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SEMINAR ON INFORMAL FINANCIAL MARKETS IN DEVELOPMENT

INFORMAL FINANCE AND THE MANUFACTURING SECTOR: The Case of the Footwear Industry in the Philippines

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ABSTRACT

Paper provides a description of the shoe manufacturing industry in Manila, Philippines and also presents details on how these small scale operations are financed. Recent studies have shown that these small firms often provide goods on consignment to larger firms that purchase their shoes, but also rely on suppliers to provide inputs on credit for the manufacture of shoes.

INFORMAL FINANCE AND THE MANUFACTURING SECTOR:
The Case of the Footwear Industry in the Philippines

by

Mario B. Lamberte

I. INTRODUCTION

Studies on informal finance in the Philippines are quite abundant.[1] They cover a wide range of topics including types of informal finance, interest rate determination, size and structure, interlinkage of credit with other markets, savings mobilization potential, among others. Since the liberalization of the financial markets that was earnestly started in the early 80s, an increasing number of people including policymakers are beginning to appreciate the role of informal finance in the domestic economy. In fact, the previous government introduced credit programs that made use of traders/millers/input dealers who are active in lending to farmers as conduits for government funds.[2] The repayment rates of these programs were much better compared with the conventional types of special credit programs for agriculture wherein soft loans were coursed through formal financial institutions, such as rural banks. The new government has maintained some of these non-conventional types of credit programs. But more importantly, it has officially recognized for the first time in its medium-term development plan the role of informal finance in mobilizing and allocating resources.[3] However, this does not mean that all policy makers have changed their attitude towards informal finance. In fact, many still look upon informal finance with great disdain. This is exemplified by a current bill in Congress proposing that interest rates on loans in the informal credit markets be controlled. Also, interest groups are lobbying against the program of coursing government-financed loans through traders/millers/input dealers who are making loans at market rates.

Most of the existing studies dealt with informal finance in the rural, agricultural sector. This is understandable since this sector, large as it is and vital to the economy, has been left out by the formal financial system. Interestingly, the character of operating informal finance has been observed by these studies to vary from crop to crop.[4] And this is where informal finance makes a lot of difference since it tries to satisfy the requirements of borrowers, such as synchronizing the repayment schedule of farmers to their cash flow patterns with minimal transaction costs.

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[1]See Lamberte and Lim (1987) and Agabin et al. (1989) for a review.

[2]See Esguerra (1987).

[3]See the Updated Medium-Term Philippine Development, 1986-1992.

[4]For example, see Geron (1988).

In contrast, not much is known about informal finance in urban areas where the manufacturing sector is concentrated. The presumption that the urban sector is adequately serviced by formal financial institutions could be the reason why little attention is given to urban informal finance. However, a large number of small- and medium-sized manufacturing firms do not have access to formal finance for the same reason that farmers do not have.[5] They are considered by banks as less creditworthy and lacking in collateral.[6] In addition, their loans are too small for banks to make a reasonable profit given alternative uses of their funds. The fact that they have proliferated and have been able to sustain their operations over the years suggest that they are either fully self-financing or have access to external finance other than banks. Thus, it is important to understand the character of informal finance that is supporting the small- and medium-sized manufacturing firms. This is the main focus of this paper. The ultimate objective is to draw lessons from the results of this study for policy formulation.

The next section presents a descriptive analysis of a segment of informal finance in the urban area. The last section discusses policy implications.

II. THE MANUFACTURING SECTOR AND INFORMAL FINANCE[7]

To fully appreciate the role and features of informal finance in the manufacturing sector, it is necessary to describe first the processes involved in producing and marketing manufactured goods because for every real transaction, there is an equivalent financial transaction. Since there is a wide variety of industries in the urban sector, it would be virtually impossible to deal with all of them in this paper. Hence, for the purpose of addressing the objective of this paper, it is worthwhile to examine more deeply one industry. And for this, we have selected the footwear industry located in Marikina, one of the thirteen towns and cities comprising Metro Manila. About 70 percent of the total number of footwear firms in the country are located in this town. The information analyzed in this study were obtained from 63 footwear manufacturers randomly selected from a total of 1,219 firms. The average value of the fixed assets of these firms was about P0.6 million in 1986. Eighty-seven percent of the sample firms are single proprietorship.

