

Financial Liberalization, Saving Mobilization  
and Banking Innovations

(Abstract)

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## Financial Liberalization, Saving Mobilization and Banking Innovations\*

(Abstract)

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The paper provides an empirical analysis of the impact of the series of measures undertaken by the Philippine Monetary Authority for liberalizing the financial system. The paper notes that the measures were undertaken gradually over about 12 years. The staggered manner of liberalization is shown to produce poor results. Since 1994 when full liberalization took place, the financial market exhibited accelerated development: fairly rapid rise in saving mobilization, rapid growth in the physical financial infrastructure, a narrowing of the interest rate structure and the introduction of modern payment mechanisms such as electronics transfer system. These are all welcome developments but they entail some risks. The paper concludes with recommendations for prudential and technical measures to minimize the risks that a rapidly growing financial market entail.

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The Philippines took a long time to correct obviously bad policies in both the trade and the financial sectors. Over the years from the time that the Central Bank was founded (1948) to the end of the 1980s, monetary policy had been repressive. The interventions in the market intensified during the Marcos regime from mid 1960 to the end of his administration in February 1986. Piecemeal liberalization which was started in 1976 proved ineffectual. The paper shows that the major forms of repression must be abandoned first before the desired effects of liberalization could be achieved. The upward adjustment of interest rate ceilings in 1976 and their abandonment in 1981-1983 produced little if not zero impact on saving mobilization for they were being countermanded by the politically directed credit management of the Central Bank that crowded out deposits and legitimate loans. The Aquino administration stopped the latter but imposed its own repressive measures - restricted bank entry and high intermediation taxes. President Ramos undertook additional reforms. He relaxed foreign bank entry, raised foreign equity limits to controlling levels and established an independent central bank, now called the Bangko Sentral ng Pilipinas (BSP). We see an acceleration of saving mobilization, a narrowing of interest rate differential, adoption of electronics technology, and greater integration with the international financial markets.

The paper is organized as follows. Sections 2 to 3 is a historical account of repression from the founding of the Central Bank of the Philippines to the Aquino Administration and the partial reforms that were undertaken since 1976. Section 3 analyzes the progress and remaining problems under the Ramos administration. Section 4 has the concluding remarks.

## **2. Interventions and Interest Rate Repression, a Historical Account**

The country's post-independence monetary history may be divided into three periods - pre-Marcos from 1948 to 1965, Marcos from 1966 to February 1986 and post-Marcos under Cory Aquino and Fidel Ramos. The first period laid the institutional setting for repressive policies with interest rate repression and directed subsidized credit. The repression was intensified during the Marcos regime when the CB engaged itself in large-scale financing of government and crony private banks ostensibly for development objectives. The post-Marcos administrations took on the task of reforming the system but imposed additional intermediation taxes to help finance government deficits.

The Central Bank of the Philippines was established by law in 1948 as a development-oriented central bank, mandated to promote growth in output and employment and to maintain price and exchange rate stability. It was given ample powers to pursue these objectives. CB is governed by the Monetary Board, the monetary policy-making authority of the country. CB was not an independent body since its Board was chaired by the Secretary of Finance and had a majority membership from the Cabinet. Up to 1960 monetary policy was centered on

maintaining the exchange rate which the Philippines was pressured by the United States under the Bell Trade Agreement to fix at the pre-WWII level of P2/\$1. This was an unrealistic exchange rate considering the high inflation that cumulated during WWII and the pent-up demand from the war years. Monetary policy had to be very conservative in order to stem devaluation pressure. CB controlled imports through quantitative controls favoring import substitute industries. One of the first acts of President Macapagal (1960-1964) was to free the exchange rate which was permitted under the Laurel-Langley Agreement (1955). The exchange rate adjusted immediately by 50% and was supported at about P3.60/\$1 until 1966. Quantitative controls were later replaced by high tariffs as a means of stabilizing the exchange rate and pursuing import substitute industrialization. After wards the exchange rate has been allowed to rise through the years reaching P32/1 presently.

