

1. *What are interest rates?*

Generally, interest rates are prices. They are the price paid for the use of money for a period of time and are expressed as a percentage of the total outstanding balance that is either fixed or variable. There are two ways by which interest rates can be defined: first, from the point of view of a borrower, it is the cost of borrowing money (borrowing rate); and second, from a lender's point of view, it is the fee charged for lending money (lending rate).

2. *How are interest rates classified?*

The interest rates charged on borrowed funds are generally classified according to the tenor or the maturity period: short-term (less than one year); medium-term (more than one year but less than five years); and long-term (more than five years).

Interest rates differ, depending on the type of instruments (e.g., traditional deposit instruments like savings deposit, time deposit, and some demand or current accounts, and investment instruments like bonds, securities) and on the tenor of investment.

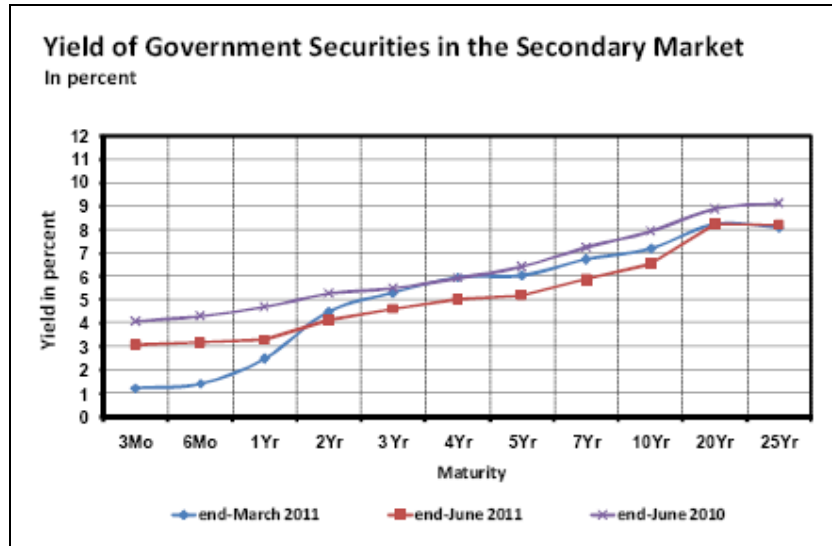
3. *What are real interest rates?*

Real interest rates are interest rates adjusted for the expected erosion of purchasing power resulting from inflation. Technically, it is defined as nominal interest rate minus the expected rate of inflation. As an example, if the nominal interest rate is 10 percent and inflation is 5 percent, then the real interest rate of return is 5 percent.

4. *What is the yield curve?*

The yield curve is what economists use to capture the overall movement of interest rates (which is also known as "yields" in Wall Street parlance). Plot the day's yield for various maturities of Treasury bills (T-bills) and bonds on a graph and you have the day's yield curve. As can be seen from the chart, the line begins on the left with the 3-month T-bills and ends on the right with the 25-year T-bonds. The yield curve as of end-June 2010 flattened slightly relative to its end-March 2010 level. This reflected the strong appetite for government securities following the release of a better-than-expected 7.3 percent GDP growth in the first quarter, the successful electorate exercise in May 2010, and the continued benign inflation outlook in June 2010.

Secondary market yields reflected market participants' expectations on the future path of policy rates as well as their sentiment on the fiscal developments in the country. Yields were markedly higher as of end-March 2011 relative to end-December 2010 except for the 10- to 25-year tenors. This was due to inflation concerns during the quarter following the statement by the BSP that it expects heightened inflation risks in the near future, coming from higher electricity rates as well as escalating food and oil prices.



5. How are interest rates determined?

Interest rates prior to its liberalization in 1981 were fixed by the Bangko Sentral ng Pilipinas (BSP). Today, the level of interest rates is determined by the interaction of the supply and demand for funds in the money market.

