

PHILIPPINES DEVELOPMENT FORUM
REMARKS OF MR. JAIME AUGUSTO ZOBEL DE AYALA
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Secretary Teves, Secretary Favila, World Bank Country Chair Mr. Bert Hofman, distinguished cabinet secretaries, heads of delegates and development partners, ladies and gentlemen, good morning. Thank you for the kind invitation and the privilege to speak before you today. I am delighted to be here to share some thoughts, from a private sector's perspective, that may be worth considering in the process of setting the country's long-term development agenda.

The government has made great strides in recent years, almost unprecedented in fact, in setting the country's fiscal position in order. It has mustered the political will to successfully institute basic reforms that will create the needed fiscal capacity for the country to pursue its development plans and targets. The Vice President, Secretaries Teves and Favila outlined these in their remarks earlier and it is encouraging to hear that we remain on course in our efforts to provide greater fiscal flexibility for crucial economic and social development programs.

However, following my own responsibilities in the private sector, it might do us no harm to continue a dialogue that raises the bar for all of us, whether we are from the private or public sector. It is usually best not to become complacent during periods of success and instead use positive momentum to continue pressing for a progressive agenda. In my own business responsibilities, I worry most when things are going well.

I intend to use this invitation to reflect on three key issues.

First, is the fundamental issue of governance and strengthening the value of trust in our private and public institutions. I would argue that good governance lays the foundation for economic development, just as it lays the foundation for growth and value creation of any private enterprise. Having the best development plans, the best infrastructure, even the best labor pool will come to little if we cannot establish a business environment and investor climate that guarantees property rights, sanctity of contracts, the rule of law, transparency, and consistency in our policy and regulations.

Second, is the need to develop a forward looking economic blueprint as a basis not only for setting a long-term growth strategy (and defining a role for the country within a knowledge-based global economy), but more importantly, as a basis for resource allocation; given the finite amount of capital we have available as a nation at this stage of our development. Public sector investment plays a critical role in this regard by raising the quality of skills and labor through focused investments in the basic educational system, and by lowering the cost of doing business through similarly focused investments in critical physical infrastructure projects. The imperative word is "focus". This way, wherever the private sector chooses to invest, returns on capital will be competitive with those that can be obtained elsewhere in the region.

Lastly, is our need to strengthen and develop industries where we have distinct competitive advantages and build the infrastructure to support these to ensure that the country maintains a relevant and competitive place within the global economy. This

requires constant work and will always evolve as the needs of the market dictate over time.

Allow me to briefly elaborate on these issues.

Governance as foundation for economic development

First, is the issue of governance. From a personal, private sector standpoint, I have come to realize that businesses are now increasingly regarded as having an implicit social contract with society. Now, more than ever, the private sector needs to take into account the social impact of its business activities and more importantly, the manner by which they conduct their business affairs. This is the only way to nurture and build trust among all stakeholders—customers, business partners, regulators, financial investors, shareholders and other varied communities. This is important in the value creation process and the growth of any enterprise. I also feel that this new paradigm is relevant to the broader economy and the government's own role as a catalyst in setting a competitive and progressive agenda for a nation.

In a recent issue of *The Economist* (“*Order in the Jungle--Economics and the Rule of Law*”, March 15-21, 2008), it noted that “governance and the rule of law have become the motherhood and apple pie of development economics.” It continues to say that “the rule of law is held to be not only good in itself, because it embodies and encourages a just society, but also because of other good things, notably growth.” Daniel Kaufmann, an old friend from my university days and the head of the World Bank Institute's Global Governance group worked out the “300% dividend”, asserting that “in the long run, a country's income per head rises roughly 300% if it improves its governance by one standard deviation.” I subscribe to Mr. Kaufmann's argument that “rule-of-law improvements tend to help growth; that few countries have sustained gains in growth without improving their rule of law; and that places that have growth without such improvement have subsequently lurched backwards (i.e. Argentina).” In other words, the better the rule of law, the richer the nation becomes.

