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United States Agency for International Development

DEVELOPING THE PHILIPPINES' CAPITAL MARKET

USAID initiatives strengthened the regulatory oversight of the stock market in this Asian nation and promoted creation of greater efficiency in its operation. This was achieved with only modest resources, mainly through technical assistance and training. Though it's too early to gauge the project's long-term effect on poverty, it may be that the strengthened market helped cushion the country from the worst devastation of the Asian financial crisis.

SUMMARY

- USAID was able to attract high-quality specialized experts to advise the Philippine government's regulators, drawing upon U.S. capital market expertise.

- USAID's willingness to cancel the project if the Philippine government did not take necessary actions was critical to the project's ultimate success. The Agency's sound reputation as being committed to Philippine development served it well in producing a positive resolution.

- The case for USAID assistance to government regulation of the capital markets is more obviously justifiable than support for the private sector. Nevertheless, the inclusion of a private sector component to the Philippine project contributed significantly to its success. An emphasis only on the government would have reduced the Agency's ability to respond flexibly to changing circumstances and thus diminished the project's ultimate impact.

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- The approach made possible by the project—emphasizing disclosure of relevant financial information and constant market revaluation of asset pricing—provides the ability to adapt to changing circumstances that should help avert financial crises.

COUNTRY CONTEXT

Much in Philippine history separates the archipelago from its Asian neighbors. The country was ruled by Spain until 1898, when the United States freed it from that colonial master but imposed its own rule. William Howard Taft was the first U.S. governor general. Conquered by Japan in 1942, it was liberated by American troops in 1945 and became independent the following year.

Economic Environment

From the vantage point of the early 1960s, the Philippines appeared to be a country of great promise. Its per capita income was higher than that of most of the other East Asian countries, including Taiwan, South Korea, and Thailand. Educational levels, supported by years of U.S. involvement, were higher than in most other countries in the region. It had a democratic political system and close ties to the United States. These advantages made many expect the Philippines to be the first to follow Japan into developed-country status.

The conventional wisdom was wrong. Instead of rapid, sustained economic growth, the Philippine economy had an extended period of economic instability and sluggish growth. Unlike some of its neighbors, Philippine policymakers chose to emphasize import-substituting industrialization. Barriers to imports from abroad were raised to encourage industry producing for the domestic market. This led to relatively inefficient production, interfering with the development of efficient export industries. Consequently, the Philippines gradually became more isolated from the world economy. Its share of world exports fell by half between the 1950s and the mid-1980s. These problems were made worse by extensive use of government power to favor particular enterprises or groups. The term “crony capitalism” was coined to describe the Philippines under the long rule of President Ferdinand Marcos. Marcos was forced from power in 1986, and a process of political and institutional reform began following his overthrow.

By the late 1980s, Taiwan and South Korea, which lagged behind the Philippines in purchasing-power-based gross domestic product per capita in 1958, had reached levels five times that of the Philippines. Thailand, China, and Indonesia, starting from per capita GDP levels substantially behind the Philippines, had also pulled ahead. Its poor performance—more due to the surprisingly rapid rise of many of its neighbors than to performance relative to other developing countries—earned the Philippines the epithet “sick man of Asia.”

The Marcos government manipulated the results of a presidential election in 1986 to claim victory over the incumbent’s opponent, Corazon Aquino, but mass demonstrations led Aquino to power. The return of democratic governance did not initially produce political stability, for there were several attempts to overthrow the Aquino government. Nor did faster economic growth ensue. Some attributed the country’s continued disappointing performance to the Spanish cultural tradition it shared with Latin America. Critics pointed to both land tenure, with large estates controlled by a rural-based aristocracy, and political factionalism based on family alliances.

During the administration of Fidel Ramos (1992–98) some of these concerns were dispelled by an economic boom and by an apparent reduction in political factionalism. Economic growth accelerated from the anemic 1.6 percent average GDP growth from 1980 to 1992 to a robust 5 percent a year for 1993–97. This period brought a new impetus to modernize and liberalize the Philippine economy, including the financial sector.

Several factors in addition to political developments helped generate a period of sustained growth starting in 1993. Key people in the Philippine business and financial communities, government service, and academe recognized that the Philippine economy had performed poorly and had the potential to do much better. Drawing from this loose coalition, the Ramos administration explicitly supported a new round of measures to liberalize the economy policy framework.*

The liberalization was particularly sweeping for international transactions. In 1992 the central bank—Bangko Sentral ng Pilipinas—removed controls on the purchase and sale of foreign exchange and permitted free movement of financial capital in and out of the country. These actions led to a significant inflow of remittances and capital from overseas Filipinos and to the return of previous flight capital. There was also a surge in new foreign direct and portfolio investment. On the trade side, the government steadily reduced and simplified tariffs through the 1990s, abolishing all but a handful of quotas on imported goods. The Philippines also joined the World Trade Organization, agreeing to eliminate all quotas by 2004 and setting a goal of reducing tariffs to a uniform 5 percent rate.

