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# RURAL FINANCE IN THE PHILIPPINES: RECENT CHANGES AND PRIORITY ISSUES

by

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# PREFACE

This publication is prepared under a collaborative research project concerning rural finance in the Philippines. The principal collaborating institutions are the Philippine Institute for Development Studies (PIDS), the Agricultural Credit Policy Council (ACPC), and the International Rice Research Institute (IRRI). OSU participation is funded by the USAID Mission in the Philippines and the Bureau of Science and Technology, AID, Washington. The views expressed in these publications are those of the authors and may not be shared by any of the collaborating or sponsoring institutions.

A complete list of publications produced by OSU for this project is provided at the end of this paper.

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RURAL FINANCE IN THE PHILIPPINES:
RECENT CHANGES AND PRIORITY ISSUES[1/]

by
Richard L. Meyer

Two years ago, when the World Bank and USAID were planning their co-financed Rural Financial Services Project, the Philippines faced serious problems in its rural financial sector, but there was little expectation that rapid change would occur in the basic approach to rural finance. The situation today is strikingly different. Some financial reforms were initiated beginning in the early 1980s, but many were taken at the insistence of the Central Bank and lacked widespread acceptance. The fall of the Marcos regime opened up new possibilities for dialogue and change that were hardly imaginable just two years ago. The rural financial system still faces serious challenges, but a number of important changes have occurred and some key preconditions have been met which lay the groundwork for a stronger system. The purpose of this paper is to summarize some of these key developments, to assess their probable impact, and to identify some of the remaining issues to be tackled.

Before taking up the details, two general observations should be made to place the Philippines experience in broader perspective. First, the road to financial reform is not yet clearly marked and the interaction between financial and non-financial reforms is beginning to be better appreciated. Several

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1/ I am indebted to Jon Halpern, Mario Lamberte and Bruce Tolentino for discussions about several ideas presented here. The usual disclaimers apply.

countries in the Southern Cone of Latin America have undergone major economic reforms and now have a decade or more of experience. Their achievements and shortcomings are becoming evident. A recent book by Connolly and Gonzalez-Vega describe some of these as does a paper by Corbo and Melo. Second, the long-term nature of the financial reform process and the setbacks that may periodically occur are evident in the Indonesian experience, and were discussed by Jafri and Patten in a recent evaluation of the USAID rural finance project in Bangladesh. These experiences seem to imply, amongst other things, that for financial reforms to be effective they must be supported by appropriate policies in other sectors, that reform does not follow a simple linear path, and that major setbacks can occur, especially due to uncontrolled internal political problems and changes in the external macroeconomic environment. These considerations must be kept in mind when analyzing a country like the Philippines where the new political regime is still far from being consolidated. An encouraging observation is that this regime, unlike the one it succeeded, so far seems to have avoided the pitfall of using the financial system to buy short-term political support.

Three recent publications summarize key rural finance developments and needs. The first is the excellent comprehensive literature review of rural financial markets by Lamberte and Lim. The second is the analysis prepared by a group of social scientists from academe and research institutions (hereafter referred to as PIDS) of the first eleven months of the Aquino government. The third is the paper by Tolentino analyzing several of the recent program and policy changes. The first section of this paper draws heavily from these publications for organization and content. The second section discusses a number of additional issues that appear to the writer to be important for the future of rural finance in the Philippines.

## KEY DEVELOPMENTS AND REMAINING PRIORITIES

### Monetary Policy

The Philippines financial sector has been dominated during the past few years by policies that stressed credit allocation, raised intermediation costs, and were biased against deposit mobilization. The Aquino government inherited several weak and failing banks, and the rural financial system, especially Rural Banks, was in serious trouble. Recent policy changes have helped to reduce the allocative function and to restore the stabilization function of the Central Bank. Specifically, the rediscount rate has been made uniform and aligned with the market rate, the rediscount rate has been lowered from 12.75 to 10%, reserve requirements have been lowered from 24 to 21%, and there has been a substantial reduction in outstanding Central Bank bills. The charters of the Development Bank of the Philippines and the Philippines National Bank have been revised, some nonperforming assets have been transferred to the Asset Privatization Trust (APT), and some special bank privileges have been phased out.

