

THE EVOLUTION OF PHILIPPINE INTEREST RATE POLICY*

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While past national development strategies have addressed themselves to more rapid capital formation as a necessary condition for the achievement of higher levels of output and national income, it is paradoxical that these strategies have not concurrently provided a more definitive role for interest rates in the mobilization of resources for capital formation. It is, therefore, significant that the government has taken steps, such as the recent amendment of the usury law, toward reform of Philippine interest rate policy to make it more consonant with overall national development strategy.

INTEREST RATE POLICY: AN INSTRUMENT FOR DEVELOPMENT

A clearer understanding of the role of interest rate policy in national economic planning may be obtained if it is viewed not as a target of development, such as the 7% growth rate target for GNP, but as an instrument for development; in which case, it should be evaluated in terms of its contribution to the mobilization and allocation of an economy's scarce resources. As an instrument for development, interest rate policy may be used either as a means of regulating the cost and availability of credit or as an allocational device to determine optimal saving and investment. The first stresses welfare considerations and requires the establishment of statutory ceilings on alternative forms of savings and investment. The second relies more on market forces to determine the cost of capital and, conversely, subjects the funds market to the discipline of the pricing mechanism. Past Philippine interest rate policy has been more of the former than the latter. In view of the growing sophistication of the Philippine financial system and the rapidly expanding economy, the issue that needs to be resolved is the relevance of continuing a primarily protective and welfare-oriented interest rate policy.

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HOW EFFECTIVE HAS A PROTECTIVE AND WELFARE-ORIENTED INTEREST RATE POLICY BEEN?

To determine the relevance and usefulness of a welfare-oriented interest rate policy, it may be worth asking whether this policy has indeed served to protect the welfare of certain economic sectors. Studies by various government agencies and academic research work¹ have borne out the view that by stressing welfare considerations, present interest rate policy has in fact failed in its welfare objective. Citing from these studies a few arguments on this point may be made here. For instance, the fact remains that in spite of the usury law, rates in unregulated financial markets have remained at usurious levels. Rates in the organized markets have been controlled; thereby straining their ability to compete for funds with the unorganized markets. To the extent that organized markets have been hampered in attracting funds from the unorganized sector, seekers of funds from organized markets have been denied access to more funds. Consider further the creation by law, in seeking to maintain low rates, of a bias against long-term rates in favor of short-term rates in the sense that since statutory ceilings cannot be exceeded, long-term financing requiring rates higher than present ceilings are discouraged. To the extent that more long-term financing cannot be feasibly undertaken, long-term investors have been discriminated against.

The same studies also point out another bias of lending created by the policy in favor of larger industrial borrowers. With the existence of an excess demand for credit arising from low interest rates, credit rationing has resulted. Without adequate compensation for risk, financial institutions have tended to put more stress on collateral and personal banking relationships. Since larger industrial borrowers can more readily fulfill collateral requirements and have closer relationships with banks and other intermediaries, credit rationing has favored them.

Aside from encouraging banks to be collateral and personal-banking-oriented, the policy may tend to encourage them to be over-dependent on Central Bank loans for funds. Since banks cannot

¹ See, for example: Joint IMF-CB Survey on the Philippine Financial System, *Inter-Agency Committee Study on Interest Rates*; Tan, Edita, *Central Banking and Credit Policies in the Philippines*, UP School of Economics, (Quezon City, 1972); Tan, Edita, *Credit Measures and Their Impact on the Development of the Financial Structure*, UP School of Economics, (Quezon City, 1971); Sicat, Gerardo, *Policy Problems of a Vigorous Industrialization*, UP School of Economics, (Quezon City, 1970); and others.

attract sufficient funds from the more normal sources, such as deposits, at the low interest rates set by the policy, they would seek out the CB as a lender of first resort contrary to the accepted norm that it is the lender of last resort.

Relying heavily on CB loans for their financing activities, banks may evolve unbalanced liability structures and render themselves extremely vulnerable to minor changes in CB lending policies. Since CB financing is high-powered money, the situation described promotes inflationary conditions. Deposit substitutes may also be resorted to by banks as another source of raising funds. Even if theoretically excluded from money supply, these deposit substitutes such as bank bills, deposit certificates and others contribute to overall liquidity and therefore may nullify any attempt to curb liquidity through CB instruments which are based solely on the more limited concept of money supply. The recent CB circular on reserves against deposit substitutes has been designed to counter the nullifying influence of deposit substitutes on CB policies.