Infrastructure bottlenecks were significantly reduced from the dire situation inherited from the Marcos regime, but they still remained a serious impediment to efficiency. A severe shortage of electricity-generating capacity was resolved starting in late 1993. The government partially deregulated inter-island shipping, privatized several large companies, and allowed foreign companies to enter the telecommunications market in joint ventures with domestic partners.

Steps were also taken to strengthen the domestic financial market. The Bangko Sentral allowed 10 new foreign banks to enter the market in 1995, raising the number of foreign commercial banks to 17. The government's deposit insurance corporation was brought back from the brink of insolvency. The government also moved to strengthen its own finances. It gradually reduced the fiscal deficit, which had been crowding the private sector out of the financial market and raising interest rates. The deficit fell steadily from 3.4 percent of GDP in 1990 to zero in 1995, followed by small surpluses in 1996 and 1997. The central bank gradually reduced commercial bank reserve requirements, lowering them from 20 percent in 1992 to 15 percent in 1997. Interest rates gradually declined in response to these policies, with the treasury bill rate falling from the 25–30 percent range before 1993, to 12 percent from 1993 through 1996.

Economic performance responded quickly. The GDP growth rate rose steadily, from 0.3 percent in 1992 to 2.1 percent in 1993 to above 4 percent in 1994 and 1995 and to above 5 percent in 1996 and 1997. Exports grew at an average annual rate of 25 percent over the 1990s. The stock

*There had been some liberalization in the early 1980s, when the Philippine economy was even more tightly regulated. Starting from very high levels, tariffs on imports of some products were reduced, and interest rates were freed. Some reduction in government controls occurred, though political cronyism continued to be a pervasive feature of government policy.

market soared. Foreign capital inflows fueled much of the increase in stock prices as combined foreign equity and portfolio investment increased 13-fold, from $446 million in 1990 to $5.7 billion in 1996. Central bank international reserves climbed from negative levels in the late 1980s to $10.5 billion in mid 1997.*

The country was affected by the Asian financial panic that began in mid-1997, but only moderately. The currency depreciated, and interest rates rose, but no major crisis occurred. Foreign short-term borrowing by the Philippines was much smaller then elsewhere, and Philippine banks were in better condition than those in the most affected countries. This relatively favorable position for the Philippines was evident in growth forecasts for 1998. The midyear forecast by the Institute for International Finance put Philippine GDP growth at 2 percent, modest but far better than the forecasts of –6 percent for Malaysia and South Korea, –7 percent for Thailand, and –20 percent for Indonesia.

Savings and Investment

Philippine savings rates during the last decade have averaged about 20 percent of GDP, slightly below the average for all developing countries and well below the 30 percent typical of the Asian tigers. Investment rates have typically been several percentage points higher than savings but have tracked the trend in savings fairly closely. Foreign saving represents the difference between the two. Foreign savings have tended to respond to conditions in the country, declining during periods of instability to less than zero, and rising during expansions. Since 1992, foreign savings inflows have been particularly large.

*Statistics are generally from Bangko Sentral ng Pilipinas, "Selected Philippine Economic Indicators," Department of Economic Research.

Interest rates are market determined and have trended downward during the 1990s, as inflation was brought under control and fiscal deficits were reduced. Commercial bank deposit rates fell from 20 percent in 1990 to just under 10 percent in 1997. Adjusted for inflation, savers received positive deposit rates for each year of the period at approximately 3 percent with no clear trend.

A few large commercial banks dominate the Philippine financial market. They are the major players in the Philippine equities, bond, and foreign exchange markets. Until 1993 the relative importance of bonds and bank assets (loans) was greater than that of equities. During 1988–92, the value of bonds outstanding represented 28 percent of GDP, and bank loans were 42 percent, compared with 22 percent of GDP for equities. The rise in share prices and increase in new stock issues raised the ratio of stock market capitalization to 80 percent of GDP in 1993–95. With the improvement in the financial markets, the other instruments also rose in importance—bonds to 41 percent and bank loans to 52 percent of GDP. Foreign capital inflows fueled much of the increase in equity investment as combined foreign equity and portfolio investment increased, as noted, by a factor of 13.

The Philippine bond market consists primarily of government treasury bills and intermediate-term bonds. There is a secondary market for these issues, made up of selected banks, some nonbank investing institutions, and authorized private dealers. A handful of the largest corporations also issue bonds, for which the main purchasers are a few commercial banks. Because of taxes on bond transactions, such securities tend to be held to maturity, and very little trading occurs. The corporate sector still relies primarily on retained earnings to finance investment rather than on borrowing from banks or on sale of equity.

