

## Strengthening the Investment Climate

*Strengthening the investment environment to more fully achieve the nation's potential for a higher growth pattern is a vital part of achieving a better development outcome. Survey findings and experience from other countries indicate that this calls for bold actions to strengthen public finances to reduce perceived country risk, complementing the existing Special Purpose Asset Vehicle Law with effective corporate recovery and securitization provisions. This should allow for corporate and financial sector restructuring, reduced operating and dispute resolution costs, and improvements in infrastructure. Investors need fiscal incentives less than a secure and stable environment that is both predictable and has well-implemented regulations and competitive operating costs.*

### Background

Despite sharing many characteristics with its neighbors—outward orientation with a strong export sector, liberal domestic and foreign investment regimes, and good entrepreneurial and technical talents—the Philippines is not currently well positioned to take advantage of robust global and regional growth. The reform and liberalization measures implemented in the early and mid-1990s established the basis for a competitive economy. But since then, the country has not been effective, or consistent, in leveraging these reforms to attain high growth rates, reduce unemployment, and rapidly improve standards of living.

***Against a background of increasing global competition, countries need to improve quickly to remain competitive.*** Philippine companies operate in a highly competitive and dynamic region where investors are not short of choices. At one end of the scale, a country such as Vietnam is an attractive location for low-cost, labor-intensive manufacturing and export operations. At the other end are Malaysia and Thailand, which are far ahead of the Philippines in their existing stock of domestic and foreign industrial investments. They also have better infrastructure, enjoy lower country risks, and—because of better fiscal balances—can afford to invest more aggressively in infrastructure. Then there are the low-cost, rapidly growing continental economies of China and India, attractive to investors

because of the size of their domestic markets and because they offer low-cost global sourcing platforms for skills-based manufacturing and services.

***The nation's private sector growth engine is not keeping pace with its neighbors because the investment climate is perceived as having deteriorated, at least relative to other countries.*** Episodes of political turbulence have played a role in the suboptimal performance of the private sector. More fundamentally though, concerns about security, a fragile fiscal and debt position, a start-stop process of reform, weak performing infrastructure, and low-quality and inconsistent administration have discouraged domestic and foreign investors and entrepreneurs, at the same time as shortening investment horizons.

To compete in the more competitive global and regional environment, the Philippines needs to reverse the decline in its (i) volume and productivity of investment, and (ii) competitiveness

***More fully achieving the nation's potential for rapid development will depend in part on restoring credibility, consistency, and constancy in economic policies and in the application of regulations.*** A well-defined and publicly announced commitment and program to reforming public finance and public administration, and rapid implementation of the already announced judicial reform program could quickly reverse many negative perceptions about the

investment climate. Thereafter, measures to increase public and private investments in both hard and soft infrastructure, accompanied by continuing efforts to increase competitive forces in the economy, would establish an investment climate that, through higher investments and productivity, would generate employment and higher standards of living.

### Key Issues

*The Philippines is perceived as less competitive (table 1).*

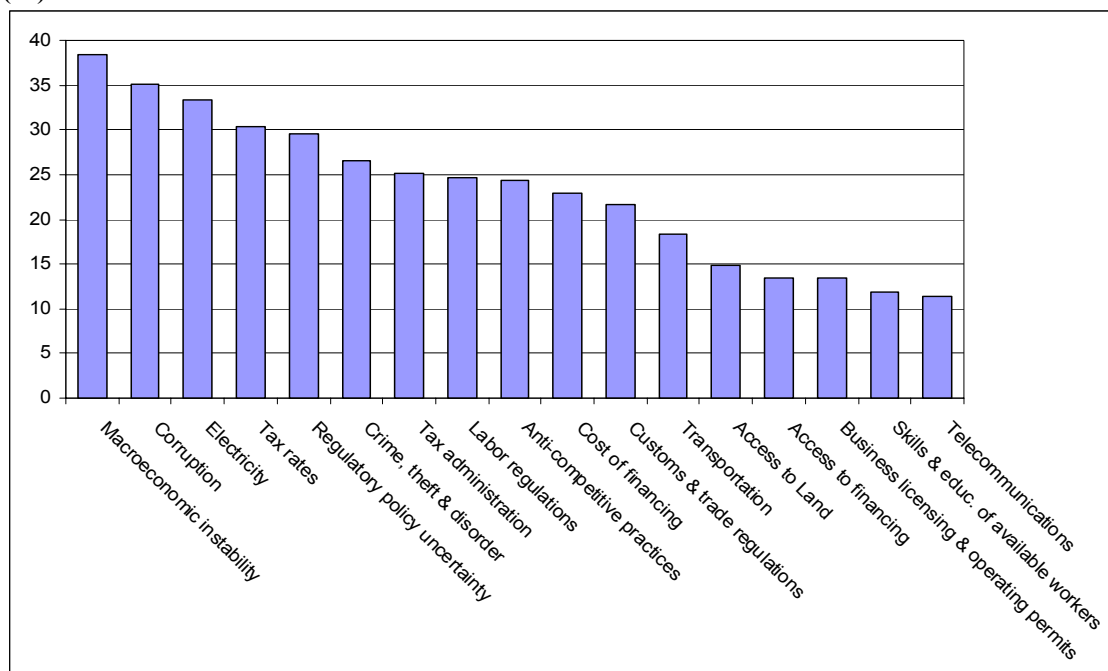
**Table 1. Declining relative competitiveness**