The PIDS evaluation notes that intermediation costs are still very high, however, and that PD717 (requiring banks to lend 25% of their portfolios to agriculture) should be repealed along with the 5% gross receipts tax (GRT). In the absence of a strong competitive banking system, these high intermediation costs are passed on to consumers rather than absorbed by financial institutions. It is questionable whether this form of taxation (with the increase in interest costs it implies) is the most socially desireable way to raise government revenues in light of the reported weak credit demand and the slow pace of economic recovery. Furthermore, the disincentives for financial savings have actually increased because of the increase from 17.5 to 20% in the tax rate on interest income. This has occurred just when the tax on dividend income has been removed. This effort to encourage depositors to shift to the equity market can only benefit the relatively rich in urban areas at the expense of rural depositors with fewer investment alternatives.

Rural Financial Markets

The credit allocation schemes, the heavy role of credit subsidies, the myriad of rules and regulations, and the distortions and fragmented financial markets that resulted were most obvious in the rural sector under the previous regime. A most serious outcome was the destruction of the Rural Banking system due to accumulated arrearages with the Central Bank, a lack of discipline amongst both bankers and borrowers, and an undermining of rural deposit mobilization. This situation made it difficult for sound rural financial intermediation to develop and, indeed, it is surprising that some Rural Banks were able to survive the last fifteen years as well as they did, and that some commercial banks were able to find rural market niches for profitable operations.

The reforms which began in the early 1980's coupled with recent actions have improved the conditions for sound rural financial intermediation. The uniform and market oriented rediscount rate has replaced selective credit policy, loan allocations and credit subsidies. The creation of the Rural Bank Review and Rationalization Committee and the adoption of its rehabilitation plan, the creation of the Comprehensive Agricultural Loan Fund (CALF) which merged seventeen out of the thirty--nine separate loan funds for the commodity programs previously implemented by the Department of Agriculture, and the creation of the Agricultural Credit Policy Council (ACPC) to manage CALF and synchronize all agricultural credit policies and programs are the most noteworthy developments.2/

Much remains to be done, however, to assure the orderly development of the rural financial markets. Current regulations still restrict bank entry and branching, and Rural Banks are being closed at the rate of about one per week (currently about 850 remain out of the more than 1,000 that existed a few years ago) without a suitable alternative to take their place in many

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2/ These developments and their apparent implications were analyzed by Douglas Graham. Corales and Cuevas analyzed the partial effects of interest rate deregulation.

local markets. It is not clear what assistance, if any, financial institutions in rural areas need to help them respond to the new unregulated environment where deposit mobilization is supposed to replace Central Bank funds. It is not clear, for example, the extent to which a weak Rural Bank with a poor community image can successfully compete for deposits. As noted in recent interviews with two Batangas bankers, an aggressive deposit mobilization program by a RB may actually be interpreted by customers as a sign that it is near collapse. Furthermore, the Rural Bank crisis has logically absorbed the attention of policy makers while other financial opportunities may have been neglected such as the prospects for strengthening rural cooperatives and cooperative rural banks.

Two specific issues regarding the Rural Banks are of concern to the writer. One is the recent problem of excess liquidity in some Rural Banks. An apparent cause is tighter loan appraisal, but it is also suggested that rural loan demand is weak. One wonders whether or not this represents market failure in that Rural Banks are unable to identify credit-worthy projects when thrust out of their customary role of following specific CB rules and regulations for targeted lending.[3/] Alternatively, perhaps government offices are not efficient in performing their role of

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3/ Gonzalez-Vega of OSU noted that one of the problems encountered in the recent USAID project to open deposit windows in rural branches of the Agricultural Development Bank in the Dominican Republic was that the bank management, accustomed to only lending Central Bank funds, was reluctant to develop its own lending programs for fear that funds would be unavailable when depositors demanded withdrawals.

identifying alternative enterprises for local investors. There is no evidence that the CB has noted this liquidity problem, which may be unique in the Rural Bank experience, and is attempting to do anything about it. Seasonal and regional surpluses and deficits should be expected in any rural banking system, however, and an appropriate mechanism must be created, perhaps by the CB, to help the system manage these liquidity problems. Otherwise, rural deposit mobilization will be discouraged, lending will be restricted to short-term, and loan/deposit ratios will be kept low because rural banks will be forced into a conservative asset portfolio. It may also encourage banks to extract deposits from rural areas for urban lending. Central Bank regulations currently restrict interbank movement of funds because of the deposit retention scheme and the fact that Rural Bank deposits in another bank are treated as loans rather than bank reserves.