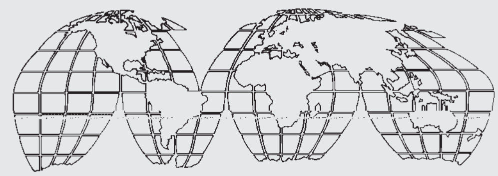
Capital Market Institutions: Evolution and Characteristics

The formal Philippine capital market is one of the oldest in Asia. The Manila Stock Exchange was established in 1927. Gold and copper mining stocks dominated trading during the first five decades of operation, and trade in oil stocks caused a boom in the late 1970s. A rival financial group established a second stock exchange in 1963. After years of conflict, the government induced the two exchanges to merge in 1994 to form the Philippine Stock Exchange (PSE).

The stock market took on increasing importance in the late 1980s. In the five-year period beginning in 1987, total market capitalization grew from $3 billion to $14 billion. This resulted both from bidding up prices of existing issues and major new offerings, such as from privatization of the Philippine National Bank and by the property-holding Ayala Corporation. Despite major fluctuations, as with a coup attempt in 1989, the market continued to boom, with capitalization jumping to $40 billion by 1993 and doubling again by 1996 to $81 billion. But the market lost more than half its value in dollar terms following the crash in Asian financial markets. It ended 1997 at $36 billion.

The stock exchange is owned by its 185 broker–dealer members. Their representatives control the PSE board of directors. Because there is equal voting power among dealers, the more numerous small brokers tend to control board decision-making. A few firms do most of the trading, and their dominance has increased. The top 20 firms handled nearly 60 percent of total daily transactions in 1990, but their share had risen to 80 percent by 1997. Investors have been and continue to be predominantly institutions; the retail market is relatively small.

Traditionally, the operations of the two stock exchanges, and then the early PSE, were essentially nontransparent, with weak self-regulation and few meaningful investor safeguards. Transactions costs were relatively high. All trades required the physical transfer of stock certificates, with settlement taking from 27 to 45 days.



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A government regulatory body, the Philippine Securities Exchange Commission (SEC), was formed in 1936. In its oversight of securities markets, the SEC operated on the principle of "merit regulation." Under this approach, the commission had to give its approval prior to public issuance of stock in any company. After reviewing and valuating the company's offering, the SEC would set the price at which the issue could be sold. The commission did not conduct surveillance or actively regulate the stock exchange. Units within the SEC frequently had overlapping responsibilities, and staff had little or no knowledge of regulations or the techniques required to conduct tasks. The commission chairman personally made virtually all major SEC decisions.

USAID CAPITAL MARKET DEVELOPMENT ACTIVITIES

In February 1998, a five-person team from USAID's Center for Development Information and Evaluation traveled to the Philippines to assess the effectiveness of the Agency's assistance for capital market development. The mission was part of a five-country study that also included India, Kenya, Morocco, and Romania.

USAID's interest in the Philippine capital market goes back to at least 1985, when the Agency funded a study of that market. The study has helped guide subsequent work by USAID and other donors. Guided in part by the study, the Agency designed a $13.6 million Financial Resources Mobilization Project in 1987. It aimed to strengthen the private sector by 1) supporting Philippine government privatization efforts and 2) helping the financial sector mobilize more investment capital. The second component was intended to work with a combination of private and government entities, including the securities regulatory body, the Securities and Exchange Commission. The government's commitment to the program, initially weak, waned further, and the project was canceled before implementation began.

The Capital Market Development Project

The Agency commissioned further research in 1988, and the Asian Development Bank developed a comprehensive agenda for financial sector reforms in 1993. The Philippine government, the Asian Development Bank, the World Bank, and USAID agreed to coordinate their efforts to upgrade the Philippine financial market, drawing on the Asian Development Bank study. USAID would help the Philippines implement institutional and policy changes in the financial market, the World Bank would concentrate on assisting the central bank, and the Asian Development Bank would provide a $150 million program loan conditioned on policy changes in the financial sector.

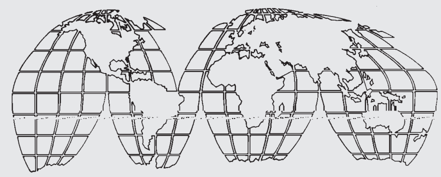
The Asian Development Bank study provided much of the basis for the design for the five-year, $13.5 million USAID Capital Market Development project. The project started in October 1993. It featured separate but coordinated and complementary public and private components. The public sector component was to provide assistance to restructure the Securities and Exchange Commission. The private sector component was to be managed by an umbrella association of private sector financial institutions, the Financial Executives Institute of the Philippines. (Members were primarily leaders of commercial and investment banks, brokerage firms, and other intermediaries.)

The capital markets project was only one of several related USAID activities aimed at promoting Philippine development. A separate project, with $5 million in USAID resources, provided technical assistance for the privatization of major government-owned companies, leading to their listing on the stock exchange. The Philippine National Oil Company (Petronas for short) the largest of these, is now one of the leading issues traded on the Philippine Stock Exchange. Another USAID-financed activity helped the Philippine Board of Investment keep American firms informed of the improving environment for foreign portfolio investment in the Philippine market.