|             | 2000 | 2001 | 2002 | 2003 | 2004 |
|-------------|------|------|------|------|------|
| Singapore   | 2    | 3    | 8    | 4    | 2    |
| Korea       | 29   | 29   | 29   | 37   | 35   |
| Malaysia    | 26   | 28   | 24   | 21   | 16   |
| Thailand    | 31   | 34   | 31   | 30   | 29   |
| India       | 41   | 42   | 41   | 50   | 34   |
| China       | 24   | 26   | 28   | 29   | 24   |
| Philippines | 35   | 39   | 40   | 49   | 52   |
| Indonesia   | 43   | 46   | 47   | 57   | 58   |

*Source:* Int'l Institute for Management Development (IMD), World Competitiveness Yearbook 2004.

A recently completed Investment Climate Assessment survey of more than 600 firms in the Philippines provides an indication of the key concerns of investors that contribute to this lack of competitiveness (figure 1). Survey respondents most frequently rated macroeconomic instability as a “major” or “very severe” constraint. Other “major” or “very severe” constraints included corruption, regulatory policy uncertainty, crime, theft and disorder, tax rates and tax administration, and infrastructure (electricity and transport).

**Figure 1. Firms Evaluating Constraint as “major” or “very severe” (%)**



*Source:* Investment Climate Survey, ADB & World Bank, preliminary data, 2004.

*The Philippines is perceived as a riskier country than its neighbors.* (table 2) A perception of high political and economic risk has reduced the attractiveness of the country as an investment location. It does not appear among the top 20 destinations for the top 1,000 global firms, according to a survey by A.T. Kearney in 2003—though Malaysia, Thailand, China, and India do. This finding is also echoed in a recent survey of US companies conducted by the American Chamber of Commerce—prospects in East Asia are considered very bullish, with the exception of Indonesia and Philippines. US companies do not want to increase their exposure in Philippines.

**Table 2. Higher country risk than in most neighbors**

|             | <b>EIU Country Risk Scores<sup>(1)</sup></b> |
|-------------|--|
| China       | 41   |
| Malaysia    | 30   |
| Thailand    | 39   |
| Vietnam     | 50   |
| Indonesia   | 61   |
| Philippines | 51   |

<sup>(1)</sup> The lower the score the lower the country risk.  
*Source:* The Economist Intelligence Unit.

*The volume of fixed investment has been low and has not been compensated by high productivity performance.* For more than a decade, gross fixed capital formation has been low in comparison to most regional competitors. For example, Malaysia and Thailand have recovered from the Asian financial crisis and are once again investing rapidly. Neither do future investment prospects appear very promising for the Philippines. Surveys of investment intentions conducted by the Bangko Sentral ng Pilipinas and the Makati Business Club suggest a very cautious investment stance in the Philippine corporate sector. FDI data from the United Nations Centre on Transnational Corporations suggests that FDI has also contributed less toward gross fixed capital formation than in Malaysia, China, and Thailand. The problem of low investment has been compounded by poor productivity performance. Cross-country studies by the Asian Productivity

Organization indicate that growth of total factor productivity (TFP) in the Philippines is lower than in Malaysia and Thailand. Various estimates of TFP in the Philippines suggest a negative TFP growth, or at best a marginally positive growth rate.

*The poor quality of infrastructure has discouraged investment and muted productivity performance.* Public investment in infrastructure has been declining and at less than 3 percent of GNP is one of the lowest in the region. The country ranks low for most infrastructure indicators. The World Economic Forum ranked it 68 out of 75 countries in the overall quality and sufficiency of infrastructure. With respect to its Asian neighbors, the country's rank in terms of service delivery is 8 out of 11 in the quality of electric supply, 6 out of 12 in telephone subscribers per 100 people, and 6 out of 12 in total road network. Problems arising from exercise of monopoly power also contribute to the high cost of interisland shipping.