In the long run, however, the above requirement may serve as a disincentive to the creation of deposit substitutes as a means of raising funds. Consequently, the competitiveness of banks in the overall financial markets may be weakened. Since there is a disincentive to these types of financial claims, the diversification of portfolios of both savers and investors is hindered. These redound to a constraint on the growth of the overall financial system. The CB need not rely on palliative measures, such as the requirement of reserves against deposit substitutes, to regulate overall liquidity in the market. The more efficient and lasting solution is a full and realistic interest rate policy.

On the side of suppliers of funds, the interest rate policy has been just as discriminatory. Reference is made to holders of savings and time deposit accounts as a form of financial savings. In the face of a 10% average annual inflation rate for the past six years, holders of these forms of savings have been receiving negative returns since rates on these accounts are fixed at lower levels. Time and savings deposits have accounted for a high 15.2% ratio to GNP for the past six years, suggesting that a large category of savers comprises holders of savings and time deposits. Since the large category of suppliers of funds, coming mostly from lower income brackets, in effect has been required to subsidize large industrial borrowers, the policy has been inequitable.

It is also argued that the policy has kept the interest rate from performing its role of reflecting real capital scarcity. Consequently, distortions in resource-employment have resulted to the point wherein utilization of alternative inputs has been insensitive to real and effective factor-cost differentials. In other words, by making capital available at relatively cheaper price, the policy has indirectly tended to discourage extensive employment of relatively more abundant resources such as labor.

This aspect has already been heavily underscored by several economists, industrialists, and policy-makers in the country. Apart from contradicting the social objective of providing more employment to labor, distortions in resource allocation have hindered the overall economy from achieving higher productivity.

Current indications of the opportunity cost of capital in the country place the rate between 15% to 30% which is way above the statutory ceilings on interest rates. Based on the sample of the *Business Day's* Top 1,000 corporations, the average rate of return on equity of all economic sectors from 1968 to 1971 has been about 15%.

TABLE I

Weighted Median Rates of Return on Equity
of Top 1,000 Corporations, by Sectors (1968-1971)

Sectors	1971	1970	1969	1968
Manufacturing	11.1	10.2	19.2	11.4
Mining	18.0	37.8	19.1	19.3
Commercial	12.5	25.5	8.7	10.8
Services	4.8	12.8	8.2	16.9
Utilities	39.1	0.4	15.7	10.6
Agriculture	7.0	14.3	6.2	3.4
Unclassified	—	6.8	—	—
Weighted Average*	14.8	15.0	16.2	12.3

Average Rate of Return on Equity from 1968-1971: 14.6% or 15%

*Weights used were the percentage shares for that year of each sectoral equity in the combined equity of all sectors for the same year.

Apart from the yields of alternative investments in financial claims, listed stocks have been posting average price-earnings ratios ranging from 5 to 7 times indicating an approximate cost of equity capital between 14 to 20 per cent. Some unlisted stocks, on the other hand, have been posting P/E ratios of from 4-5 times indicating a much higher range of from 20 to 25 per cent.

A random survey of the effective lending rates for secured loans of five large financial institutions in 1972 showed rates charged ranging from about 14 per cent to as high as 28 per cent.

Table II
1972 Effective Lending Rates for Secured Loans
of 5 Financial Institutions, in %

Institution	Effective Rate Charged
A	28.80% p.a.
B	24.28% p.a.
C	17.92% - 28.80% p.a.
D	13.63
D	13.40% p.a.
E	13.63% - 13.66% p.a.
Weighted Average	26.70% or 27%

Source: Private Development Corporation of the Philippines

The recently conducted ILO Comprehensive Economic Survey Mission has estimated the opportunity cost of capital in the Philippines to lie between 20% to 30%. This range nearly coincides with the range suggested by the rates in the tables above. Although incomplete, these indications nevertheless strongly suggest the consideration of increasing statutory ceilings on interest rates to more realistic levels.

ARGUMENTS FOR REGULATING THE COST OF CREDIT

Several arguments are marshaled to defend the present welfare-orientation of Philippine interest rate policy and maintain its present ceilings. Firstly, if the cost of credit is unregulated and interest rates are allowed to rise to market levels, industries will suffer higher costs of production. Consequently, and as a second argument, a cost-push

inflation would be generated **posting** higher rates of price increase. Thirdly, to raise the cost of credit would mean higher costs for government borrowing and greater pressure on government revenues.