The project sought to enhance the integrity and capacity of the capital markets to facilitate an increase in the number and types of equity and debt securities. That would, in turn, encourage savings mobilization and increase the quantity and quality of private investment.

The Public Sector Component

The Securities and Exchange Commission was revamped to do a better job of regulating and promoting the securities industry. In large part it undertook this goal by limiting its own role to broad strategic concerns and delegating much of the day-to-day regulation to market institutions. Ultimately, that would create a more fair and efficient capital market. The capital markets project provided the SEC with a team of advisers from the American accounting firm Arthur Andersen & Company. The team helped the commission identify areas for reform, conduct policy studies, draft revised laws and regulations, and reform the commission's own organization, procedures, and records management. The project also helped the SEC design and procure computer systems to streamline its internal operations. The advisers completed their work in September 1997.



"When it became clear in the fall of 1995 that reform of the SEC could not succeed in the face of opposition by the chairman, USAID announced its intention to cancel the project unless the commission moved forward with its restructuring."

The most basic issue addressed by the project was the SEC's overall approach to regulation. Extensive discussion encouraged by the consultants led to agreement that the existing approach of the commission—the merit regulation, earlier described—was ineffective. In mid-1994 a consensus was built among the SEC's commissioners and department directors that the key policies around which the commission should be organized in the future were self-regulation, full disclosure, and enforcement.

For almost two years project implementers worked on drafting rules and legislation, preparing groundwork for staff reorganization, and finalizing the information technology plan in anticipation of approval of the changes by the SEC chairman. The commission chairman was one Rosario Lopez, a presidential appointee who had been in office 32 years. She was perceived by the other commissioners and by market participants alike as dictatorial in style and strongly opposed to abolishing the merit system. As time passed, it became evident she would be unwilling to implement the changes envisioned in the capital markets project despite the enthusiasm of other members and many staff. The proposed revisions in the SEC's approach would substantially reduce the power of the commission, and of the chairman, to influence specific stock issues or to use the power of the SEC for political patronage.

When it became clear in the fall of 1995 that reform of the SEC could not succeed in the face of opposition by the chairman, USAID announced its intention to cancel the project unless the commission moved forward with its restructuring. The situation had come to an impasse; USAID consultants were unable to fulfill their assignments at the commission. A straightforward letter the mission director sent to the secretary of finance was leaked to the press, bringing into the open a clash between the politically powerful chairman and the reform effort. The issue was resolved when President Ramos asked the chairman to retire. Within the next few months the SEC implemented USAID's reorganization design. It consolidated and computerized the filing system, submitted draft legislation, and reordered the functional flow in the remodeling of the SEC's office building.

The Private Sector Component

Under a cooperative agreement, USAID supported the program of the Financial Executives Institute of the Philippines (FINEX) to promote development of the capital market. That included several elements: establishing a privately owned investor information service, creating a financial training institution, and instituting a "challenge grant" to help create a stock market clearing and settlement facility. The project would provide $1 in grant funds for each $4 of investment mobilized from private Philippine institutions to capitalize such a facility, up to a maximum of $1 million. In the actual event, $9 million of private investment was raised, so all $1 million of the USAID grant was disbursed. Its proceeds are held by FINEX as its share of the capital stock of the Philippine Central Depository, Inc.

The Capital Market Development project's assistance to FINEX was completed in March 1998. The private component of the project, with FINEX as the grantee, involved senior executives from the entire Philippine financial industry, including the stock exchange and the associations of bankers and investment houses, as well as corporate issuers and potential issuers. FINEX established a project management office to provide full-time professional support for implementation and to serve as the secretariat for the Project Implementation Committee. The monthly meetings of the committee were headed by the chairman of FINEX and attended by representatives from the various member institutions, the Securities and Exchange Commission, and the Agency.

Through FINEX, there was a close and effective working relationship between the project and a high-level Philippine public–private committee to oversee restructuring and management of the country's financial markets. This body, the Capital Market Development Committee, had been formed before the start of the capital markets project. Its seven members included the secretary of finance, the SEC commissioner, the governor of the central bank, the chairman of FINEX, and the presidents of the stock exchange, bankers association, and investment house association. The project management office became the secretariat for the committee. The mixture of high-level government and private sector representatives in both the Project Implementation Committee and the Capital Market Development Committee provided optimal communication and coordination between the public and private sectors on project strategic direction and implementation.

Debt Market Activities

Most activities of the Capital Market Development project have concentrated on the stock market, with only limited attention to debt market issues. Developing a long-term debt market depends in the first instance on the government's creating a stable macroeconomic environment. Two factors are involved. First, inflation, including expected future inflation, has to be reduced to levels that induce large number of savers to be willing to make long-term commitments. (At the same time, a secondary debt market provides such investors with both liquidity and the ability to manage risk.) Second, the government has to limit its use of the debt market so as to avoid crowding out private firms.