In the latest Global Competitiveness Report released by the World Economic Forum; corruption, policy instability and inefficient institutions have been cited as the most problematic factors in doing business in the Philippines. We live in a competitive, globalized and integrated world where investments flow and seek the most fertile location. Capital has become mobile to an unprecedented degree. Under an environment where the private sector is expected to play a major role in driving investments, it is government's role to be a progressive catalyst and to ensure that it establishes the right governance framework, encourages and practices transparency in all its dealings and follows a strict adherence to rules and regulations. It should also allow a stable regulatory framework to exist that is not susceptible to manipulation by vested interests or inappropriate political pressures, and that it abides and enforces the rule of law equally. Even as we have moved forward, as pointed out by Sec. Favila, more can be done.

Understandably, any investor, foreign or domestic, only seeks to minimize and understand the risks they are undertaking and will invariably define and evaluate first and foremost, the rule of law, the level of transparency in rules and regulations, and finally be motivated by a vibrant local private sector.

Investments gravitate towards countries with a thriving private sector that signal the availability of opportunities. A thriving local private sector, in turn, is a result of a combination of opportunities, an appropriate business environment, and confidence in the existing and future economy.

These basic ingredients are common in any successful development experience, irrespective of whether they are driven by centrally-planned societies like Singapore, or more “laissez-faire” economies like Hong Kong’s. The development model is less important than the adherence to a strict code of governance standards. In the same way, these ingredients are notably absent in less successful emerging environments. I would argue that this is what we all must work on assiduously —rebuilding trust in the institutions that were established to foster an investor-friendly climate. This is particularly important at a time when the competitive nature of global markets requires countries to compete for investment and capital in much the same way as companies and enterprises do across industries. In the same breath, I must add that the same responsibility lies with all of us in the private sector. We also need to foster the same standards in the way we lead and build our businesses.

Economic blueprint and resource allocation

Let me move on to my next point. Assuming that the right governance framework is in place, it would be helpful to chart the country’s growth strategy and aspirations under a defined economic blueprint that not only defines the country’s role within the global economy but also forms a basis for the resource allocation of scarce government capital. We just do not have the luxury to spread out resources without clear justification.

I specifically look to a country like Ireland as an example of how a well-crafted and well-thought out long-term economic blueprint helped transform a country from a previous position of being among the poorest in Western Europe to one of the fastest growing nations in the region today.

The Irish government pursued a variety of policies that created first and foremost an economic climate attractive to both foreign and domestic companies. This was the cornerstone of their National Development Plan that included developing indigenous industries and creating favorable fiscal policies. They formed enterprise agencies to encourage and promote inward investment. One tasked to accelerate development of Irish companies, another to secure new and support existing foreign investment, and another focused on promoting research and development in science and technology (i.e. ICT and biotech). Their plan embodied a roadmap for improving social and economic infrastructure, promoting social inclusion, while sustaining economic and employment growth. This was supported by education reforms that created a highly skilled workforce that matched Ireland’s economic needs and this eventually reversed the emigration of their skilled labor. They achieved this while cutting their tax rate to half the level of their surrounding countries.

A direct result of the execution of this blueprint was an appreciable growth in inward foreign direct investment which grew nearly 20 times within a decade (you can see the jump in the graph after 1995) and average annual GDP grew by 10.2% from 1994-2004, better than most of the EU countries. The unemployment rate also fell dramatically with

the development of a number of their industries like organic chemicals, pharmaceuticals, manufacturing of ICT goods and business process outsourcing services.

To my mind, the Philippines can benefit from a similar blueprint or strategy to set the direction for a more sustainable economic growth path. Sustainability is absolutely key to creating longevity and acceleration of growth as seen in the graph. More importantly, it gives a clearer basis for prioritizing public sector investments in areas that will improve labor productivity through investments in basic education; and ultimately lower the cost of doing business, through investments in critical infrastructure projects that will give the best impact for the limited resources available.

