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CREDIT MEASURES AND THEIR IMPACT ON THE DEVELOPMENT OF THE FINANCIAL STRUCTURE

by

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LIST OF TABLES

"For a writer, it's better to be silenced than silent."

SPLopez

POLICIES, INSTRUMENTS AND LAWS AFFECTING CREDIT IN THE PHILIPPINES

In pursuing the goal of economic development, the Philippine government has relied substantially on credit measures to increase available capital funds. Most of these measures were selective in nature. In general, there is a policy to artificially cheapen credit absolutely and relatively for favored activities. Public financial institutions were established and private institutions were encouraged to be put-up as a means of implementing the above policy. A secondary objective of this policy was to develop the capital market. There were other policies, especially those relating to foreign trade and taxation that also affect the cost of capital. One is struck by the extensiveness of measures affecting credit and the cost of capital. There seems to be a need for a review of the credit measures and laws to see their impact on the development of the financial market and on production. Though the capital market has been favored in general by the policies, it is important to [illegible] what financial structure evolved out of all these measures. [illegible] paper will show that the instruments through which cred[illegible] is effected determine the structure of the financial s[illegible]

The impact of the credit measures on production [illegible] treated in a separate paper.

Two legislations have the most pervasive influence on credit, the Usury Law of 1916 and the Central Bank Act of 1948. The Usury Law imposed a ceiling on the rate of interest that may be charged on loans. The Central Bank Act of 1948 created a very powerful institution which has supervisory power over all banking institutions, and which controls the supply and allocation of credit and foreign exchange. In controlling the supply and allocation of credit, the Central Bank is able to influence very strongly the development of the financial structure.

A. Usury Law & MIC →

The Usury Law stipulates a ceiling on the rates of interest that may be charged on loans. All other forms of credit such as purchases on installment, issue of bonds and other claims are not covered by the Usury Law. Though there is a Truth in Lending Act for purchases on installment which requires full disclosure of all charges related to the purchase, there is no stipulation as to what could be included in computing the rate of interest. Moreover, there still exists a fairly large unorganized capital market over which the Usury Law is difficult, if not impossible, to implement.

The impact of the Usury Law depends essentially on the size of credit whose equilibrium market rates are above the ceiling rates. In a freely operating market the structure of interest rate will be determined by supply and demand for various forms of credit. Both quantity supplied and demanded of any form of credit will in turn depend on its liquidity and risk. There are some forms of credit, the very liquid and safe ones whose equilibrium rate in the market will be below the ceiling rate. At the same time there are other forms whose equilibrium market rate will be above the ceiling rate. It might seem at first blush that the only forms of credit that the Usury Law would affect are the loans whose market rates are above the ceiling rates. The Usury Law has a much wider impact than it would seem because of the extensive participation of the government in the provision and allocation of credit. The country has consistently followed cheap credit policy and cheap credit seems to have meant "cheaper" than the Usury Law ceiling rates. Hence we find through the history of this policy that the rates of interest chosen for loans for priority industries and those charged by the government or government-supported financial institutions were lower than the Usury Law rates. The rates on intermediate and long-term government securities were also fixed at rates very much lower than the ceiling rates.

The Usury Law affects the financial market both directly and indirectly, directly, by imposing ceiling rates on loans of private individuals and institutions, and indirectly, by setting a standard for the choice of interest rates by the Monetary Board and the Treasury. But the more important effect of the law is on the choice of various rates of interest by the Monetary Board be they deposit rates, loan rates or discount rates.

B. The Central Bank of the Philippines

As discussed in a previous paper,[1] the Central Bank Act of 1948 created a very powerful institution. The Philippine Central Bank controls not only the quantity and allocation of credit, but also the allocation of foreign exchange. It supervises all banking institutions and decides the rate of interest on government security issues.

With respect to the control of the quantity and the allocation of credit, the Central Bank has used various measures, the most important of these are the following:

1. Assistance for the establishment of banks.
2. The discount window.
3. Interest policy.
4. Exchange controls.
5. Reserve requirements and reserve composition.

Special features of each of these measures are discussed in the sections that follow.

C. Government and Government-Supported Financial Institutions.

A significant number of banking laws have been passed after the Central Bank Act of 1948. Among them are laws that created the following financial institutions:

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[1] Sue Van Atta and Edita A. Tan, "The Role and Structure of the Central Bank of the Philippines," IEDR Discussion Paper No. 70-14, July 21, 1970.

1. rural banks
2. cooperative banks
3. private development corporation
4. Government Service Insurance System
5. Social Securities System
6. A.C.F.A., now A.C.A. (Agricultural Credit Agency)
7. The Veterans Bank

Earlier, the two largest governemnt [ment] banks were established: The Philippine National Bank, a commercial bank and the Re~~construction~~ [habilitation] and Finance Corporation, now the Development Bank of the Philippines, an investment bank. Some government financial institutions are commercial banks like some rural banks and the Philippine Veterans Bank, while some are savings banks like the private development banks. The GSIS and the SSS provide social insurance services.

The public and semi-public banks were established for specialized functions. By specialized function we mean the concentration of lending to certain segments of the economy or to certain productive activities.