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[5]See Lamberte et al. (1989) and Salazar (1986).

[6]The typical collateral-to-loan ratio requirement of banks ranges from 120 to 150 percent (Graham and Lapar, 1988).

[7]This section draws heavily on Lamberte and Jose (1988).

A. Distribution Channels of Footwear Products, Sources of Inputs and Trade Credits

Figure 1 outlines in detail the sources of inputs for a typical footwear manufacturer and possible distribution channels for his footwear products. The manufacturer needs material inputs, some of which are locally produced while others are imported. Locally produced material inputs are sourced directly from domestic input suppliers. In the case of imported material inputs, the manufacturer may buy them either directly from foreign suppliers or from domestic suppliers who import the required material inputs. This depends on the manufacturer's financial capacity. Raw material inputs comprise at least 50 to 55 percent of the total cost in footwear manufacture.

The relatively huge financial resources required to purchase the needed inputs oftentimes strain the resources of manufacturers. Most affected are the small manufacturers who find it difficult to raise their own working capital internally. Thus, trade credit becomes a very attractive arrangement for them. It is also possible that input suppliers who provide trade credit to footwear manufacturers supplement it with cash credit so that the latter can purchase other inputs.

Footwear manufacturers have various distribution channels for their products. Some may have their own domestic retail stores. Others who would like to concentrate in production sell their products to either retailers, like department stores and supermarkets, or to wholesalers/traders. The latter, in turn, sell the footwear products to domestic and foreign retailers. One mode is to sell the products directly to foreign buyers. However, only big manufacturers who have direct access to foreign markets have this capability. To most of the footwear manufacturers, the domestic retailers and wholesalers/traders would be their major customers.

It is not easy to capture customers of products whose style changes frequently depending on the fashion. Being ahead or at least in step with what is in vogue is necessary for the survival of a footwear firm. Thus, it is not enough to simply establish good relations with customers.

To stay in business, therefore, a footwear manufacturer must be aggressive in marketing his products. Unlike a farmer, he does not just go on producing products in large quantities when the season comes. He starts by sending samples of his products and corresponding price quotation to prospective customers/buyers. Whenever the customers/buyers perceive that there is a sufficient demand for the sample products, they then place an order. Only then will the manufacturer start producing to fulfill the order.

Customers of footwear manufacturers may not immediately pay in cash for the delivered goods. In other words, they obtain trade credits from footwear manufacturers for a term of say, 30 to 60 days. This is a buyers' market. Thus, to stay competitive, footwear manufacturers have to extend trade credits to their customers, especially big department stores and large wholesalers/traders. Here is a case wherein small firms are providing credits to the bigger firms, a transaction that seldom happens to farmers.

The manufacturer's resources are locked in between the time he delivers the goods to his customers and the time he receives the payment. However, he does not stop producing but tries to get new orders to keep his business going. To do this, he needs additional working capital. Such may come solely from plowed back profits if they are sufficient for his requirements. The other alternative is to turn around and ask for trade credit from his input suppliers using as security the credit instrument issued to him by his customers who obtained trade credits from him. Thus, we have a case wherein the footwear manufacturer plays a dual role. He provides trade credit to his customers at one end and obtains trade credit from input suppliers at the other end. Synchronizing receipts and payments is crucial in these transactions.

It is likely that the maturity period of the trade credit which the footwear manufacturer obtains from his input suppliers is shorter than the maturity period of the trade credit he gives to his customers. Under such situation, he has to look for other sources of funds to pay his obligations to input suppliers. Other sources of credit may include banks, moneylenders and friends/relatives. These alternative sources of credit may also be tapped by the footwear manufacturer if he does not obtain trade credits from his input suppliers, or if such trade credit is not sufficient for his needs.