The project's primary effort in the debt market involved removing legal impediments to the creation of a viable market for corporate debt. Problem areas include taxation of secondary-market transactions in debt and a requirement for stockholder approval of any corporate issuance of debt.

The USAID mission has addressed a range of debt market issues in other parts of its assistance program. These include the Microfinance Policy Improvement Program, which is part of a larger effort to consolidate government lending activities, and two local government projects. Under one such project, work has been done to advocate development of a tax-exempt municipal bond market. Two concerns arise with respect to this activity. First is the underdevelopment of the debt market, due to the range of factors discussed above, and the extent to which that underdevelopment limits the potential success of these promotion efforts. Whether USAID should be promoting municipal bonds, without more systematically attempting to address the constraints on the overall market, is a logical question. The second concern is advocacy of tax exemption for municipal bonds, which, by providing a subsidy to municipalities, appears to contradict USAID efforts to liberalize and to reduce distortions in other parts of the Philippine financial sector.

CAPITAL MARKET INSTITUTIONS

Stock Market Infrastructure

The Philippine capital market had been evolving over a long period of time, with the first stock exchange established more than 50 years before. This meant that the country had relatively sophisticated institutions and substantial numbers of people with financial expertise.

State of Affairs in 1993

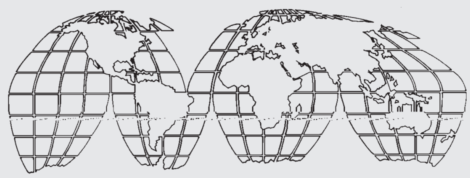
By the close of 1993, the year USAID was beginning its involvement in the Philippine capital market, a total of 180 companies were listed.* Total market capitalization amounted to 1,088 billion pesos (US$40 billion), representing 74 percent of GDP. Some 635 million shares had been traded during the year, for a total value traded of 182 billion pesos (US$6.8 billion); the turnover rate was 25 percent, reflecting the low liquidity of the market. Equities were trading on average at about 30 times historical net earnings, again highlighting the scarcity of Philippine quoted equities. The index stood at 3,196, having recorded a jump of 154.4 percent over the previous year. The bond market was inactive and the money market relatively subdued.

Two exchanges were competing against each other, the **Manila Stock Exchange** and the **Makati Stock Exchange.** Companies were quoted on both exchanges, providing arbitrage positions for brokers rather than investors. Trading took place by means of open outcry. Shares were in certificated form. Most players were foreign institutional investors; few retail investors participated in the market. Clearing and settlement procedures were abnormally slow. It took an average of 50 days—from the date of trade to the date of receipt of physical certificates—to clear a domestic stock trade on the exchanges.

The **Securities and Exchange Commission** regulated the market. In addition to administering and enforcing provisions related to public offerings and trading in securities in the secondary market, the SEC exercised jurisdiction over all corporate bodies, partnerships, and associations and was responsible for enforcing 20 laws and presidential decrees. Securities-market regulations suffered from overlap and duplication of rules, regulations, and procedures. The SEC lacked the information technol-

**Source:* IFC 1997 Factbook and Philippine Stock Exchange. All figures quoted for 1993 are derived from these sources.

ogy necessary to monitor the capital market and keep the commission's management and market participants informed. As a result, the rules of the capital market were constantly violated, market surveillance was inefficient, information disclosures were poor, and the rights of minority shareholders were not adequately protected.



"Securities-market regulations suffered from overlap and duplication of rules, regulations, and procedures. . . . As a result, the rules of the capital market were constantly violated, market surveillance was inefficient, information disclosures were poor, and the rights of minority shareholders were not adequately protected."

In addition, the SEC perceived its role as protector of investors through direct intervention in the markets. Therefore, it operated on a merit system rather than full disclosure. The long-standing chairman, Rosario Lopez, in a totally opaque environment, based the price of primary issues on a judgment of the merit of the initial public offering. The chairman, also behind closed doors, decided which broker–dealers would receive allocations of the IPOs. The chosen brokers then sold the IPOs at large markups to buyers. The IPO process required long time periods, and because there was a large price difference between sellers and buyers, the interest of neither the firms raising capital nor investors was served. The system afforded ample opportunity for corruption.

Status Quo in January 1998

As of the beginning of 1998, market conditions were as follows. The two exchanges had been merged into the **Philippine Stock Exchange** in 1994. A total of 221 companies were quoted, covering 13 different sectors. A small number of bonds, preference shares, and warrants were also traded. Total market capitalization was approximately 1,250 billion pesos ($31 billion) after having peaked at 2,121 billion pesos ($81 billion) in 1996. The ratio of market capitalization to GDP had increased to 100 percent. Approximately 1,923 billion shares had been exchanged during the year for a total value traded of 586 billion pesos (US$15 billion); the turnover ratio had increased to 47 percent. The average price/earnings ratio was less than 10 and the book-value multiple close to 1. The index stood at 1,869. Foreign institutional investors accounted for about 75 percent of the volume of traded shares. Fifty-eight underwriters were licensed by the SEC. A million retail investors participated in the market, almost exclusively from metropolitan Manila, and eight mutual funds had been created, though in aggregate they had less than 10,000 shareholders. Table 1 summarizes basic stock market statistics for the period 1993–97.