In 1948, the banking system consisted of 7 commercial banks, 3 thrift banks, the Agricultural and Industrial Bank, the sole government specialized bank, and 7 foreign bank branches. CB encouraged the establishment of banks to service a wider clientele. In 1952, the Rural Bank Act was passed and in 1954, the Agricultural and Industrial Bank was merged with the Reconstruction and Rehabilitation Fund to form the Development Bank of the Philippines, DBP, at the same time that CB began assisting the establishment of private development banks (PDBs). CB provided both rural banks (RBs) and (PDBs) 100% counterpart financing for equity and highly subsidized rediscounting facility. The system inherited the Anti-usury law of 1906 which set loan ceilings of 12% for secured and 14% for unsecured loans. Between 1948 to 1965, the number of banks of all types increased quite rapidly. Commercial banks increased from 7 to 35. This alarmed CB and it then stopped licensing new commercial banks but continued to permit the establishment of other types of banks. No new foreign bank branches were allowed and only four remained until 1994.

Money supply increases were largely coursed through CB rediscounting and equity financing of banks. Apparently the CB was quite prudent with its financing facilities until the end of the 1960s as shown by the relatively moderate annual money supply growth of a little over 10%. This is very much lower than the growth in later years. Inflation rate averaged less 1% in the first decade and averaged only 2.9% in the whole period. The low inflation rate weakened the repressive impact of the interest rate ceilings so that M3/GNP ratio was able to increase from 18.9% to 26.4% in this period. (Table 2)

The Marcos government lasted 20 long years from January 1965 to February 1986. The policies of the previous governments were retained for most of the Marcos years - the interest rate ceilings, the promotion of rural and private development banking industry and CB development financing but with one important difference. CB development financing intensified. CB funds were coursed through the government banks and the crony banks. CB, in fact, became a tool for stealing money for the Marcos group. The rediscounting rates had been set earlier at very

low level in relation to the ceiling rates. Not content with its money printing powers, CB participated in the large-scale foreign borrowing by the Executive. The glut in Petro dollars encouraged borrowing. CB credits grew at average annual growth rate of 15.2% in the 1950-1969 period to 23.5% in the 1970-85 period resulting in the acceleration of money supply growth from 12.1% to 18.9%. Inflation jumped to a new high level, averaging 16.9 for the same period (from 2.9% in 1950-1969). The economy has not been able to lower money supply growth and inflation rate since then.

The monetary environment had the expected disintermediation impact. It also led to wasteful allocation of credit and capital flight. The high-inflation which pulled down the real value of the ceiling rates discouraged deposits and created excess demand for loans, hence rationing. The political environment fostered moral hazards in borrowing. In turn, the banks were encouraged to source their funds from the rediscount facility instead of deposits. (Appendix A for a graphical analysis).

Perhaps, easy credit did more harm to the economy than interest rate repression. Easy credit to crony banks and businesses led to a strong investment disincentive as well as inefficient allocation. Politically favored borrowers found it more profitable to simply keep the loan proceeds than to invest them. A new word, **front ending**, was coined to describe this action. Much of the funds borrowed were invested abroad partly to escape possible prosecution. Boyce (1988) estimated the capital flight in the last 10 years of the Marcos regime to have amounted to at least \$10 Billion. Front-ending also took the form of careless choice of investment projects, many of which did not get completed. The misallocation is evidenced by the bankruptcy of the three largest government financial institutions and crony banks that were instrumental in funneling CB funds to bad projects. The non-performing assets of the Development Bank of the Philippines amounted to about 87% of the total and those of the Philippine National Bank, 65%. The Government Service Insurance System also had 50% of its assets as non-performing. The abuses led to a significant number of bank failures including the Philippine Veterans Bank, a government bank, three known crony banks, and rural banks. Over the 1970-1986 period, a total of 221 banks were closed; these include 6 commercial banks and 180 rural banks. In addition to these were other bankrupt banks that were allowed to be merged with or be taken over by solvent banks. (Table 3).

The economy went into a deep recession in 1983-1985 when GNP declined by 7.5% per year. There was disintermediation during the recessionary years with M3/GNP ratio falling from 31.4% to 24.2% in the same years. Partial reforms were undertaken starting mid-1970s partly from pressure from the World Bank and the IMF. A joint World Bank-IMF financial review of 1976 saw bank size and interest rate repression to be the main problem. Following their recommendations, CB raised the ceiling rates on loans and deposits and raised the capital requirements for banks via new capitalization, mergers and foreign equity infusion. In 1981, the ceiling rate on long-term deposits and loans were abolished and in 1983, all other

ceilings were removed. But without putting a cap on CB lending and raising the rediscount rate, the abuses continued. The growth of CB credits was in fact the highest after these measures were undertaken. (Table 2).