The footwear manufacturer may also enter into a "tie-in" arrangement with input suppliers who are also wholesalers/traders. Under this arrangement, the input supplier provides trade credits to the footwear manufacturer on the condition that the latter sells to him the footwear manufactures at a pre-agreed price. The manufacturer's debt is settled once he delivers the goods to the input supplier. This is similar to the trader/miller-farmer "tie-in" or linked credit arrangement now prevalent in rural areas.[8]

Figure 2 summarizes the main points discussed above. In particular, it portrays the flow and kinds of credit provided/obtained by a footwear manufacturer.

B. Major Findings

This part discusses trade credits granted and obtained by footwear manufacturers, effective interest rates, and other sources of credit.

Trade Credits Granted by Footwear Manufacturers

All the sample footwear manufacturers have been granting trade credits to their customers (see Table 1). In 1986 alone, the volume of their products sold on credit averaged 82 percent of their total sales. This is equivalent to P1.4 million per manufacturer.[9] Retailers, such as department stores and supermarkets, garnered 70 percent of the trade credits granted by footwear manufacturers (see Table 2). About 84 percent

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[8]See Sacay et al. (1985).

[9]The average peso/dollar exchange rate in 1986 was P20.39.

of the total sample firms granted trade credits to retailers. Roughly 30 percent gave similar arrangements to wholesalers/traders. Except for the individual customers/buyers, the average maturity period of the trade credits ranged from 69 to 72 days depending on the types of customers.

Since trade credit is term credit, manufacturers usually demand some sort of security to ensure payment. The most popular instrument used as security is the post-dated check. Almost all firms prefer to receive a post-dated check from their customers. Implied in the post-dated checks is the maturity period of the trade credit.

The post-dated check is not a perfectly risk-free security instrument. Customers may have closed their bank accounts before the maturity of the check. Delayed payments may also occur. When customers encounter liquidity problems, they may persuade the concerned footwear manufacturer not to cash the check upon maturity. Among the different customers of footwear manufacturers, the incidence of delayed payments in 1986 was alarmingly high for retailers and wholesalers/traders (see Table 3).

Respondents were asked whether the prices they charged for their products sold on credit were higher than the prices they charged for the same products sold in cash. Only 22 percent of the total respondents answered the question positively. On the average, the price differential was 7 percent.

Trade Credits Obtained by Footwear Manufacturers

Since a great proportion of their sales is locked in as trade credits which can be liquefied only after 60 to 90 days, footwear manufacturers have to resort to borrowing to allow themselves to continue operating. Ninety (90) percent of the sample respondents admitted that they availed themselves of trade credits from input suppliers in 1986 (see Table 4). Input suppliers and wholesalers/traders who are also input suppliers are their primary sources of credit. About 84 percent of the respondents obtained trade credits from input suppliers. Twenty-four (24) percent of them also obtained trade credits from wholesalers/traders who are also input suppliers. On the average, 80 percent of the value of the material inputs were bought on credit. In peso value, trade credits obtained by footwear manufacturers from input suppliers in 1986 averaged P476,920. This is only 38.5 percent of the value of trade credits they granted to their customers in the same year.

Of the total trade credits obtained by footwear manufacturers in 1986, 85 percent were contributed by input suppliers while 15 percent came from wholesalers/traders who are also input suppliers (see Table 5).

The average maturity period of the trade credit is 48 days for wholesalers/traders who are also input suppliers and 51 days for input suppliers. Note that this is shorter than the maturity period of the trade credits granted by footwear manufacturers to their customers.

There are several credit instruments that may be accepted by input suppliers, but the most popular is the post-dated check issued by customers of footwear manufacturers. This is considered the most highly negotiable credit instrument. Interestingly, about 21 percent of the respondents had only verbal agreements with their input suppliers.