As can be seen from table 1, 1996, the year before the Asian crisis began, was the year in which the Philippine Stock Exchange was most active. The index reached 3,171; market capitalization peaked at 2,121 billion pesos (US$81 billion), turnover at 668 billion pesos (US$26 billion); and a record 2,273 billion shares were traded. On a compounded basis, during 1993–96, market capitalization grew by 25 percent a year; the value of shares traded, by 47 percent a year; and the volume of shares traded, by 52 percent a year. But a major decline occurred in

Table 1. Stock Market Summary, the Philippines, 1993–97 (figures are in million pesos or million shares, unless otherwise stated)

	1993	1994	1995	1996	1997
Market capitalization	1,088,819	1,354,660	1,543,871	2,121,059	1,251,288
percent change	208	24	14	37	–41
Value turnover (pesos)	182,179	364,296	378,982	668,866	586,172
percent change	135	102	4	76	–12
high (monthly)	40,359	56,272	45,338	78,422	76,638
low (monthly)	6, 194	17,417	17,506	40,149	26,867
Volume turnover (shares)	635,488	704,273	1,006,225	2,273,835	1,923,991
high (monthly)	95,345	102,299	191,648	327,614	572,805
Low (monthly)	16,863	19,948	33,611	68,019	23,549
Turnover rate (%)	25.1	29.9	26.1	36.5	46.8
Number of listed companies	181	189	205	216	221
Number of listed issues	284	290	302	307	300
Number of IPOs	12	21	16	13	6
Index general (composite)	3,196	2,786	2,594	3,171	1,869
Average p/e ratio	n/a	20.2	18.3	25.4	9.9
Book value multiple	n/a	0.28	0.29	0.34	0.96
Number of brokers	181	185	186	185	185

Source: Philippine Stock Exchange and 1997 International Finance Corporation Factbook.

1997 as a result of the Asian financial crisis. The composite index declined slightly, from 3,171 to 2,808, during the first half of 1997, and then fell sharply to 1,869 by the end of the year. If one takes 1997 instead of 1996 as the reference point for the same calculations, the compounded growth rates of the PSE's market capitalization, value and volume of shares traded are 4 percent a year, 34 percent a year, and 32 percent a year, respectively. Still, the increase in market liquidity is significant, as demonstrated by turnover ratios for the respective years (25 percent for 1993 versus 47 percent for 1997).

The growth in market activity can to a large extent be attributed to a series of policy, legislative, and institutional reforms covering all facets of the Philippine capital market that took place during 1993–97, and which are still going on. The USAID-financed Capital Market Development project contributed to this change process.

As of January 1998, the project had caused or been instrumental in causing the following reforms:

1. Merging the two stock exchanges into the Philippine Stock Exchange.

2. Putting into place an automated securities order-driven trading system.

3. Incorporating the **Philippine Central Depository, Inc.,** as a private company. The SEC authorized the organization of the PCDI in March 1995. It was incorporated in August 1995 and began operations in January 1997.

4. Undertaking an internal reengineering of the SEC. Rules and regulations were upgraded, staff members were trained, and information systems were computerized. In a major change, the SEC embraced a regulatory philosophy based on disclosure and enforcement rather than merit regulation.

5. Taking steps to organize the PSE and broker–dealers into self-regulatory organizations.

6. Establishing, within USAID's private-sector counterpart (the **Financial Executives Institute of the Philippines**) a private sector–led, full-time, professionally staffed institution for training, education, policy research, and advocacy. That institution, the **Capital Market Development Center, Inc.,** is nonprofit. It aims to professionalize the capital market and foster an environment of growth and development. The center provides short-term specialized courses on fixed-income securities, derivatives, portfolio management, real estate analysis, and equity analysis. In addition it has developed a certification program culminating in an examination that will become compulsory for all Philippine chartered financial analysts.

7. Preparing a series of legislative reforms. These include a law to rationalize the taxation of securities, the Revised Investment Company Act, the Securities Act of 1997, and H6545, which exempts from taxes gains realized by investors upon redemption of mutual fund shares.

Equity Issues

The Philippine stock market was in the doldrums during the Aquino government but began to revive in 1992. The improving equity valuations during the first years of the Ramos regime presented a potentially attractive source of capital to larger Philippine companies capable of undertaking a successful initial public offering.