The argument that costs of credit should be regulated to lower the production costs of industries appears untenable on two counts. In the first place, it is arguable whether the subsidy to industries in the form of controlled costs of credit has compensated for the losses in productivity of these industries arising from distortions in resource allocation which the same policy has engendered. Secondly, if the policy sought to protect small and medium-sized industries, it has instead failed as pointed out earlier, since larger scaled industries have been the primary recipients of the subsidy. The ILO Comprehensive Economic Survey Mission has pointed out that smaller and medium-sized industries appear to have higher productivity of capital relative to larger industries so that the objective of the policy of protecting these industries seems not only illusory but also unfounded.

The illusory objective of present interest rate policy in lowering the cost of credit is again evident considering that circumventions of the law have effectively raised costs to borrowers, in some cases exceeding 30% or more than twice statutory ceilings. Maintaining the *status quo*, therefore, where effective costs of credit nevertheless can exceed statutory ceilings, is not any less inflationary than instituting a realistic increase in ceilings or even going to the extent of aligning nominal rates with prevailing effective rates. If nominal rates are increased, however, the rise of effective rates may be dampened by the additional supply of loanable funds generated by higher nominal rates.

Those who seek to maintain the *status quo* may argue that even if nominal rates are increased, the savings behavior of the community may not be responsive enough to bring about a substantial supply of loanable funds that would help dampen any excessive rise in effective rates. To elicit sufficient response, a policy that will institute real and competitive returns to savings may be necessary. A real incentive to savings, moreover may discourage unproductive consumption activities and effectively curtail inflationary pressures in the economy. An effective interest rate policy, in this sense, may prove to be more effective in dampening inflationary tendencies than any fiscal instruments the government may use for the purpose.

The government must decide whether to hold credit costs at low

but illusory levels which constrict the supply of funds or to raise nominal rates which would stimulate a larger inflow of loanable funds.

The argument that the cost of government borrowing would increase if current interest rate ceilings are raised may be disputed on welfare and equity grounds. Maintaining present nominal rates at their low levels to enable the government to borrow at less cost would tend to suggest that the private sector subsidize government borrowing. Considering the fact that the government can borrow without the risk constraints which private sector borrowing is subject to, government borrowing would be given a supreme advantage.

ALLOCATIONAL EFFICIENCY TO GUIDE INTEREST RATE POLICY

The foregoing considerations suggest a re-examination of the protective and welfare-orientation of present interest rate policy and highlight the need for future Philippine interest rate policy to focus more on allocative efficiency not only in the financial but also in the real sector.

Actual relative scarcities in resources would be allowed to dictate factor use such as labor employment, if interest rate policy is made to conform with real economic constraints such as the relative scarcity and productivity of capital. Moreover, the flow of hoarded savings from unorganized sectors into financial assets in the organized sector serves to reduce the competition from unregulated financial groups in the former and stimulate further the growth of financial institutions in the latter sector. In other words, it would be easier to monetize savings through realistic interest rate policies. By subjecting the funds market to the discipline of the pricing mechanism, monetary authorities may be able to exercise more effective control over the asset preferences of both financial and non-financial sectors since financial assets tend to be sensitive to interest rate changes.

Sustaining the growth momentum of the economy to meet the planned growth rate target of about 7% for the next few years² will exert upward pressures on price levels including costs of credit. Moreover, the increasing number of people entering the labor force

²This is the GNP growth rate target set by the *FY 1974-1977 Four-Year Development Plan*.

will require larger portions of national output devoted to capital formation. This entails generating more savings from all sectors of the economy. To ensure that the required volume of investment resources will be forth-coming necessitates a more optimal pricing of such resources.

THE PROPER TIME TO RAISE CEILINGS

Such considerations coupled with the convergence of favorable economic conditions such as the rise in international reserves, the reformation of the banking system among other things which will be pointed out later, make a decision to re-orient present interest rate policy both necessary and timely.

The strong performance of the external sector due to favorable export prices and effective management of import levels and overall foreign exchange transactions of the country have brought about an unprecedented rise in international reserves. Consequently, this has rendered the economy relatively liquid. If short-term rates are tolerable and stable, the government could restructure interest rate ceilings without worrying too much that the effective cost of funds will rise as much as when rates are at initially high levels. Secondly, restructuring interest rate ceilings which more directly apply to longer term financing will reinforce the attractiveness of shifting funds to long-term financial assets. This is an effect which should be favored in view of the objective of promoting long-term investment activity. Moreover, the coinciding larger inflow of both domestic and foreign investments at present would be directed more toward the long-term if the interest rate structure is re-oriented in favor of long-term rates.