Effective Interest Rates and its Components

The effective interest rate on trade credits obtained by footwear manufacturers from input suppliers includes the discount rate on post-dated check, the plain interest rate on trade credit from input suppliers, and the implicit interest rate arising from price differentials of inputs bought on credit and in cash. The components of the effective interest rate on plain trade credit (i.e., trade credits obtained from input suppliers) and on tie-in credit (i.e., trade credits obtained from wholesalers/traders who are also input suppliers) are shown in Table 6.

The discount rate on post-dated checks is almost the same for plain trade credit and tie-in credit. The same is true of the plain interest rate. However, the implicit interest rate greatly differs between the two sources of trade credit. In particular, the implicit interest rate charged by input suppliers is twice as high as the implicit interest rate charged by wholesalers/traders who are also input suppliers. An explanation of this is in order.

Wholesalers/traders usually have marketing contracts with big retailers or exporters. To assure themselves of a steady supply of footwear manufactures, they engage in tie-in arrangements with footwear manufacturers. This is the best way they can reduce business risk arising from non-delivery of goods when they have no control over production. Since footwear manufacturers have alternative outlets for their products as well as alternative sources of inputs, wholesalers/traders are therefore compelled to give footwear manufacturers a better price for their products. The marketing contract also reduces the risk of default on the credit they extend to footwear manufacturers.

This is not the case, however, with input suppliers who are solely supplying inputs. Footwear manufacturers find the necessity of borrowing from them since their working capital is tied up with the trade credits they extended to their customers. Thus, input suppliers can exercise some degree of pricing power which is reflected in the greater margins on inputs.

The total effective interest rates charged by input suppliers and wholesalers/traders who are also input suppliers are 116.4 percent and 78.3 percent per annum, respectively. These are not substantially different from those charged by informal moneylenders which are discussed below.[10]

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[10]See also Lamberte and Bunda (1988).

Alternative Sources of Credit

Aside from input suppliers, footwear manufacturers had other sources of credit to finance their business operations, such as banks, moneylenders, and friends/relatives. Of the 63 respondents, only 6 borrowed from banks in 1986. These are relatively big firms. The average amount borrowed was P55,000 with a maturity period of one year. The average interest rate was 16.5 percent per annum.

Seventeen respondents borrowed money from moneylenders to finance their business operations in 1986. The maturity period for loans from moneylenders was short, ranging from 30 to 60 days. The interest rate for the loans ranged from 36 to 120 percent per annum. Those who presented post-dated checks for discounting paid lower interest rates. The average discount rate charged by moneylenders for post-dated checks was 36 percent per annum, which was slightly lower than the input suppliers' discount rate for post-dated checks.

About one-third of the respondents turned to their friends/relatives for additional working capital. These were mostly interest-free loans.

We have described above the operating informal financial markets in one industry. And even then, only certain aspects of informal finance in this industry has been examined. Nevertheless, we have demonstrated that informal finance is very much alive in the urban, industrial sector. The same character of informal finance can be found as well in other manufacturing industries, such as the gifts and houseware industry, food processing industry, furniture industry, garments industry, among others.

There are other types of informal finance operating in urban areas. The most common among them is the "paluwagan," the Philippine version of a ROSCA. They can be found in government and private offices as well as in some pockets of low-income communities in urban areas. In one low-income urban community studied by Lamberte and Bunda (1988), market vendors have formed several "paluwagan" units. The existence of a variety of "paluwagans" in this small community offers low-income households with opportunities to save and overcome the problem of indivisibilities in investment and consumption that is in accord with their financial capacity. Some "paluwagan" units have transformed themselves into cooperative credit unions.[11] In the Philippines, the cooperative credit unions are virtually unregulated, and in that sense, still belong to the informal financial markets. The cooperative credit union of the employees of the Central Bank of the Philippines is one of the largest and fastest growing cooperative credit unions in the country. It offers savings and time deposits to its members and accommodate housing and consumption loans. Market vendors' cooperative credit unions are also by no means small.