The second issue concerns the role that the Land Bank will play as it becomes a stock holder for the Rural Banks which select that option under the rehabilitation program. Graham suggests that over 500 Rural Banks may be eligible to voluntarily join the rehabilitation program but only time will tell how many will actually choose the Land Bank option. Suppose that 200 do. Although the Land Bank is recognized as being a strong institution (late in the Marcos regime there was a suggestion to merge it with the weaker DBP and PNB), it is questionable if it really has the capacity to selectively resolve the problems of 200 individual banks when simply occupying a seat on the bank's board may be an insufficient intervention to ensure viability. As noted below, the proposed land reform program will also place huge demands on the institution and the Land Bank president has announced his intention of moving more aggressively into commercial banking. Will the transfer of this portion of the RB debt and management problem from the CB to the Land Bank really rehabilitate the banks? Under what conditions can it be expected to do so? Are the incentives adequate for other banks to share with the Land Bank the task of this rehabilitation effort?

It has been frequently argued that Central Bank policies, rules and regulations have impeded rather than foster the development of viable formal financial institutions in rural areas. It is not clear the extent to which commercial and development banks might have expanded rural operations under more favorable conditions, or how effective Rural Banks might have been if encouraged to mobilize more deposits rather than push cheap government credit. These issues of structure and regulation will be better understood after the SGV group completes its Rural Banking Services study for the Central Bank scheduled for August or September, and PIDS/OSU completes its comparative bank study. The ACPC/PIDS/OSU study and experimentation with deposit mobilization will also shed light on the potential for and problems of mobilizing deposits in rural areas.

## Agricultural and Natural Resources Policy

Rural banking cannot be viable unless the agricultural sector it serves is profitable. This lesson is abundantly clear from the U.S. experience of the past few years. When agriculture is weak or disorganized or poorly monetized, the only lenders that survive are those with a small agricultural loan portfolio that can be subsidized by nonagricultural operations. Recommendations made to the new Aquino government by faculty at the University of the Philippines, both Diliman and Los Banos, argued for improved terms of trade for agriculture and the removal of serious structural bottlenecks[4/]. The government has responded by dismantling the sugar and coconut monopolies, removal of export taxes on agricultural products except logs, liberalizing fertilizer importation, lifting the copra export ban and reducing the role of NFA trading in wheat, flour and other feed imports.

Other problems have not yet been tackled or have lagged because of budget constraints. Procurement at NFA support prices has been limited because of cutbacks in government support, the NIA spent more than its allocated funds on large-scale irrigation systems leaving relatively less for smaller-scale systems, and the reorganization of the agricultural research and extension system has been slow. In the natural resources area, a log export ban has been put in effect while the government reviews its program of concessions, but relatively little appears to have been done in the fisheries sector.

Overall, the PIDS document applauds the rapid dismantling of price disincentives but the authors feel that with the current

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4/ These recommendations were contained in the reports Economic Recovery and Long-Run Growth: Agenda for Reforms, PIDS and Agenda for Action for the Philippine Rural Sector, UPLB.

exchange rate agriculture is still not getting sufficient protection from imports. Land reform, of course, is the key structural issue being debated and more will be said about it in the next section.

## EMERGING ISSUES

There are a number of issues that the writer feels deserve special attention either because they represent long-standing problems or have emerged because of recent developments.

### Land Reform

The next few weeks will be crucial for land reform policy. The writer was invited by Secretary Dominguez to give a seminar in May on the Chilean agrarian reform to the land reform task force. It was clear from the discussion that followed that there may be a brief window of opportunity for the Aquino government to enact an expanded program before the new Congress assembles in July.

