loyalty to the institution (which translates to prompt payment of dues and obligations, productive use of loans, etc.);
2. the effective use of technical assistance and access to formal institutions, especially for credit, marketing, and production activities; and
3. the link of various agrarian programs to cooperative institutions to ensure that the benefits of reforms will be felt by the small farmer.

The support to credit cooperatives or self-help groups by the government will require some amount of commitment and financial resources even if minimal credit subsidies will be given to these groups. The provision of technical assistance, accreditation and linking with these NGOs or coops on a national scale will entail a significant amount of money and some logistical support in the national and regional level. The ACPC again recommends supporting "self-help groups," but a national government program for such groups needs to be designed and formulated in more detail.

#### 4. Summary and Conclusion

This study gives support to the general thrust of the policy recommendations of ACPC in its attempt to cover the credit gap for agricultural production. These include:

1. rural savings mobilization;
2. a continuation of the Comprehensive Agricultural Loan Funds for use as guarantees to formal agricultural loans;
3. programs to uplift the rural sector and to increase agricultural productivity such as infrastructure building and agrarian reform; and
4. support for farmers' credit cooperatives or self-help groups.

The above, however, are being threatened by the general macro policy trend of the government. In particular, the obstacles are:

1. tight monetary policy that restricts credit availability particularly to the small farmer and rural producer;
2. restriction to bank entry and bank competition, particularly in the rural areas;
3. very low real rates for savings deposits due to market segmentation in the deposits market;
4. a tight government budget with cutbacks in capital outlay including rural infrastructures spending;
5. a stagnation in the agrarian reform program of the government even if the Asset Privatization Trust had sold billions of pesos worth of government and sequestered properties (the funds of which are supposed to be channeled to the agrarian reform program); and
6. a weak and inefficient government bureaucracy in the rural areas which hinders needed support to farmers' NGOs, self-help groups and credit cooperatives.

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