Irresponsible CB lending proved to be the more pernicious tool than interest rate repression against saving mobilization. It may have been the single most serious cause of the financial and economic collapse of the 1980s. It caused the interdependent problems of wasteful and inefficient investment, foreign borrowing, capital flight, inflation, trade deficits and a number of bank failures. The series of bank failures led to uneven growth among banks. The conservative banks that survived the crisis drew the clients of the failing banks. Consequently, they assumed increasing dominance and power concentration. In 1986, six out of the original 30 commercial banks owned 56% of the total commercial bank assets. The smaller banks and the failed banks lost their competitiveness against the big banks. The big banks appear to have been able to exercise some monopoly power which is partly reflected in the increased bank intermediation margin and a large differential between saving deposit rate and the rates on larger-denominated assets. Tan (1989) argued that saving depositors are small savers who are segmented from the more attractive market-competitive financial assets like time deposits and treasury bills so that banks could practice interest discrimination against them (saving depositors). Many financial assets are in large denominations which only the wealthy can acquire. Commercial papers and Treasury Bills are in P100,000 denomination, minimum stock orders are at least P5,000, time deposits and dollar deposits are also in relatively large denominations. There were no mutual funds to break the indivisibility problem. They are just starting to be developed.

### 3. Reforms under the Aquino and the Ramos Government

The Aquino government (Feb. 1986-May 1992) inherited a weak and monopolistic banking system and a very large foreign debt. The Marcos government increased foreign debt from \$2.1 Billion in 1970 to \$28 Billion in 1986. Four policy issues immediately confronted the new government: 1) to privatize, close or rehabilitate the two large bankrupt government banks, PNB and DBP; 2) to foster competition in the industry in light of the concentration that had evolved; 3) whether or not to maintain the developmental role of the CB; and 4) financing the foreign debt servicing including that of the two government banks. Subsequently, it was found that CB was also bankrupt because of the losses it incurred from its foreign debt management. In order to favor crony borrowers, CB gave out dollar loans in peso terms. It suffered losses from defaults and from the depreciation of the currency.

CB immediately stopped its easy and subsidized rediscounting. Rediscounting was to be a stabilization not a development tool, and the rediscounting rate was to be determined by the market rate on short-term instruments. After some debates, the government decided to rehabilitate PNB and

DBP by freeing them of their non-performing assets so that they could start anew with a clean slate. Their relative importance in terms of asset share was drastically cut as DBP's assets were slashed down to 13% and PNB to 35% of their 1986 respective levels. Their non-performing assets, like other government corporate assets, were taken over by the Asset Privatization Trust. PNB and DBP no longer enjoy special rediscounting and foreign debt borrowing privileges.

The Aquino CB Governor was against entertaining the entry of new banks as a means of expanding the system and fostering competition. (He was a founder and major owner of one of the 6 largest commercial banks.) As in earlier years, he allowed take-over, merger and foreign investment in existing banks. Some of the failed banks had to wait a few years before finding new financiers. This barrier to entry meant added cost in establishing a new bank but it did not discourage would-be bankers for banking was a highly profitable industry. At this writing, all failing banks have been revived by any one of these measures.

The large foreign debt wrought great difficulties not just in the fiscal sector but also in the financial market. In the beginning years of the Aquino Administration the debt-service ratio was almost 50% with as much as 77% of the public debt. Debt servicing resulted in large fiscal deficits of more than 6% of GNP. CB purchases of foreign exchange to service the debt infused pesos and increased the monetary base. At the same time, the national government had to issue bonds and TBs to finance the deficits. CB counteracted the peso infusion by issuing its own CB bills and increasing the reserve requirement to 25%. Additionally, CB imposed a 17% final tax on deposit income and 5% gross receipts tax on banks as a revenue measure.\*\*\* All these measures raised interest rate and crowded out private investments and the small denominated saving deposits. There were talks that CB's foreign debt biased its exchange rate policy against devaluation since this would result in exchange rate losses.

The Aquino government succeeded to act on government bank rehabilitation and rediscounting reforms. But it left the decision on bank entry, intermediation taxes and the CB debt to Mr. Ramos the next President. Following much debate that lasted almost three years, the Congress finally passed the law (1993) allowing the entry of foreign banks and controlling foreign interest in domestic banks. More domestic banks and more branches, both foreign and domestic, were to be allowed. Ten foreign banks have actually been allowed in the first year. These together with new domestic banks increased the commercial banks to 51. Additionally numerous branches of foreign banks have also been allowed. Domestic banks have also branched out at a quite rapid rate. The number of branches grew rapidly in the post-Marcos years from 1736 to 2743 in 1986 to 1994 and then to 3656 in 1997. Because of the failure of many rural banks, their number declined from more than 1000 in the

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\*\*\* This is inequitable. The rich whose income tax rate exceeded 17% pay this rate on their deposit income while the poor have the reverse burden.