The Philippines is probably paying a price for the uncertainty rural investors are now facing. First the uncertainty was due to the change in regime, then to the recent elections, and now to the land reform debate. Some investors are probably postponing investments until they feel more secure about the future. The longer the debate drags on the more devastating it will be to agricultural investment, production and rural employment. Experience in other countries seems to suggest that land reform must be simple and swift to be effective. This is difficult by definition in a country implementing reform through a democratic process with a need to respect legal rights and to provide fair compensation.

The financial aspects of any reform program will be crucial and ACPC is putting in a great deal of effort to develop some of the financial components. High levels of compensation to owners should reduce opposition but will increase the eventual cost to beneficiaries if they are expected to reimburse the costs. The mismatch in payment schedule between the one used to compensate owners and the one used to recover payments from beneficiaries will increase the government's financial cash flow problem of land transfer. The additional costs for supportive services may also be high, and the writer is concerned about the Land Bank's capacity to simultaneously expand the reform program and engage in Rural Bank rehabilitation.

The current land reform brief proposes an adjustment loan for beneficiaries of land as a way to substitute for the expected disruption in government and landowner services when reform is undertaken. In the seminar, the writer objected to the proposed fixed 6 percent interest rate on this loan as it smacks of the previous subsidized credit system which caused so many problems for the financial system. It appears that a newer version of the proposal specifies market determined rates. Another problem is that the planners view this loan as an entitlement which would seem to be eventually perceived as such by beneficiaries and, therefore, may be translated into an even poorer repayment performance than already exists for the current land reform program. A grant provided to beneficiaries may be far better as it would introduce fewer distortions into the financial system.

Hayami et.al. have noted the special working capital needs of beneficiaries expected to produce longer-term crops such as sugarcane and pineapples. Contract farming arrangements may provide inputs, markets and loans for some farmers producing these longer cycle crops. A recent paper by Floro discusses the role of farmer-lenders and trader-lenders in rice and corn producing areas and shows their significance in areas that have been the focal point for subsidized credit. Esguerra conducted a brief survey of some Ministry of Agriculture programs designed to provide loans which link input, product and credit markets. The record of some of these programs, especially regarding loan recovery, appears to be better than other credit lines.

It is clear that if accelerated land reform becomes a reality in the Philippines in the next few weeks there will be several financial and credit issues to be addressed. It will be important then to monitor the emerging design of the program to see that it does not undermine the commendable progress made in rural finance in recent years.

## Formal/Informal Financial Linkages

In several Asian countries, a rethinking of the role of informal financial systems is underway. The ADB regional research project on informal finance is indicative of this renewed interest. As in the Philippines, the general view is that the informal sector has reemerged in rural areas due to the failure of many formal credit programs. Actually it may have been important all along but conveniently overlooked or downplayed in the zeal to develop formal institutions.

The attractiveness of informal finance is two fold: first, it may be the only way to provide financial services to the poorest rural households located on the most distant farms because of the high costs of formal institutions in servicing such customers. Secondly, although informal sources also experiences loan losses, their loan recovery record seems to be better than for many formal institutions. There are at least two concerns, however, about the informal sector. The first is the time honored view, especially on the Indian subcontinent, that informal sources charge usurious lending rates and earn monopoly profits on their operations. Both Harriss and Floro present data which tend to refute this assertion however. The second is that informal sources and especially farm-lenders are socially undesirable because their primary objective is to acquire the land of mortgaged farms. Here Floro's arguments about the distinction in motives between farmer-lenders and trader-lenders are useful.

It is clear that there is much to be learned about the practices of the informal sector in the Philippines, how it is linked to the formal sector, how these linkages affect the ultimate borrowers, and how the formal and informal sectors evolve under different crop regimes and in different ecological areas. The IRRI/OSU study of formal/informal financial linkages will build on the Floro and Esguerra work to improve our understanding and provide insights for appropriate policy making. A key question is whether or not specific programs should be designed to facilitate such linkages or if it is adequate to simply ascertain that any restrictive regulations are reduced so the linkages can naturally develop when the market demands them.