During most of this period, the SEC was a bottleneck. It stood in the way of additional equity offerings and faster growth of the equity market. The country's association of investment underwriters, the **Investment House Association of the Philippines** has 55 members, so there was no lack of investment companies to underwrite a larger volume of new issues. Investment bankers have described the market as very receptive to initial public offerings. Participants and market observers believe that when the SEC was operating under the merit system, it intentionally sought to limit the number of offerings to about 15 a year to allow adequate time to negotiate IPO prices and allocations to broker–dealers. Some interviewees noted that despite the demise of the merit system, the number of IPOs has continued to be constrained by the broker–dealers, who prefer to use the earnings from one IPO to finance their purchase of the next IPO (see table 2). This process requires a slow sequence of such offerings.

During 1996–97, companies with revenues ranging from 400 million pesos to more than 6 billion pesos had successful IPOs, with the median size being 1.2 billion. Some 400 corporations were reported to have revenues exceeding 1 billion pesos, and another 350 companies had revenues between 500 million and 1 billion. At the end of 1997 the Philippine Stock

Table 2. Initial Public Offerings, The Philippines, 1992–97

Year	Number	Value (billions of pesos)
1992	12	8
1993	11	9
1994	21	37
1995	16	34
1996	13	27
1997	6	10

Exchange listed fully 221 companies. It would appear that there is no dearth of future IPO candidates that could use the equity market.

USAID EFFECTIVENESS IN CAPITAL MARKET DEVELOPMENT

The Agency's Capital Market Development project succeeded in strengthening the regulatory oversight of the stock market and in promoting creation of greater efficiency in the operation of the market. This was achieved with modest resources, mainly through technical assistance and training but also through the $1 million challenge grant to create a clearance and settlement facility. Strong host country commitment to project goals was instrumental in its success. Even so, USAID involvement speeded up the pace of change and pushed the process of reform in the proper direction. Moreover, the availability of USAID-financed experts probably helped the Philippine government avoid missteps in its efforts.

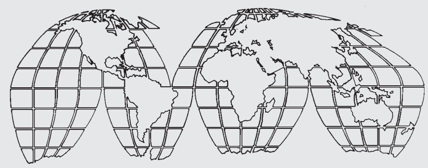
Since 1993, and especially since late 1995, the Securities and Exchange Commission has become appreciably stronger and more technically capable of supervising and regulating the market. Starting in 1996, the SEC began to encourage the Philippine Stock Exchange to become a self-regulatory organization. In early 1996, after the change in the SEC chairmanship, the commission dropped merit regulation, reorganized, adopted a disclosure system, and increased its enforcement capability with the introduction of new standards that proscribed insider trading, fraudulent statements to investors, and underwriter and broker–dealer abuses. The stock exchange increased the requirement for broker–dealer net capital positions and introduced other investor safeguards. In 1996 the stock exchange had introduced changes to increase transparency and reduce transaction costs. In early 1997 the Philippine Central Depository was introduced, and the stock exchange's trading system was converted from paper to a scripless computerized system. This reduced settlement and clearance time from as long as 45 days to 4 days. It also significantly increased the integrity of the trading and settlement process.

As we have seen, the incumbent SEC chairman had blocked modernization of the commission during the first 18 months of the capital markets project. Action by the mission director—he sent a plain-spoken letter to the secretary of finance pressing for a change at the top—brought results. After a few months, President Ramos removed the chairman from office, replacing her with someone committed to the reform program. All interviewees with whom the evaluation team discussed this issue stressed that replacement of the politically influential chairman would not have occurred without USAID's involvement.

The SEC's final report on the project in 1998 concluded that USAID's involvement helped upgrade standards and improve understanding of the commission's regulatory and developmental roles. The SEC chairman complained, though, that the project provided too little computer hardware, attributing this to the leadership of the Department of Finance rather than the commission in initial project design. The CDIE evaluation team's review did not identify any significant problems caused by inadequate computer hardware. It concluded that the project properly concentrated mainly on the SEC's general approach, organization, and systems.

USAID also catalyzed creation of the securities depository. The Philippine Central Depository is an important market institution, substantially reducing transactions costs in securities trading, and reducing the risk of failed transactions.

It is an essential prerequisite for attracting international institutional investors. The broker–dealers who own the Philippine Stock Exchange had been discussing creation of such an entity but had not been willing to make the necessary investment. The Agency provided the $1 million challenge grant to finance part ownership by the Financial Executives Institute of the Philippines of a central depository. In interviews, several institutional representatives volunteered that they were willing to invest in the depository only because of FINEX's $1 million stake, and that the challenge grant substantially speeded up the creation of the depository. Altogether, $9 million was raised from a variety of sources. The depository is now contributing to greater efficiency and liquidity in the equity market.



"The Philippine financial community appears unanimous in its opinion that USAID's project contributed significantly to a more professional, better focused, and more respected Securities and Exchange Commission."

The Philippine financial community appears unanimous in its opinion that USAID's project contributed significantly to a more professional, better focused, and more respected Securities and Exchange Commission. The Agency's role in the replacement of the SEC chairman was widely recognized and applauded as critical in this process. The project's role in promoting improvements in the stock exchange and in creating the central depository was also seen as important. These actions, along with a perception that a continuing process of further improvements is under way, have given the investment community more confidence in the equity market. That translates into more participants, which improves both valuations and liquidity.