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[11]See Lamberte and Balbosa (1988).

III. POLICY IMPLICATIONS

Concerned with lack of access to formal credit by small manufacturing enterprises, some lawmakers have recently filed a bill requiring banks to allocate a certain proportion of their loanable funds to these firms. Also, recently, the Department of Trade and Industry has introduced several special credit programs for these firms carrying concessionary rates. Such had been the approach taken in the past to ensure the flow of credit to the agricultural sector. And almost all of them failed, leaving behind the rural banking system in shambles.

Interestingly, while the special credit programs for the agricultural sector are now being gradually phased out, new ones are being created for the industrial sector. And like the special credit programs for the agricultural sector in the past, the new ones have been designed without taking into account the role and character of informal financial markets in the industrial sector. It seems that policymakers for the industrial sector do not know much about the workings of informal finance in the urban, industrial sector. But they cannot entirely be blamed for it because as pointed out at the beginning of this paper, there is a dearth of studies on informal finance in urban, industrial areas.

The results of this study offer some insights useful in designing policies that could enhance the efficiency of the urban financial markets, both formal and informal, without necessarily using a special credit program as an intervention instrument. We can perhaps be more specific in this regard by adding more insights.

The market for post-dated check recently has attracted the attention of one large commercial bank. In 1986, it set up a Shoe Industry Desk in its Marikina branch. It lends to small footwear manufacturers by discounting post-dated checks. Loans can be obtained quickly. It even opens its branch in Marikina on Saturdays to service borrowers. This is one case where a formal lending institution mimicks informal lenders. It competes with input suppliers by offering lower discount rate on post-dated checks. Admittedly, its current impact on the market is still limited. The main reason is that it honors only those checks issued by large, well-known retailers and supermakets. In effect, it competes with input suppliers only insofar as the prime post-dated checks are concerned. What is important, however, is that it has started an innovative lending program. As it gathers more experience and information about the market, it certainly will expand to non-prime instruments. And this is where some intervention is required to accelerate that process.

A good information system about the financial health of firms, big and small, which are regularly issuing post-dated checks as payments for the goods delivered must be available at a reasonable cost so that banks and input suppliers can make proper assessment of the risk involved. The main reason why the bank mentioned above does not accept post-dated checks issued by small retailers is that they have insufficent knowledge about the financial conditions of those firms. On the other hand, input suppliers charge a higher discount rate for post-dated checks issued by small firms than those issued by large firms to compensate for the higher perceived risk. Perhaps, the government-owned Credit Information Bureau, Inc. can be strengthened and its coverage

be expanded to include in its rating program small, post-dated issuing firms. This will hopefully enhance the integrity of post-dated checks as a security instrument approximating that of the well-established "quedan" (warehouse receipt) system.

The above mentioned program should be accompanied by a change in the branching policy. The overly restrictive branching policy presently pursued by the Central Bank discourages competition, hence existing banks or branches are not motivated to innovate.

For instance, the number of banks and bank branches in Marikina seems to be small relative to the size of its economic activity, and yet the Central Bank considers it as an "overbanked" area, which means that no new bank or branch can be established there. It is high time to reconsider this policy.