Risk Reducing Mechanisms

Risk reducing mechanisms may emerge as the most important factor affecting the future supply of rural credit now that some of the resource allocation and subsidy schemes have been reduced or eliminated. The experience from other countries suggests that many crop and loan programs have been ineffective and have saddled governments with huge losses. CALF funds are now destined to support the existing guarantee facilities of the Philippine Crop Insurance Corporation (PCIC), the Guarantee Fund for Small and Medium Enterprises (GFSME), and the Quedon Guarantee Fund Board (QGFB). This is an important development since these guarantees are generally perceived to be well run. There are suggestions that the crop insurance program should be expanded to include more crops, and a report submitted to the Central Bank on the subject should be evaluated for possible action.

Another guarantee issue concerns deposit insurance. The ACPC/PIDS/OSU study will seek some insights from rural households concerning their perceptions about such insurance and whether or not it affects deposit behavior. Apparently some depositors experienced long delays in gaining access to their funds when some urban banks were closed and it will be important to see if rural households are affected by this fact. Another side of the issue is the method of operation of the insurance program, its viability and the risk exposure it has with Rural Banks.

These topics would seem to be prime candidates for research by the type of staff that Citibank/ABT will likely field for its research component. The SGV study and recommendations due in a few months should provide a useful starting point for this research.

Bank Regulation and Support

The Central Bank of the Philippines, like many central banks in Asia, adopted a more aggressive development oriented role two to three decades ago. A key program has been the expansion of the banking system into rural areas which actually began as part of the package of programs put in effect in the 1950s to counter the Huk insurgency. The problem alleged by many is that the CB capacity has been limited largely to developing a set of rules and regulations which reached such detail as defining the themes for the annual Rural Bank conferences and approving maintenance expenses for individual Rural Bank vehicles! The supervisory function is reported to be strongest on auditing compliance with these rules and weakest in providing management or technical support. At the same time, the Rural Bankers Association and the Cooperative Rural Banks Federation, both of which should be able to identify some of the crucial needs of their members, have not yet progressed very far towards developing the capacity to provide support services.

The most promising recent institutional development is the creation of ACPC. It has gotten off to a fast start with a small but dynamic professional staff. Two questions arise, of course, with respect to the creation of any new institution. First, will it really be given the opportunity and responsibility to develop an appropriate support system for rural banking? Second, if given this opportunity and responsibility, will it have the capacity to implement it? To date, ACPC has performed well because it has "done its homework". There is always a certain irony in that those agencies known to do good work are often given more work to do until finally they become swamped and can't maintain their quality standard. This could happen to ACPC, or an even worse scenario for rural finance could emerge if the best senior staff are reassigned to other agencies. Hopefully sufficient local and foreign support will be available so this promising institution will flourish and attain its full potential.

The best future division of labor for the development/regulatory/support/advocacy dimensions of rural banking is not obvious given the present activities of the CB, ACPC and the trade associations. This is a long-term issue and one that would seem to be a natural topic for the experience and expertise that Citibank/ABT can bring to it.

A closely related issue for further study is that of an apex or lead bank for the rural sector. This issue has been talked about for some time but the writer has seen no analysis which carefully discusses the reasons for such an institution and the functions it might perform. The problem of managing liquidity as noted above may require an institution to facilitate the inter-bank flow of funds amongst surplus and deficit units. Before that argument can be made, however, rural financial institutions must demonstrate they can actually mobilize large volumes of deposits and that these deposits in fact follow sharp seasonal or regional patterns. There is always the fear that part of the reason for advocating an apex institution is the unstated objective of capturing cheap government or foreign funds, an approach which disabled many of the strong Latin American credit unions during the 1970s. In contradiction to the present effort to clean up the system through CALF, this would be stepping backward to create a COW with lots of cheap milk.

## CONCLUDING COMMENT

In spite of more than three decades of pump priming, subsidization and regulation, rural financial markets in the Philippines are dominated by weak and fragmented institutions. The ratio of agricultural credit to agricultural output has actually gone down in recent years, and Rural Banks (the corner-stone of the effort to bring rural banking closest to the farming community) are being closed at the rate of one per week. Desireable policy changes were started in the early 1980s and have been accelerated by the Aquino government. They have laid the base on which a stronger system can be built. The structure of that system is not yet clear and will emerge slowly over time. The several pieces of policy oriented research that are underway or can be initiated soon will help determine the extent to which current policies and programs will have the desired effect. In the meantime there appear to be plenty of rural finance issues for the government and the new Congress to deal with using current information.

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