6. What influences the rise and fall in interest rates?

Essentially, the interest rate level is affected by the price level or inflation rate, fiscal policy stance, and intermediation cost.

- *Inflation rate.* The BSP's policy direction to achieve its mandate of maintaining price stability has a marked influence on the interest rate level. When there is too much liquidity in the system, there is more pressure for inflation to rise. To curb inflationary pressures arising from excess liquidity in the system, the BSP will have to increase its key policy rates, i.e., overnight borrowing rate or reverse repurchase rate (RRP) and overnight lending rate or repurchase rate (RP). By increasing its key policy rates, the BSP is sending a signal to the market that the general level of interest rates will be on an uptrend. In mirroring the movement of the BSP's policy rates, the benchmark 91-day T-bill rate also sets the direction for other rates, specifically, bank lending rates.
- *Fiscal policy stance.* The fiscal policy stance may also influence the direction of interest rates. A government that incurs a fiscal deficit needs to finance its existing budgetary requirements by borrowing from the domestic market or from abroad. The higher is the fiscal deficit, the stronger the demand to borrow to finance the

gap. This exerts upward pressure on domestic interest rates, particularly if the government borrows from a relatively less liquid domestic market.

- *Intermediation cost.* Financial institutions incur costs in extending their services. Interest rates will tend to be high when intermediation cost is high. Included in the intermediation costs are administrative costs and the BSP's reserve requirements.

Other factors that could influence the interest rates include the maturity period of the financial instrument and the perception of risks associated with the instrument. Those with longer-term maturity and with higher probability of incurring loss carry higher interest rates. The lack of intermediation could also affect interest rate movement. For instance, with their larger holdings of non-performing assets (NPAs), banks are more cautious in their lending activities. This would tend to induce an increase in interest rates.

7. *What is the BSP's policy on interest rates?*

Since 1983, the BSP has followed a market-oriented interest rate policy. That is, it allows the market to set its own rates. The Monetary Board only sets rates for the BSP's overnight borrowing and lending facility to influence the timing, cost and availability of money and credit, for the purpose of stabilizing the price level.

8. *Can the BSP set interest rate levels?*

Yes, by law, the BSP can effectively set interest rates. Under the Usury Law (Act No. 2655, as amended by P.D. 116), the Monetary Board can prescribe the maximum interest rates for loans made by banks, pawnshops, finance companies and similar credit institutions, and to change such rates whenever warranted by prevailing economic conditions. Moreover, the BSP charter (R.A. No. 7653) allows the Monetary Board to take appropriate remedial measures whenever abnormal movements in monetary aggregates, in credit or in prices endanger the stability of the Philippine economy. Nevertheless, since 1983, the BSP has followed a market-oriented interest rate policy.

9. *Does the BSP regulate the interest rate charged by banks, lending investors and pawnshops?*

No. In 1981, the then Central Bank of the Philippines deregulated all bank rates except short-term lending rates. In 1983, the deregulation of bank rates was completed with the removal of the remaining ceilings on short-term lending rates. However, for transparency purposes, the BSP requires that the interest rates applied must be duly indicated on the pawn ticket in case of pawnshops, the promissory note in the case of lending investors, and loan agreements in the case of bank loans.

10. *Can the BSP intervene so that banks will not charge very high lending rates?*

The BSP's past experience with rate-setting made apparent the limitations of an administratively fixed interest rate. For this reason, the BSP shifted to a market-oriented interest rate policy in 1983. The re-imposition of rate ceilings or limits on the spread between the T-bill rate and lending rate will only introduce distortions in the credit market, including: a) the pricing of credit outside of the fundamental issue of risk; b) the exclusion of certain segments of the economy from the market; c) the need to also regulate other banking products and services; and d) the increased burden on bank supervision.