FIGURE 1

DISTRIBUTION CHANNELS OF FOOTWEAR PRODUCTS AND SOURCES OF INPUTS

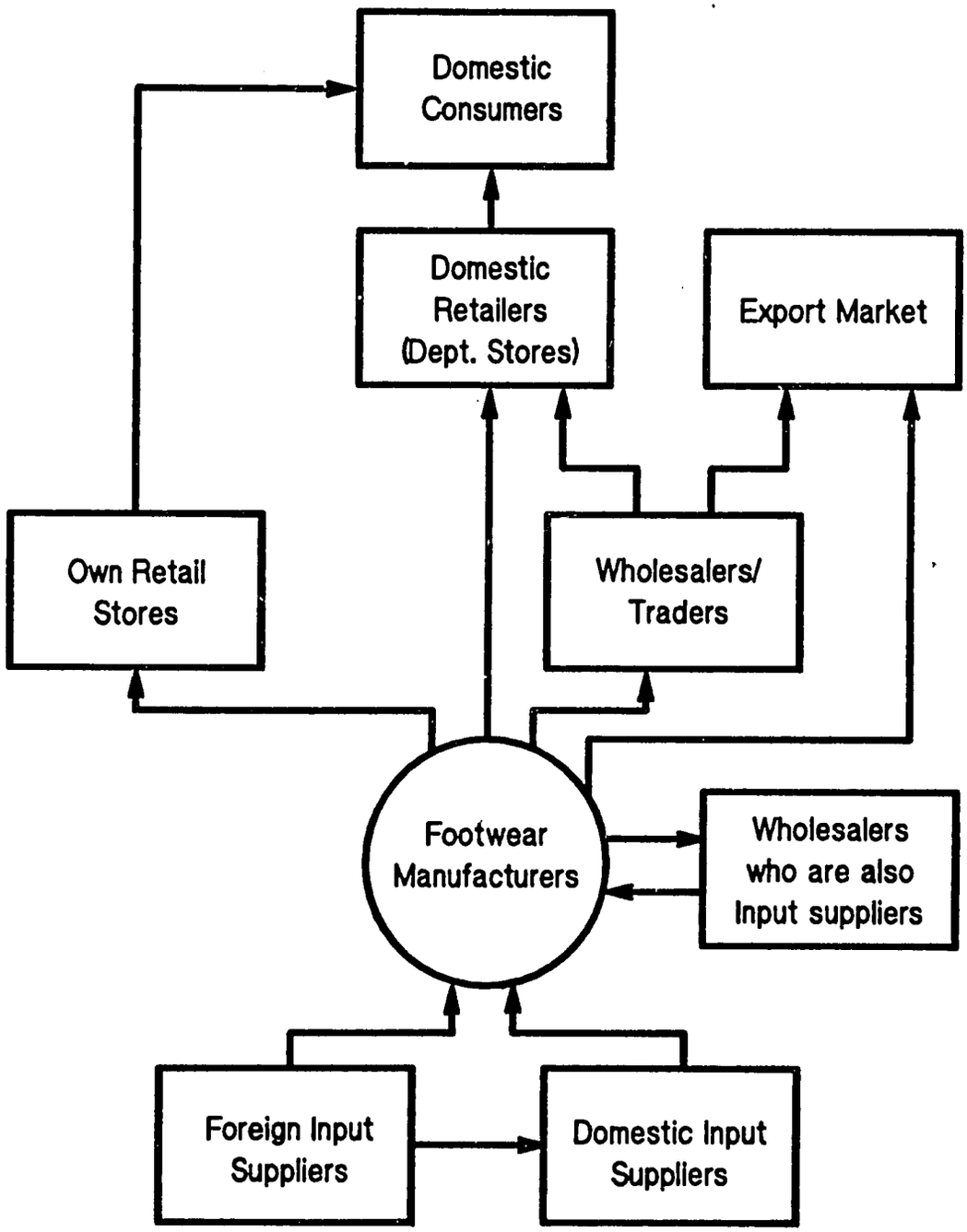

FIGURE 2

FLOW AND KINDS OF CREDIT

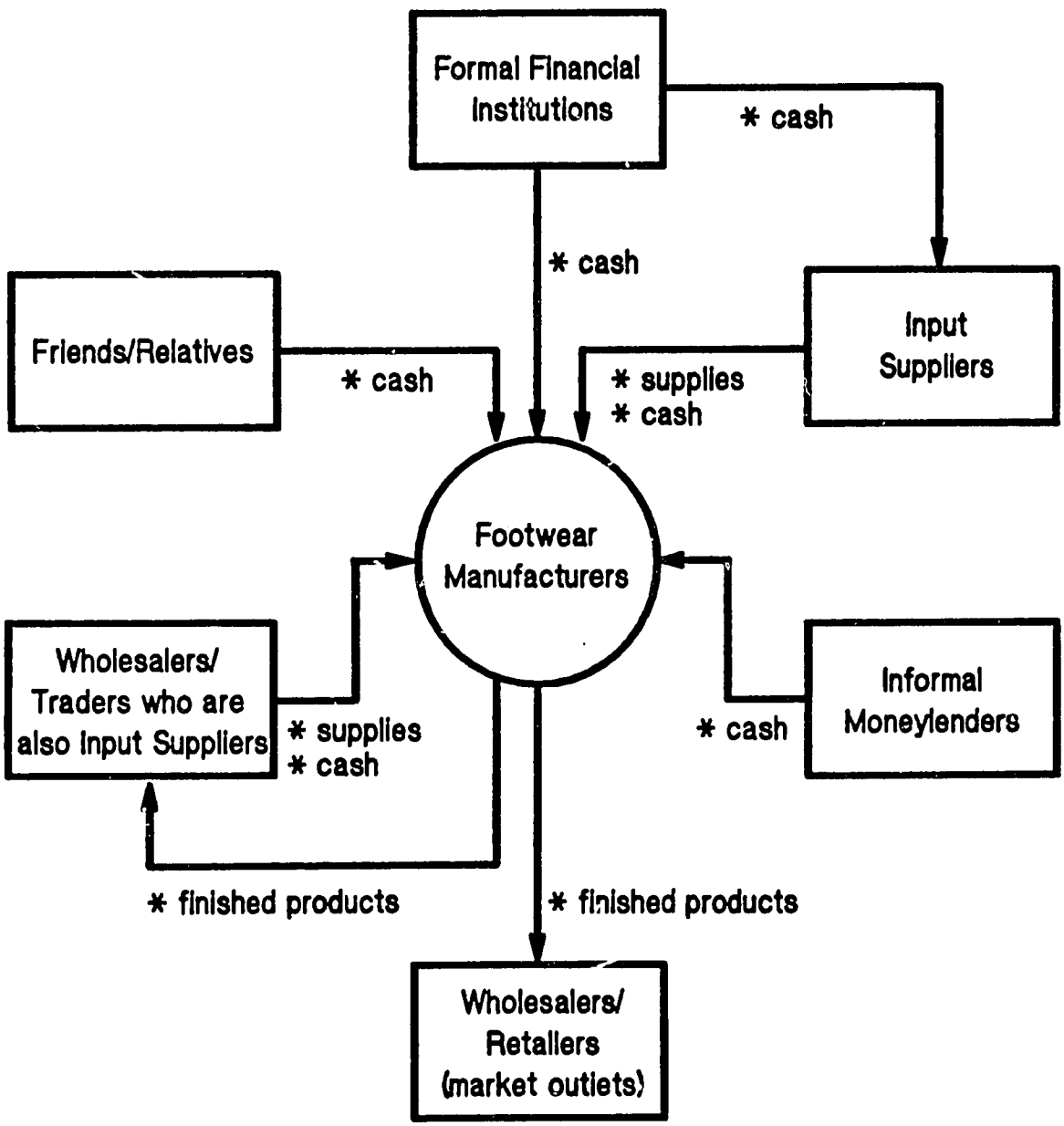

TABLE 1

Proportion and value of trade credits granted by footwear manufacturers to their customers

Information	No. Reporting	Percent
1. No. of footwear manufacturers who granted trade credits to their customers	63	100.00
2. Proportion of trade credits to total sales (%)		
below 50	5	7.94
50 - 75	11	17.46
76 - 95	22	34.92
96 - 100	25	39.92
	63	100.00
Mean	82.508	
S.D.	23.329	
Median	90.000	
3. Value of trade credits (P)		
below 100,000	4	6.35
100,001 - 500,000	19	30.16
500,001 - 1,000,000	15	23.81
above 1,000,000	25	39.68
	63	100.00
Mean	1,383,885	
S.D.	1,668,554	
Median	790,020	

TABLE 2

Distribution of trade credits and average maturity period of trade credits by type of outlet.