*High costs of borrowing and limited access to finance deter domestic entrepreneurs and investments.* Real domestic interest rates are one of the highest in the region and high government borrowings crowd out private credit demand. Also, the banking system, struggling to cope with a high level of nonperforming loans, is charging high interest rates. These issues are exacerbated by uncertainty and imperfection in the secured lending regime, which leads to high-risk premiums. Access to external private finance is limited by country risk factors. High spreads on sovereign bonds—the highest in the region—make external borrowing difficult for all but a handful of private firms. Domestic capital markets and nonbank financial institutions are underdeveloped and concerns about corporate governance and sanctity of contracts inhibit risk capital and joint ventures. An important consequence is the “missing middle”—the dynamic medium-sized firms that are most often important engines of growth and competition.

Investor confidence has also been damaged by recent high profile contractual disputes and policy reversals in the infrastructure sector. Not only has this affected private investment in infrastructure but it has also cast doubts in general about the security and profitability of investments. The perception that laws and regulations are not consistently applied is taking deeper root.

### **Suggestions for Improving the Investment Climate**

*Bold and dramatic policy reforms in a few key areas could materially and quickly alter investor sentiment.* Having been often disappointed in the past, investors will now want stronger evidence of commitment to reforms and willingness of the Government to take on vested interests. They will adopt a “wait and watch” attitude and will start making long-term investments only when they are convinced that the Government is seriously translating policy pronouncements and reform programs into concrete actions. The country cannot afford to move at a leisurely pace. Implementation of a few bold measures to address the issues discussed above are needed to prevent the domestic business environment from falling further behind that of regional competitors.

*An irreversible public commitment by the Government to implementing a well-conceived and preannounced short- and medium-term public finance reform program would be the most effective signal to investors and financiers.* Public finances are under stress and the debt situation is making financiers nervous. This translates into uncertainty, a higher cost of capital, and unwillingness on the part of entrepreneurs and financiers to undertake and finance new investments. The poor state of public finance has also made it difficult for the Government to step up public investments in both hard and soft infrastructure. This deficiency in turn adds to the private cost of investment. (The causes of, and remedies for, this situation are discussed in the briefing dealing with the sustainability of

public finance, rebuilding public revenues, strengthening public expenditure management and the power sector. A quick adoption and implementation of the recommendations made in those briefs would have a powerful and positive impact on the investment climate.

*Improve the credibility of policies by vigorously pursuing restructuring of the banking and corporate sector.* The Special Purpose Asset Vehicles (SPAV) Act was passed more than a year ago—but it has had no impact. In part this is because of the constraints imposed on regulators to act decisively and swiftly; in part this is because the SPV Act was not accompanied either by other measures or legislation to enable a quick and orderly process of reorganization or financing via securitization of distressed assets. Immunizing bank and Securities and Exchange Commission regulators from political and legal harassment in the course of their duties and quick enactment of the Corporate Recovery Bill and the Securitization Bill is necessary. The solutions **to many of the corporate restructuring and financial sector problems** are well known. The issue is credible and quick implementation. This would signal to markets, in an unequivocal manner, the Government’s determination to support the most productive use of scarce resources in the economy and its willingness to tackle entrenched vested interests. The level playing field The resultant more equal opportunities so created would encourage new entrepreneurship, trigger new investment financing, and establish an environment where winners are decided mainly on the basis of efficiency and competency.

*Lower costs of business, and improve the judicial enforcement and dispute resolution processes.* Systematic efforts to lower the costs of business could be an effective differentiating strategy for the Philippines (table 3). The cost of dispute resolution in the country is one of the highest in the world and decisions are unpredictable. In uncertain

and legally costly environments, firms prefer contracting and partnership arrangements that restrict exposure and lower the cost of exit. A consequence of this is lower levels of technology transfer, lower supply of capital, and slower integration into production networks. This problem also affects the flow of foreign capital and expertise in

restructuring situations. Foreign investors are unlikely to invest in troubled companies if an incomplete legal framework, uncertainty, and delays in judicial enforcement cast doubts about the sanctity of contracts or the ability to restructure operations via mergers, acquisitions, and securitization.

**Table 3. The relatively high cost of doing business in the Philippines**

|             | <b>Business<br/>Registration (Days)</b> | <b>Contract<br/>Enforcement (Days)</b> | <b>Insolvency<br/>(Years)</b> | <b>Labor Restructuring<br/>Flexibility Index <sup>(1)</sup></b> |
|-------------|---|--|-------------------------------|---|
| Philippines | 59                                      | 164                                    | 5.7                           | 39  |
| Indonesia   | 168                                     | 225                                    | 6.0                           | 43  |
| Malaysia    | 31                                      | 270                                    | 2.2                           | 15  |
| China       | 46                                      | 180                                    | 2.6                           | 57  |
| Thailand    | 42                                      | 575                                    | 2.6                           | 30  |
| Singapore   | 8                                       | 50                                     | 0.7                           | 1   |
| Hong Kong   | 11                                      | 180                                    | 1.0                           | 1   |
| India       | 88                                      | 225                                    | 11.3                          | 45  |

<sup>(1)</sup> Lower value indicates higher flexibility.