This brings me to my next point about the need to have a more focused approach to infrastructure spending.

Focused infrastructure spending

To a great extent, the government's current Medium-Term Philippine Development Plan (MTPDP) is a good start as it outlines a strategic framework for policy and reforms to address the country's growth agenda up to 2010. And this has had some visible impact, as GDP grew and reached its highest level in the past 25 years. This growth however has been driven largely by overseas remittances. While this has been positive for the economy as it advanced domestic consumption, retail and wholesale trade, and real estate on one hand; manufacturing and investments, which are critical in generating the kind of growth momentum needed to keep pace with our Asian counterparts, remains anemic in relative terms to our neighbors.

The Asian Development Bank pointed this out in its recent report. The contributions of investment to GDP growth have stayed below one third that of private consumption. The recent pace of growth may not be sustainable unless the declining trend in investment is reversed.

I refer to the chart I showed earlier pointing out that next to corruption, the country's inadequate supply of infrastructure has been identified as the second most problematic factor.

Clearly there needs to be a concerted effort to invest in critical physical infrastructure and basic education to improve productivity, lower the cost of doing business, and enhance the opportunity for investment. Some of the infrastructure projects urgently required in the country are those that lower the cost of doing business and raise our level of competitiveness in relation to others.

While we are gradually building momentum, there needs to be more focus and concentration of government and private sector infrastructure spending and investment in more strategic projects that will "catalyze" aggregate investment. Professors from the UP School of Economics (Medalla, Fabella, De Dios) assert that it would perhaps be far more effective to concentrate infrastructure efforts in the country's core growth areas. I tend to support their thinking. They argue that resources should be focused on the national capital region; the central-southern Luzon growth corridor; the metropolitan Cebu area; and the metropolitan Davao area. These areas account for a large and growing share of national output, with the national capital region and the Calabarzon area alone

producing almost half (48.4%) of the country's GDP. Any incremental infrastructure investment to relieve the binding constraints to production in these areas is bound to yield higher gains in terms of productivity than the same amounts invested in peripheral areas. As a sustainable model and new capital develop, these can be deployed elsewhere in subsequent stages.

Discipline in resource allocation is imperative at this stage. Large as these challenges might be, I believe a multi-sectoral approach within a specific and relevant economic blueprint, coupled with a sharper definition of where and how the private and public sector can work together to advance investments in these critical areas, can prove effective in achieving scale and impact.

Our own experience as a business group in Manila Water and Globe Telecom has proven this possible. Under both instances, we have seen how private-public sector partnerships can work well in augmenting the country's infrastructure needs given the right regulatory framework and a clearly defined role of private investment that promotes a win-win situation for proponents and stakeholders. For example, in the case of Manila Water, which was part of a government privatization effort, customer service and access to water improved significantly, especially in low income communities and capital re-investment increased dramatically. At the same time, Manila Water continued to increase in value for shareholders even while it generated additional revenues for the government. It has been a win-win formula for all parties.

With the liberalization of the telecom industry we have seen similar results. A majority (61%) of the population now have access to telecommunications services from less than 1% prior to the liberalization of the sector. Globe in particular has increased customer coverage with over 20 million subscribers today and has delivered consistent growth and value to shareholders over time while fulfilling a vital infrastructure need. The telecom sector has also become one of the biggest contributors to national growth at multiple levels.

These examples, we believe, can be replicated and serve as a blueprint for private sector participation in other critical sectors.

Beyond this, we cannot hope to build a sustainable economic development model in this knowledge-based global economy without a defined commitment to education. Investment in education is of equally pressing importance, as the human resource it generates is utilized by both the domestic and global economy. Sadly though, our students in the public education system continue to lag in test scores as reflected in low retention, comprehension, and achievement scores.