After the Asian crisis, however, the Banker's Association of the Philippines (BAP) decided to implement a gentleman's agreement to maintain a cap on the spread of bank lending rate of up to a maximum of five (5) percent over the 91-day T-bill rate in the secondary market. A review of the spread between the average monthly bank lending rate charged by commercial banks (both high- and low-end) and the 91-day T-bill rate showed that banks are generally in compliance with the 500-basis point cap.

11. *What can the BSP do to promote more stable interest rates?*

The BSP does not directly influence interest rates as these are market-determined. However, the key policy rates — overnight borrowing/lending under the RRP and RP facilities, respectively — which are used as the monetary policy lever to achieve the inflation target, are watched closely by the market. The policy rates are used as reference rates in the determination of market rates, which usually move in the same direction as the policy rates.

Under the inflation targeting (IT) framework, the BSP adjusts its policy rates depending on the movement of various indicators, including the outlook for inflation. The discipline instilled by the IT framework in the determination of the BSP's policy stance has lent some stability to interest rate movements in the market.

12. *Why are interest rates not the same in all banks?*

The cost of doing business varies from bank to bank and this is reflected in the different lending rates charged by the banks.

13. *What interest rates are monitored by the BSP?*

Interest rates monitored by the BSP include:

- **RP Rate** - the interest rate on transactions in which one party (Party A) sells government security to another party (Party B), and simultaneously agrees to

buy back the security from Party B at a predetermined price on a specified future date. RPs may have overnight or term maturities.

- **RRP Rate** - the interest rate on an RP transaction that has an opposite effect on the parties involved. RRP are typically contracted between the BSP and the banks. It allows the BSP to siphon off liquidity from the banking system on a temporary basis (as compared to the long-term effect of a change in reserve requirements). RRP may also have overnight or term maturities.
- **Interbank Call Loan Rate** - the rate on loans among banks for periods not exceeding 24 hours primarily for the purpose of covering reserve deficiencies.
- **Treasury Bill Rate** - the rate on short-term debt instruments issued by the National Government for the purpose of generating funds needed to finance outstanding obligations. T-bills come in maturities of 91, 182 and 364 days. Auction is usually held on Mondays at the Bureau of the Treasury.
- **Phibor Rate (Philippine Interbank offered rate)** - represents the simple average of the interest rate offers submitted by participating banks on a daily basis, under the auspices of the BAP. The participants consist of 20 local and foreign banks, which post their bid and offer rates between 10:30 – 11:30 A.M. on an electronic monitor where lending rates in pesos are determined. The rates given by the banks are used as their dealing rates or the rates at which they will be able to borrow from or lend to the market during the day. Launched by the BAP on 1 February 1996, Phibor serves as an indicator of the banking system's level of liquidity.
- **Philippine Interbank Reference Rate (Phiref)** - is the implied Philippine peso interest rate derived from all done US dollar/Peso swap and forward transactions falling under a specified tenor.
- **Time Deposit Rate** - the weighted average interest rate charged on interest-bearing deposits with fixed-maturity dates and evidenced by certificates issued by banks.
- **Savings Deposit Rate** - the rate charged on all interest-bearing deposits of banks, which can be withdrawn anytime. It is derived as the ratio of interest expense on peso deposits of sample banks to the total outstanding level of these deposits.
- **Bank Average Lending Rate** - the weighted average interest rate charged by commercial banks on loans granted during a given period of time. Monthly

data are computed as the ratio of actual interest income of sample banks on their peso-denominated loans to the total outstanding level of these loans.

- **Lending Rate** - refers to the range (high and low) of lending rates reported by commercial banks on a daily basis. The low end refers to the prime lending rate.

(Data on interest rates are available at the BSP website through this link: www.bsp.gov.ph/statistics.online.asp)

14. *Why is there a gap between the banks' savings deposit rate and lending rate?*

The gap reflects the interest rates charged on loans, covering not only the cost of funds (marginal cost), but also intermediation and other overhead costs, as well as the spread or profit margin. The spread represents the risk premium assigned to a particular loan exposure — the higher the risk, the higher the spread. It should also be noted that the data on lending rates reflect the average interest rate level and hence, provide only a broad indication of loan tenors and risk exposures.