The Rural Banks are encouraged to be established to provide the credit requirement of "small farmers and merchants, or small cooperatives. Small farmers are defined to be those who cultivate an area not exceeding 25 hectares. Small merchants are those whose business capital do not exceed ₱25,000.00."

The Nacida Bank is of the same nature as the rural banks.

They cater to cottage industries or cottage industry cooperatives.

The Philippine Veterans Bank is an ordinary commercial bank except that it is established with assistance from the government and its profits accrue to the benefits of veterans.

The supply and allocation of credit is affected by the creation of public and semi-public institutions. When they are established available credit is automatically increased to the extent of the contribution of the Central Bank or the Development Bank to the capital of the bank. The generous discount privilege these banks enjoy is also an important source of funds. Since these banks have specialized functions, the allocation of credit is changed with their establishment. To a large extent, policies on allocation of credit are implemented through public and semi-public banks.

In every instance, the bulk of capital of public banking institutions come from the government. In the case of semi-public banks like the rural banks, the Veterans Bank, the private development and the cooperative banks, there is a matching fund from the Central Bank for the capital put up by the private sector. Given below is the percentage contribution of the Central Bank or the Development Bank to the initial capital of

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* From the Veterans Trust Fund. 60% of capital must be by Filipinos but in case they are not able to put up the matching capital, the DBP may supplement it.

public and semi-public banks.

	% capital by Government
Development Bank of the Philippines	100%
Philippine National Bank	100%
Rural Banks	50%
Philippine Veterans Bank	51%
Cooperative Banks	67%
Nacida Bank	67%
Private Development Banks	40%

D. The Discount Window.

The discount window is a very powerful credit instrument both for quantitative and selective credit control. It also gives the Central Bank a strong weapon for supervising banks since the discount privilege may be withdrawn to "erring" institutions.

Under orthodox Central Banking the discounting of notes is usually discretionary on the part of the Monetary Authority. In the Philippines, the Monetary Authority has given the banks the right to discount as long as they meet specified regulations. Most notes of banks are discountable. This discounting rule would mean that the creation of credit may continue infinitely. For example: If Bank A lends ₱100, it may discount this loan for say ₱80. This amount becomes high powered money or reserves. Hence, out of every loan, potential reserves are created. The amount of credit that can be created out of say, an increment in reserves X would be equal to

$$\Delta \text{ Credit} = \quad + drX\frac{1}{rr} + dr^2X\frac{1}{rr} \ldots + dr^{n-1}X\frac{1}{rr^{n-1}}$$

where dr is discount ratio, rr is reserve requirement.

The attractiveness of discounting at the Central Bank depends to some extent on the ~~margin between the loan rate and the discount rate~~. In general the margin between these two rates have been quite substantial ranging from .72% to 4.0% during the last ten years as shown in Table 1.[2] For priority loans, the margin is even wider. Loans by the rural banks in 1970 be discounted at rates as low as 2 to 3 per cent/(1/2 to 1 per cent during the period 1955-1963' and 1-1/2 to 2 per cent during the period 1963-1966). Loans for sugar, rice and corn production and marketing can be discounted at rates lower than for other activities. Please see Table 1. For priority activities, the margin can be as high as 9% loan rate minus 2% discount rate.

The importance to the banking sector of the discount window/is not so much the margin between the loan and the

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[2]The margin is computed as the difference between loan rate and discount rate. The loan rate used is the weighted average loan rate of commercial banks. This is likely to be understated because banks would have the tendency to understate interest rate to meet the Usury [redacted]ng.

discount rates but having the Central Bank as an important source of loanable funds and not simply as a bank of last resort. We find in the balance sheet of banks that advances from the Central Bank form as much as 25 per cent of deposit liabilities in 1969 as shown in Table 3 of all banking institutions. The ratio is higher for private commercial banks. However, the data show that banks have not made full use of the discount window since the Central Bank advances have remained a very small proportion of total loans of banks, including those of rural banks.

B. Interest Policy

The Monetary Authority implements its interest policy thr[redacted]arious measures. The more important of these measures are a[redacted]ows:

1) ceiling on deposit rates
2) differential interest rates on loans for priority activities, especially those granted by government and government-supported financial institutions
3) interest rates on government securities.

1. Ceiling on Deposit Rates

The impact of having a ceiling on deposit rates, as in the case of the Usury Law ceiling on loan rates, depends on whether or not the equilibrium rates are above the ceiling rates. There are some evidences that would indicate that in recent years the equilibrium rates were above the ceiling rates. The deposit rates paid by a selected sample of banks in 1965 and in 1970 were at the maximum allowed by the Central Bank. It is alleged that a much higher deposit rate is paid to some depositors under special arrangement. The yield on very liquid assets such as Treasury Bills and Bancom bills is much higher than the deposit rates. This rate differential would make deposits a less attractive form of wealth than bills.

	Yield in 1970
savings deposit	6.0
time deposit, 3 to 12 months	6.0 - 7.0
treasury bills	
49 days	9.88-14.03
91	6.64-15.96
180	8.42-16.39
273	8.66-16.65
Bancom Bills	11.65-16.22

2. Differential Interest Rates on Loans on Priority Activities.

In general, loans for priority activities are granted by government and government-supported financial institutions. The rate of interest on these loans are usually lower than on loans