1960s to 805 in 1976, further down to 784 in 1994, but they increased afterwards reaching 816 in 1997. The other thrift banks and their branches increased fairly well from 95 to 100 and to 113 head offices and from 297 to 721 and to 1155 branches for the same period 1986, 1994 and 1997. (Table 3)

The 1987 Constitution provided for the creation of CB as a constitutional body independent of the executive. In 1995, the Congress passed an enacting legislation creating a new Central Bank called *Bangko Sentral ng Pilipinas* or BSP. Independence is achieved by including in the 7-member Monetary Board only two Cabinet members of the President's choice. The non-ex-officio members are to have staggered tenure separate from the President's. The BSP Board is chaired by the Governor. Moreover the law limited the objective of the BSP to stabilization consistent only with the national development objectives.

#### 4. Concluding Remarks

We find that it took two decades from 1976 to 1995 to complete the reforms and liberalization of the banking industry. By 1995, interest rate ceilings have been abandoned, CB development lending has been stopped, bank entry and branching have been relaxed, CB foreign debt obligation has become manageable. With a smaller debt financing requirements (debt-service ratio of about 18%), money supply management could be directed more fully towards stabilization objectives. BSP has been able to gradually reduce the reserve requirement starting at 20% in 1987, now 16%. What remain are the 20% final tax and the 5% gross receipts tax.

The reforms have stimulated significant financial deepening. The M3/GNP shows an acceleration in its upward trend from 28% in 1992 to 39% in 1995, and possibly higher in 1996. Possibly because of competition, the interest rate differentials among deposits and TBs and commercial papers, as well as the loan-deposit margin have narrowed. (Table 4). In 1975, the loan ceilings were 12% and 14% for secured and unsecured loans. After the interest rate liberalization in 1983, savings deposits, SD, averaged 9.7%, time deposits or TD, 15.3%, TB, 14% and secured loans, 19.3%. Excepting for the SD rate, all the other rates moved together. SD rate went on a downward trend from 1986 to 1988, resulting in a widening differential between SD and all the other rates. In 1994, SD, TD and TB rates were 8.0%, 10.7% and 13.6%, a far cry from the differentials in 1988 of 4%, 13.4% and 14.4%.

The banking system continues to bear the burden of high intermediation taxes. The 20% final tax and the 5% gross receipts tax have not been abolished. The 16% reserve requirement is still high by Asian standard. Possibly financial deepening would have been greater if the high intermediation taxes were absent. Government revenue collection has increased fairly substantially from 11% of GNP in 1986 to close to 16% currently. There is a good reason to replace the intermediation taxes with a more equitable and efficient taxes. Also remaining is the

Agri-Agra portfolio requirement which we did not touch upon because it is weakly enforced. Banks are required to allocate 25 of their loan portfolio to agriculture and agricultural reform programs. The reason for this is because agriculture has been absorbing a rather small proportion of total bank loans, less than 7% in the last two decades. However banks can avoid the portfolio requirement by investing the required loanable funds in government securities.

The paper provides some lessons to economies that are still establishing their central bank. The literature focused on interest rate repression. The Philippine experience, and lessons from countries that exercised interest rate repression, is that its cost may not be very high if there is conservative monetary and fiscal management of the economy. We find that the most serious kind of repression is irresponsible financing through the printing press and foreign debt. There is also the case for preventing monopoly power in banking.

Presently, the Philippine banking system is robust. It has high equity/asset ratio, it is highly profitable, it is no longer dependent on CB rediscounting window and the interest rate differentials have narrowed. The private commercial banks have relatively low overdue accounts reported at 3.5%. There remain the high taxes which if removed could be expected to accelerate saving mobilization.