In the second quarter of 2011, the interest rates on savings and long-term time deposits averaged 1.6 percent and 2.2 percent, respectively. Bank lending rates, on the other hand, averaged 6.5 percent during the same period. This translated to a gap of about 4.3-4.9 percent between the deposit and bank lending rates.

15. *What implications do interest rate levels have on the economy?*

A low-interest rate environment, which reflects competitive conditions as well as the actual cost of funds, should impact positively on a bank's financial performance. Low interest rates encourage borrowing to finance economic activity. This speeds up economic growth, improving the borrowers' ability to repay loans, which, in turn, should affect favorably the bank's earnings. Thus, banks gain from low interest rates in two ways: the increased demand for bank loans, and the reduction in non-performing loans. The stock market similarly prospers due to prospects of high corporate profits.

The experience of many countries shows that high interest rates tend to reduce borrowing for investment activity, ultimately leading to slower economic growth. Slower economic growth, in turn, reduces corporate profits and, hence, the ability to repay loans, which impacts negatively on banks' balance sheets. High interest rates also tend to encourage investors to pull out their funds from the stock market and invest them instead in fixed-income securities.

16. *How would you describe interest rate developments since the mid-1990s?*

T-bill rates have generally been declining since mid-1998. The decline in yields continued until it reached its lowest in 2002, when rates began to inch up anew until 2004. T-bill rates eased in 2005 and 2006, reflecting decelerating inflation, improving fiscal performance, and ample liquidity in the financial system. The bellwether 91-day T-bill rate averaged 5.4 percent in 2006, lower than the 6.4 percent average in the previous year. Longer tenors of the 182-day and 364-day also settled lower at 6.1 percent and 7.0 percent, respectively, from 7.7 percent and 8.7 percent in 2005. In addition, average lending rates mirrored the movement in the yields of government securities. This decline in interest rates was accompanied by a flattening of the yield curve, which suggests an easing in monetary conditions and relatively well-contained inflation expectations.

The downtrend in T-bill rates continued until April 2007. However, beginning May, T-bill rates began to rise on account of the uncertainty brought about by the local elections. Rates continued to increase gradually until September due to worries over the impact of the US subprime mortgage market troubles on local markets, despite continued benign inflation. In December, average domestic interest rates eased to 3.7 percent, 4.6 percent and 5.5 percent for the 91-day, 182-day and 364-day instruments, respectively, following the Government's announcement of a record-budget surplus in November. These rates remain low compared to year-ago levels but are higher relative to the rates posted at the start of 2007.

In 2008, T-bill rates trekked a general uptrend to average 6.36 across all maturities, and in particular, 5.39 percent, 6.19 percent and 6.49 percent for the 91-day, 182-day and 364-day, respectively. The rise in the yields could be traced to higher inflation due mainly to rising commodity prices and later in the year, due to the higher risk premium demanded by the market players in reaction to the global financial turmoil.

In 2009, short-term interest rates trended generally downwards to average 4.19 percent for the benchmark 91-day T-bill, 4.39 percent for the 182-day tenor, and 4.58 percent for the 364-day instrument following the six cuts in the BSP's key policy rates since December 2008.

For 2010, average domestic interest rates eased further to 3.73 percent, 3.97 percent, and 4.26 percent for the 91-day, 182-day, and 364-day instruments, respectively.

In March 2011, average domestic interest rates significantly declined to 1.08 percent, 1.78 percent, and 2.08 percent for the 91-day, 182-day and 364-day instruments, respectively. T-bill rates declined relative to year-ago levels on the back of ample liquidity in the market and a benign inflation outlook, leading to unchanged BSP policy rates since July 2009.

For the periods April to June 2011, average domestic interest rates increased to 1.49 percent, 2.05 percent and 2.76 percent.