This is also a result of years of under-spending with the education budget short of the international benchmark of 6% of GDP, lower than Malaysia's 7.4%, and Thailand's 4%. Much of the budget (85%) is allocated to teachers' salaries which leave very little to capital outlays for classrooms, school buildings, books, training, and instructional materials and facilities.

While there has been some prioritization of funding to increase spending in these areas, we must be prudent and deliberate in allocating this to give us the best use, impact, and scale.

The objective is to strengthen the basic elementary and secondary level education that our students receive to prepare them for higher level learning and ensure that they can cope with and meet the demands of the global market.

Developing industries with competitive advantages

Investments in basic education are critical at all levels but can be particularly relevant in building our capabilities in niche industries. There are many industries that could be discussed but let me focus on the process outsourcing sector because it is a fine example of a cooperative private sector initiative, coupled with a through , forward looking road map for the industry with a strong dose of government coordination .

Estimates put the global addressable market for off-shoring and outsourcing services at over 1 trillion dollars, of which only around US\$45 billion is actually penetrated. The Philippines has about a 5% share but industry analyses assert the Philippines can grow this to about 10%, equivalent to a 41% growth annually for the industry.

The Philippines is already well-positioned as we rank among the top delivery locations next to India because of our highly trainable graduates, our proficiency in English, our strong affinity with Western cultures, our low cost base, and our efficient telecommunications infrastructure.

A number of trends make this the right time to pursue this growth. But our ability to capture this will be determined by how quickly we can scale up to provide a high quality and a reliable supply of the appropriate human talent.

We have seen some thoughtful initiatives on this front to develop a model for success and assimilate key learnings from the success of the Indian model. Initiated by private sector groups, the local BPO industry has come together as a community of independent businesses to form a roadmap to ensure the industry's sustainability. Key components of this include:

First, a focus on talent development and a plan to ensure that the pipeline of human resources and skills that the industry needs is properly filled. The BPAP has developed five complementary efforts to deliver the additional 300,000 to 600,000 additional recruits needed by the industry. But on the long-term, the quality of the workforce we will generate comes down to our willingness to increase our investments in the basic education system today.

Second is the development of other cities as next wave locations and making these BPO-ready. This encourages the development of other locations beyond Metro Manila. There are at least 13 additional locations identified that can support operations of more than 5,000 employees.

Third, ensuring that the business environment, including financial incentives offered to investors and overall support to develop the industry--from government, industry organization, and other stakeholders are present.

We only have a window of opportunity to capture this as other Asian countries begin to develop their capabilities in this space as well, otherwise we may lose our place in an increasingly service-oriented global economy.

The BPO industry is only one example where we can develop our competitive advantage and support its sustainability through focused investment in education and infrastructure that prolong its life cycle as a business.

There are other areas where we can build a competitive position. But bottom line, we must shape education and investment policies which take into account important global trends in migration, the relationship between science and technology capabilities and a country's competitiveness, and the effect of investment policies on the movement of our professionals.

In closing, let me summarize some of the thoughts I presented today:

First, we must build on the fundamental issue of a progressive governance standard. Clear adherence and enforcement of the rule of law, transparency, respect for the sanctity of contracts, consistency in policies are all essential ingredients to establishing an investor-friendly climate that lead to economic growth.

Second, is the need for an economic roadmap to set the long-term growth strategy for the country and to provide a basis for resource allocation, given the scarce resources available. Focused public sector investment that will yield the most efficient impact is imperative, particularly in raising the quality and productivity of labor and lowering the cost of doing business in the country. This way, returns to private sector investment can be competitive in comparison to other investment destinations.

Lastly, we must invest in our basic education system at both the elementary and secondary level to prepare students adequately to cope with the needs of the global market. This is key to developing and strengthening our competitive advantage in indigenous industries such as the business processing space. We must ensure that we remain relevant and competitive within the global economy and work hard to encourage industries that can build a sustainable model for success in this changing economic landscape.

This ends my presentation. Once again, many thanks for the kind invitation and the privilege to be here today.