The favorable external position of the economy this year provides a setting conducive for the government to concentrate on policies designed to promote domestic stability. There are uncertainties in the future concerning external factors, such as the possibility of reversals in world prices for the country's major exports and possible adjustments when the impending world monetary reform finally takes place next year. It would be timely for policy makers to consider restructuring interest rates at this time before problems of external stability impinge on efforts to concentrate on domestic concerns.

Another factor favoring a decision to restructure interest rates is the government's recent rationalization of the banking system. The

required higher capitalization of banks assures their ability to cope with altered credit conditions arising from a restructuring of interest rate ceilings. With the establishment of more investment houses and other specialized financial intermediaries, it would be timely to gear their operations toward more long-term financing services by restructuring ceilings in favor of long-term rates.

A final factor is the surpluses in the government's fiscal operations this year. For the greater half of 1973, government surpluses have been posting a monthly average of about P240 million. Surpluses in revenues imply greater ability on the part of the government to incur higher costs of borrowing should rate ceilings be restructured.

WHAT WOULD MAKE AN APPROPRIATE INTEREST RATE POLICY?

With the convergence of economic growth requirements which make a decision to restructure interest rates imperative, and favorable economic conditions which make such a decision timely, it may be appropriate for government monetary authorities, in cooperation with the private sector, to institute a new interest rate structure based more on allocative efficiency rather than on protection and welfare. If a compromise between the two bases is made, it should not be at the expense of the former in the light of the fact that a welfare-orientation renders interest rate policy ineffective as an instrument for development.

The incorporation of welfare considerations in the determination of a new interest rate structure should be predicated on a set of credit priorities indicating which economic sectors would receive preferential rates. Whichever economic sectors would be excluded from the priorities would be subject to market rates of interest. A set of criteria may be drawn up to determine priority sectors which may include certain small-scale industries, non-traditional export ventures, key import-dependent manufacturing activities or even some BOI-registered pioneer industries.

This set of criteria may require more adequate measurements of the productivity of capital by industries to provide sufficient indications as to which industries actually need preferential interest rates. A proper link between regulated credit costs and the rate of return of capital in a given preferred industry would therefore be established on both equity and efficiency. Another criterion may be the amount of investments desired in given industries. Those

designated by the BOI as preferred or pioneer and therefore require large amounts of investments may enjoy preferential rates. The rate at which investments pour into such industries may determine the length of time preferential interest rates can be enjoyed.

At any rate, the protective rates these sectors will enjoy will hinge on developmental reasons and not on any traditional disdain for high rates upon which the old usury law seems to have been based. Moreover, the criteria for determining priorities and the list of priority sectors need not be permanent. From time to time, these may be re-aligned with changing development conditions and strategies. This is to ensure that preferential industries strive for efficiency and make overall interest rate policy re-oriented towards optimum allocation of resources.

The scope is wide for re-orienting and restructuring interest rate policy without totally neglecting considerations of welfare and protection.

At this point it may be appropriate to recommend the removal of current ceilings on lending rates and allow the funds market to determine what rates will prevail. This would be in complete consonance with efficiency considerations which, as pointed out earlier, appear far superior as basis for a developing country's interest rate policy than welfare and protection. If this recommendation cannot be accommodated, a second best alternative to complete interest rate reform would be to institute higher ceilings.

If a positive return to savers will be desired, a basic deposit rate of 12% to 14% seems reasonable considering an average inflation rate of 10% since the base year of 1967. Based on the indications of the opportunity cost of capital in the country cited earlier which suggest a range of from 15% to 30%, a lending rate ceiling of 20% seems reasonable. Some sectors have, in fact, suggested the adoption of a scale of interest rates as one way toward full interest rate reform. As applied to deposits, for example, the present basic deposit rate is applied to the average savings balance during a given period of time but higher deposit rates are applied on the minimum incremental balance of the savings deposit. Several other variations have been suggested before.

In any case, the spirit of the law embodied in Presidential Decree No. 116 which amended an obsolete usury law calls for a flexible, imaginative, realistic Philippine interest rate policy.