Type of Outlet	No. Reporting	Average	S.D.
1. Distribution of sales on credit (%)			
Individual customers/buyers	7	2.4	13.0
Wholesalers/traders	19	13.3	26.4
Input suppliers/wholesalers/ traders	4	14.8	32.0
Retailers (dept. stores, supermarkets	53	69.5	39.6
		100.0	
2. Maturity period of trade credits (days)			
Individual customers/buyers	3	35.0	22.9
Wholesalers/traders	19	72.4	31.2
Input suppliers/wholesalers/ traders	11	70.9	23.3
Retailers (dept. stores, supermarkets	52	68.8	23.5

TABLE 3

Incidence of delayed payments on trade credits granted by footwear manufacturers to their customers.

Market Outlet	No. Reporting	Avg. No. of days delayed	Avg. Amt. Overdue (P)
Individual buyers	3	6.0 (1.41)	350.00 (212.13)
Wholesalers/traders	14	120.2 (165.63)	792.86 (396,704.03)
Wholesalers/traders who are also input suppliers	7	13.3 (4.08)	25,500.00 (27,508.18)
Retailers (department stores, supermarkets)	29	18.6 (12.43)	26,971.43 (93,166.32)

Note: Figures in parentheses are standard deviations.

TABLE 4

Trade credits obtained by footwear manufacturers from input suppliers.

Item		No. Reporting	Percent
1.	No. of manufacturers who bought inputs on credit	57	90.5
2.	No. of manufacturers who bought inputs on credit from input suppliers	53	84.1
3.	No. of manufacturers who bought inputs on credit from wholesalers/ traders who are also input suppliers	15	23.8
4.	Proportion of the value of material inputs bought on credit to total value of the material inputs (%)		
	below 51	2	3.5
	51 - 75	15	26.3
	76 - 95	24	42.1
	96 - 100	16	28.1
	Total	57	100.0
	Mean	80.4	
	S.D.	21.1	

TABLE 4

Trade credits obtained by footwear manufacturers from input suppliers (continuation).

Item		No. Reporting	Percent
5.	Average value of material inputs bought on credit (P)		
	Below 50,000	8	15.09
	50,000 - 100,000	12	22.64
	100,000 - 500,000	22	41.51
	Above 500,000	11	20.76
	Total	53	100.0
	Mean	416,127.44	
	S.D.	598,450.50	
6.	Ratio of the value of trade credits obtained from input suppliers to the value of trade credits granted to customers (%)		
	Below 10.01	13	20.64
	10.01 - 30.00	18	28.57
	30.01 - 50.00	18	28.57
	50.01 - 1.00	11	17.46
	Above 1.00	3	4.76
	Total	63	100.00
	Mean	34.8	
	S.D.	29.7	

TABLE 5

Proporation of the value of trade credit on inputs contributed by each source and maturity of trade credit.

Item		Number Reporting	Average	S.D.
1.	Proportion of trade credit on inputs contributed by:			
	a) Input suppliers (%)	53	85.44	30.00
	b) Wholesalers/traders who are also input suppliers (%)	15	14.56	30.00
2.	Maturity period of the trade credit (days)			
	a) Input suppliers	53	50.98	21.22
	b) Wholesalers/traders who are also input suppliers	15	47.47	29.19

TABLE 6

Components of effective interest rate.

Source/Component		Percent per year	Percent share
A.	Plain Trade Credit (Input Suppliers)		
	Discount rate on post-dated checks	33.18	28.51
	Plain interest rate	7.35	6.32
	Price differential	75.84	65.17
	Total	116.37	100.00
B.	Tie-in Credit (Wholesalers/ traders who are also input suppliers)		
	Discount rate on post-dated check	31.84	40.67
	Plain interest rate	9.60	12.26
	Price differential	36.85	47.07
	Total	78.29	100.00

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