Source: World Bank, Doing Business Database.

*Increase investments in the physical infrastructure by revamping and rethinking Private Participation in Infrastructure (PPI), financing frameworks, and the regulatory environment.* Public investment and maintenance expenditures have also been squeezed. The decline is even more severe at the LGU and municipality level. Service delivery has not improved and LGUs have not made the complementary and connecting investments necessary to leverage national infrastructure investments. In contrast, in China, capital expenditures by local governments, at 8–10% of provincial GNP, effectively leverage national investments and play a powerful role in attracting private domestic and foreign investment.

Improving infrastructure within a constrained fiscal situation will be a challenge. The Government cannot afford infrastructure investments and the private sector will not pay for it (for reasons cited above). (The policy briefs on various infrastructure subsectors identify concrete actions to step up both private and public infrastructure investment.) In terms of the

investment climate, the thrust of reforms should be to: (i) restructure municipal and development finance institutions to become efficient vehicles for mobilizing and pooling both public and private financing; (ii) introduce competition and transparency in design and award of concession contracts and use of government guarantees; (iii) quickly and transparently settle high profile contractual disputes in the infrastructure sector; (iv) develop a strategy to deal with legacy PPI contracts that have become highly politicized; (v) immunize further the regulators from unnecessary political and legal interference; and (vi) systematically develop a domestic bond and securitization market.

*Regulatory agencies need to work with the corporate sector in improving corporate governance* (table 4). Empirical evidence is fairly robust that investors are willing to pay a premium for good corporate governance, credible standard setting, and enforcement of rules and regulations governing corporate behavior and fiduciary responsibility. Not only do such measures lower the cost of capital, but they also minimize fickle

behavior on the part of investors. Most fundamentally, such measures reinforce promotional and public relations efforts at attracting investment. The Philippines has a relatively poor investment environment. The

reforms required have broad support and have also been debated and well identified within society. A quick implementation has few risks, low costs, but a high payoff.

**Table 4. Improved Corporate Governance Could Have Significant Pay-Offs**

|                    | <b>Rules &amp; Regulations</b> | <b>Enforcement</b> | <b>Political/Regulatory</b> | <b>Adoption of IGAAP</b> | <b>Institutional Mechanisms</b> | <b>Country Score<sup>(1)</sup></b> |
|--------------------|--------------------------------|--------------------|-----------------------------|--------------------------|---------------------------------|------------------------------------|
| Singapore          | 8.5                            | 7.5                | 6.0                         | 9.0                      | 8.0                             | 7.7                                |
| Hong Kong          | 8.0                            | 6.5                | 6.5                         | 9.0                      | 7.0                             | 7.3                                |
| India              | 8.0                            | 6.0                | 6.0                         | 7.5                      | 6.5                             | 6.6                                |
| Taiwan             | 7.0                            | 5.0                | 5.0                         | 7.0                      | 6.0                             | 5.8                                |
| Korea              | 7.0                            | 3.5                | 5.0                         | 7.0                      | 6.5                             | 5.5                                |
| Malaysia           | 7.9                            | 3.5                | 4.0                         | 6.0                      | 6.5                             | 5.5                                |
| Thailand           | 7.5                            | 3.0                | 4.0                         | 5.0                      | 4.5                             | 4.6                                |
| China              | 5.0                            | 4.0                | 5.0                         | 6.0                      | 3.0                             | 4.3                                |
| <b>Philippines</b> | <b>6.5</b>                     | <b>2.0</b>         | <b>2.0</b>                  | <b>5.6</b>               | <b>4.0</b>                      | <b>3.7</b>                         |
| Indonesia          | 4.5                            | 1.5                | 4.0                         | 5.0                      | 2.5                             | 3.2                                |

**IGAAP – International Generally Accepted Accounting Principles**

<sup>(1)</sup> A higher score implies a better corporate governance environment.

*Source:* Credit Lyonnais Securities Asia (CLSA)

Clearly, this cannot all be done immediately. But to achieve the sustained rapid poverty reducing growth aspired to, it is vital that (i) bold, upfront action be taken and followed up and (ii) reforms are followed through to keep the momentum going and to maintain a virtuous cycle of more rapid growth and poverty reduction. The

overwhelming importance of strengthening public sector finances to help rebuild confidence, and increasing investment suggest beginning with public finance reforms and then expanding the national reform effort into other aspects of the investment environment.