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**Table 1 Number of Banks by Type, 1948, 1965, 1976, 1986, 1994, 1997**

	1948	1965	1976	1986	1994	1997
Commercial banks	7	35	31	30	33	51
All offices			1107	1766	2776	3701
Thrift Banks	3		95	116	100	113
All offices			392	665	821	1268
Private Development Banks	0		33	43	37	40
All offices			98	213	265	508
Rural Banks			805		784	816
All offices			887		1274	1549
Foreign Banks Branches	7			4	4	9
All offices				9	9	22
Head offices						13
Specialized Government Banks (SGB)	1		83	3	3	3
All offices			73	100	225	
Non-bank financial Institution	na		1056	1897	4505	na
All offices	na		1259	2283	5730	na
No. of automatic tellers	na		na	na	na	2402
Total Assets/Banks (P mn.)						
KB		8.21	1914.7	7901.8	29283.5	40358.9
Thrift			31.8	151.3	1039.8	1846.9
PDB			14.5	129.7	753.1	1915.7
RB			3.7	10.4	35.3	58.0
SGB			4994.7	8564.3	52343.3	na
NBFI			16.8	21.6	28.8	na

Source: Central Bank Fact Book, 1994, 1997

**Table 2 Selected Financial Indicators, 1950-1997**

Year	M <sub>3</sub> /GNP	C/M <sub>3</sub>	g <sub>M3</sub>	π	g <sub>CB</sub>	CB Loans
1950-54	18.9 <sup>a</sup>	42.6	5.6	0.2	9.0	-
1955-59	20.7	33.8	10.4	0.9	27.5	6.8 <sup>c</sup>
1960-64	24.7	27.5	15.0	5.9	7.8	17.8
1965-69	26.4	22.9	12.1	3.4	16.6	12.8
1970-74	25.5	21.0	23.2	19.3	14.1	8.8
1975-79	29.0	15.7	17.6	9.8	26.9	10.2
1980	27.9	14.9	18.6	18.2	33.8	14.0
1981	29.3	14.1	20.8	13.1	24.5	16.5
1982	30.4	13.2	16.5	10.2	25.9	18.2
1983	31.4	17.2	18.8	10.0	37.6	21.2
1984	24.1	17.8	7.2	50.3	24.6	22.1
1985	24.2	17.9	9.6	23.4	9.8	20.9
1986	24.2	20.3	7.6	-0.4	-2.2	4.7
1987	24.1	35.0	12.1	3.0	-10.0	4.4
1988	25.1	20.5	22.6	8.9	-3.4	0.2
1989	27.8	20.8	28.0	12.2	1.0	-
1990	28.1	20.6	18.4	14.2	8.3	-
1991	27.7	20.0	15.5	18.7	6.2	-
1992	28.0	19.3	10.5	8.9	45.2	-
1993	32.1	17.5	25.3	7.6	164.0	-
1994	35.0	15.8	26.5	9.0	-	-
1995	38.9	14.6	25.3	8.1	-	-
1996	36.2 <sup>b</sup>	12.4	15.8	8.4	-	-

<sup>a</sup>average for 1952-54

<sup>b</sup>November figure for M<sub>3</sub>

<sup>c</sup>loan started 1957

Source: Central Bank Statistical Bulletin for 1970, 1975, 1983 & 1993. Central Bank Economic Indicators, March 1997.

**Table 3 Bank Closure, Merger and Restructuring, 1970-80**

Number Closed		1970-80	1980-87	Total 1970-86
Commercial Banks		3	3	6
Thrift Banks		45	170	215
PDB		-	4	4
RB		42	138	180
Other		3	28	31
Total		48	173	221
Mergers 11 into 5		11		
Foreign Equity Infusion		13		
US		6		
Japan		4		
Other		3		
Take overs		2		
Closed		6		
DBP				
Total Assets	1985	72,043		
Total Assets	1986	9,504		
Non-performing/Total Assets		86.8%		
PNB				
Total Assets	1985	76,151		
Total Assets	1986	26,913		
Non-performing/Total Assets		64.6%		