As part of the SEC-related project, the disclosure requirements for registrations and listed companies were significantly increased. Equity issuers seem to be coping well, with only minor complaints. Professionals point out that since "full disclosure" is not part of the cultural heritage in this part of the world, the process of ensuring full compliance will be a gradual one. Interviews with the officers of several recently listed companies demonstrated that the disclosures required for an IPO and subsequent listing produced significant changes in corporate culture. These concerns strengthened accounting practices to conform with requirements for listed companies, clarified organizational structures, and established shareholder relations departments.

In summary, USAID was an important catalyst in mobilizing the Philippine financial community to do what was needed to enable a robust equity market and to create a favorable environment for attracting international investment.

CAPITAL MARKETS AND POVERTY

Most low-income people, in the Philippines or elsewhere, are poor because they do not have "good" jobs that use capital and technology in a highly productive way. When capital markets work well, they help overcome this basic cause of poverty by providing information that helps investment find successful, self-sustaining uses. The evidence presented above suggests strongly that USAID was effective in promoting greater efficiency in the Philippine capital market. The main effects of greater efficiency might be summarized as follows:

- More financial resources are being attracted to the Philippines.
- Domestic savers are shifting more of their savings into financial form.
- Philippine companies are financially stronger because they depend less on bank credit.
- Philippine companies have cheaper access to capital, so they can grow faster.

Capital markets contribute to poverty reduction primarily by increasing the amount and quality of investment in the economy. Because capital is more abundant, a greater variety of goods and services are available to consumers at lower cost. Consequently, capital markets cannot be expected to have a direct or immediate relationship to poverty in the Philippines in the short term. It is only the accumulated effect of larger and more efficient investment over a decade or two that produces major effects on income and poverty levels.

Although the Philippine reforms cannot be linked to any significant reduction in poverty so far, one may look at this question from the other way around: what are the consequences for poverty of underdeveloped capital markets and failure to set and enforce high standards for financial disclosure by publicly traded companies? The Asian financial crisis provides one answer to this question. Financial instability can have devastating consequences for poor people. Reports suggest that the number of poor people in Indonesia is likely to at least double as a result of that country's financial crisis, and massive increases in unemployment have occurred in Korea, Malaysia, and Thailand.

Some volatility is unavoidable as financial markets grow and develop. Nevertheless, the development approach of these countries entailed considerable risk, which would have been lower with a more prominent stock market. Financing for expansion of business came primarily through borrowing from banks, with equity finance playing a much smaller role. Most of the bank borrowing was short term. That presents no difficulty in normal times but can be catastrophic if financial panic leads many lenders to refuse to roll over loans at the same time. This happened in the Asian crisis countries, with the consequence that many companies, lacking the liquidity to repay loans when due, went bankrupt. Companies that avoided bankruptcy faced far higher financial costs as interest rates skyrocketed when the crisis deepened. Use of equity rather than debt financing would have insulated companies from the consequences of this kind of shock.

CONCLUSIONS AND LESSONS LEARNED

1. The Capital Market Development project was a clear success. It made a substantial contribution to the development of the Philippine capital market both through improvements in oversight by the SEC and through encouragement of a variety of actions to improve the operation of the equity market, including the creation of a central securities depository, which permitted scripless trading.

2. USAID was a catalyst for change. The Agency's contribution consisted of analyses, encouragement, and pressure to undertake steps to increase the transparency and efficiency of the capital market. USAID clearly sped up the rate at which improvements were made in these markets. In the most extreme case, USAID pressure was instrumental in clearing the way for new leadership for the SEC—an important step in developing the capital market.

3. The combination of public- and private-sector elements in the assistance package contributed to the success of the overall effort. If the project had limited itself to the public sector alone, it would almost certainly have been less successful; it might well have failed entirely.

4. Most economists oppose granting tax-free status to municipal bonds. Some, though, have argued that it provides a relatively low-cost means for transferring resources from national governments to municipalities. USAID / Washington should develop an Agency position on the desirability of using this tool.

5. The bond market continues to be underdeveloped, except for national government issues. Passage of the pending capital markets legislation should help somewhat, but the recent macroeconomic instability has postponed the day when interest rates will come down to where long-term corporate debt financing is likely to be an active part of the market. The USAID effort to promote development of a market for municipal bonds is (at best) premature.

6. A number of problems confront the Philippine capital market. The CDIE evaluation team believes that USAID assistance can continue to play an important catalytic role and have a high payoff, at least for several more years. Areas needing attention include

- Passage of the two pieces of pending legislation on capital markets
- Further strengthening of the SEC in its core capital market functions
- Continued efforts to increase protection for investors in publicly traded stocks, in areas where the stock exchange is unlikely to take necessary steps on its own
- Continued education of market participants, including encouraging the development of new products that can increase market liquidity

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