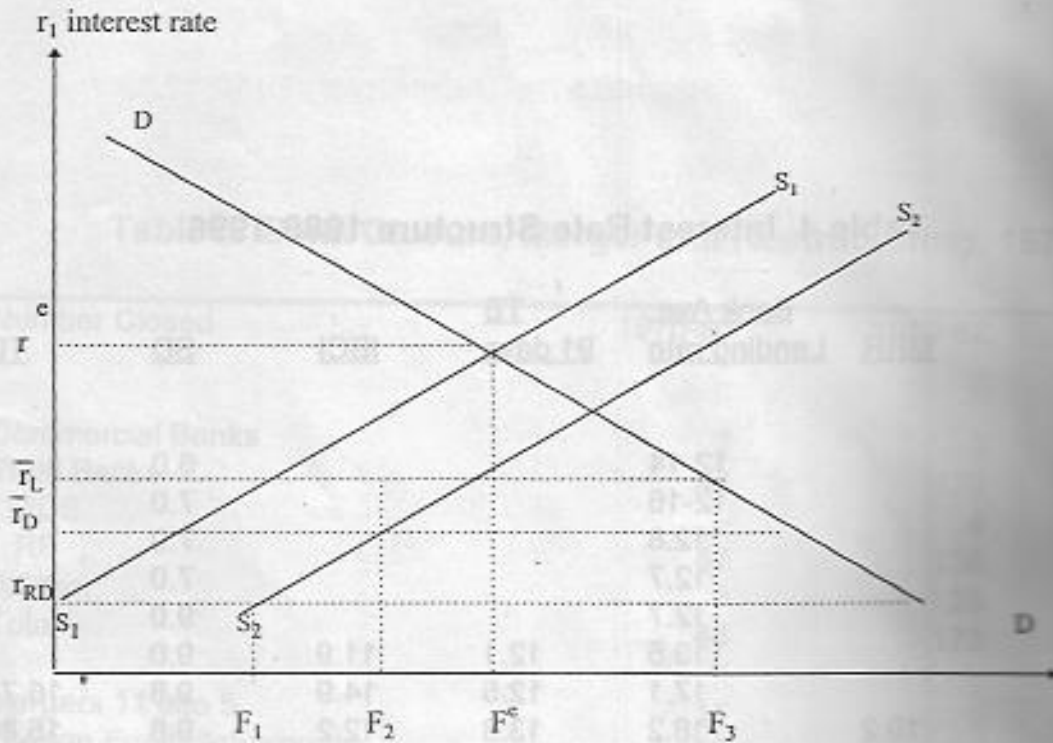
Sources: 1989 Mario Lamberte, "Assessment of the Problems of the Financial System: The Philippine Case," PIDS WP 89-18.  
1994 data from Banko Sentral ng Pilipinas Fact Book, 1994.

**Table 4. Interest Rate Structure 1980-1996**

Year	MRR	Bank Ave. Lending rate	TB 91 days	IBC1	SD	ID
1975		12-14			6.0	
1976		12-16			7.0	
1977		12.8			7.0	
1978		12.7			7.0	
1979		12.7			9.0	
1980		13.5	12.1	11.9	9.0	
1981		17.1	12.5	14.9	9.8	16.74
1982	19.2	18.2	13.8	12.2	9.8	15.80
1983	15.0	19.3	14.0	16.7	9.7	15.29
1984	22.2	26.7	14.0	28.1	9.9	24.16
1985	21.1	28.2	27.1	16.2	10.8	21.83
1986	12.3	17.3	16.0	12.5	8.0	14.77
1987	9.4	13.3	11.4	12.0	4.5	9.77
1988	12.4	16.0	14.4	14.2	4.1	13.39
1989	16.0	19.5	19.3	15.4	6.2	16.98
1990	21.3	24.3	23.4	14.8	10.8	20.21
1991	17.8	23.5	21.4	15.7	11.0	18.54
1992	14.8	19.4	16.1	16.7	10.6	14.06
1993	11.3	14.6	12.3	13.7	8.3	10.37
1994	11.6	15.0	13.6	13.4	8.0	10.72
1995	10.0	14.6	11.3	12.1	8.0	9.31
1996	11.7	14.8	12.4	12.6	7.9	11.49

Source: Selected Philippine Economic Indicators March 1997, Statistical Yearbook 1994, earlier years.

## APPENDIX A



**Figure 1**

**Note:**

Figure 1 illustrates the disintermediation impact of interest rate ceilings and low rediscounting rates. CB decides on the level of rediscounting at CB loans and the rediscounting rate  $r_{RD}$ . Interest rate ceilings on loans is set at  $\bar{r}_L$  and on deposits at  $\bar{r}_D$ . We have demand for loans  $DD$  and supply of loanable funds  $S_1S_1$ . The rediscounting shifts the supply curve to  $S_2S_2$ . The equilibrium intermediation level is  $F^c$  and interest rate  $r^c$  without the interventions. With interest and rediscounting interventions, the loans demanded exceed loans accommodated. Deposits equal  $F_2 - F_1$ , loans  $= F_2$ , loans demand  $= F_3$ . Excess demand is  $F_3 - F_2$ . The disintermediation level is  $F^c - (F_2 - F_1)$ , a very large amount.