Senate Economic Planning Office

Economic Report

July 2004 ER-01-04

First Quarter Economic Performance

Overall Economic Performance

The domestic economy (GDP) grew by 6.4 percent in the first quarter 2004. Over-all economic growth or the Gross National Product (GNP) grew by 6.2 percent for the same period. The GNP growth was tempered by a modest rise in Net Factor Income from Abroad (NFIA) of 3.3 percent.

The strong growth in the domestic economy was accounted for by the agriculture sector that grew by 7.7 percent followed by the services sector with a 6.4 percent growth rate. Industry likewise grew by 5.5 percent. On the expenditure side, exports led the growth, with a growth rate of 10 percent followed by personal consumption which posted a growth of 5.9 percent.

Table 1. Economic Growth Rates (in constant prices)

	2003 Q1	2003 Q4	2004 Q1
Gross National Product	4.6	4.8	6.2
Gross Domestic Product	4.8	5.0	6.4
Net Factor Income from Abroad	3.0	2.8	3.3
Production			
Agriculture	3.3	5.3	7.7
Industry	4.8	3.2	5.5
Services	5.5	6.1	6.4
Expenditure			
Personal Consumption	5.0	5.5	5.9
Government Consumption	3.0	2.9	2.2
Capital Formation (fixed capital)	5.6	1.2	4.8
Exports	4.2	9.8	10.0
Imports	24.1	9.4	4.9

Source: NSCB

What were the sources of economic growth?

On the Production Side:

Agriculture posted a phenomenal 7.7% growth. Growth in agriculture was led by increased palay and corn production that rose by 13.1 percent and 13.4 percent, respectively. Likewise, forestry and fishery also exhibited growths of 96.2 percent and 19.5 percent compared to same period of last year. The fishery sub-sector, which accounted for 21.4 percent in the total agricultural output, was boosted by the dramatic increase in aquaculture's output of 40.6 percent.

The improved productivity of the agriculture sector can be traced to the intensive use of hybrid rice and corn, better credit extension and an increase in irrigated areas due to the rehabilitation and operation of new irrigated systems across the country. In addition, the favorable weather during the quarter was beneficial to our farmers.

According to the National Irrigation Authority (NIA), there were 17,220 has. of newly operated irrigation systems and 114,785 has. of rehabilitated ones during the third and fourth quarters of 2003. These additional irrigation systems benefited the production of the rice sub-sector in the first quarter of 2004. In addition, PhP 648 million worth of loans were granted to the farmers by Quedan and Rural Credit Corporation (Quedancor) for the first quarter of 2004, 83 percent higher than that of the same period in the previous year. These improvements in technology, and credit and infrastructure support have resulted to higher labor productivity in agriculture.

Table 2. Labor Productivity of the Agriculture Sector (in Pesos)

	Q1 2003	Q2 2003	Q3 2003	Q4 2003	Q1 2004
Labor productivity*	4815	4314	4301	5709	5188
Growth Rate**	2.0	0.4	7.7	2.0	7.7

Source: NSCB
Notes: **value added / workers*
***compared to same period of last year*

Services largely contributed to gross domestic product growth. Given a 46 percent share to total GDP, services accounted for the bulk of increase in GDP contributing 3.0 percentage points. The growth in the sector continues to be driven by the growth of transport and communication, primarily from the communication sector that went up by 13.4 percent. Likewise, trade-related industries grew by 6.9 percent, as retail trade showed significant increases in its value added of 8.2 percent. This good performance can be traced to election-related spending.

Industry's better performance of 5.5 percent growth. Industry accounted for 32.5 percent of GDP in the first quarter. Its top contributor to growth remains to be the manufacturing sector, which grew by 4.3 percent. Based on National Statistic Office (NSO) data, the manufacturing sector increased capacity utilization to 78.5 percent from 77.8 percent in the same period last year. The continued recovery of the mining and quarrying sector, which posted a 21 percent growth rate, also contributed to the growth of the sector.

On the Expenditure Side:

Expansion in exports. The 10-percent growth of exports came primarily from increased electronic exports and non-factor services. Data from the NSO showed that electronic exports grew by an average of 6 percent during the first quarter 2004. This is attributed to the upturn in global demand for high-technology goods. The continued expansion of call center industries largely influenced the expansion of exports of non-factor services, which saw a substantial increase of 15.8 percent. The increased business created by call centers and subcontracting of backroom services have shown its positive impact on the economy.

Continued rise in private consumption. The economy was supported by a sustained growth in personal consumption shored up mainly by OFW remittances and election- related spending. Compensation inflows from abroad increased by 3.4 percent for the first quarter. Furthermore, consumption was boosted by improved farmers' income and stable prices.

Modest recovery in investments. Against the backdrop of heightened uncertainty arising from the elections, investments in durable equipment managed to rise by 5.8 percent. There was considerable increase in investments in agricultural equipment, special industrial machineries, office and data processing equipment, and other general industrial machinery.

Is the first quarter growth sustainable for the rest of the year?

Agriculture

Agriculture production is forecast to increase further. According to the projections of the Bureau of Agricultural Statistics (BAS), palay production is expected to increase by 9.5 percent in the second quarter and 14.9 percent in the third quarter this year. If the assumptions hold true and no major weather disturbance destroys crops, the growth in palay production could help sustain the growth in the agriculture sector as palay contributes 17 percent of the agriculture sector's output. In terms of contribution to growth, palay contributed 0.4 percentage points to GDP growth. It is important that the improvements in the productivity of the agriculture sector be sustained through technological improvements, and credit and infrastructure support.

Table 3. Palay Production ('000 MT)
Annual Growth Rates (%)

Quarter	2003 Actual	2004 Forecast
Q1	(0.7)	13.1 (actual)
Q2	(10.3)	9.5
Q3	20.5	14.9

Source: BAS

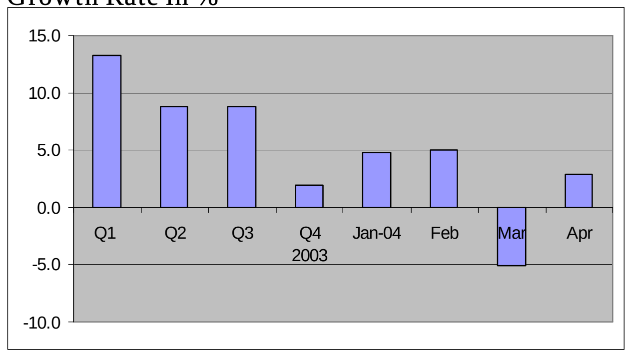
Moreover, the fishery sub-sector, which contributed 21.4 percent to the production of the agriculture sector, is seen to continue its growth for the rest of the year. It is projected to grow by 20.4 percent for the full year 2004 compared to 2003. This growth projection is attributed to several projects of the Bureau of Fisheries and Aquatic Resources (BFAR) that will increase aquaculture production by 40.6 percent for the full year 2004 through better use of technology and infrastructure support.

Industry

Industry seems to be back to a higher growth path. The industrial sector, particularly the manufacturing sector, continues to benefit from expansion of exports to trading partners. Moreover, the rise in the importation of capital goods and production inputs augurs well for the recovery of manufacturing output for the year. The manufacturing sector increased its importation of various equipment and production inputs by 15.3 percent in the first quarter of 2004.

Further, the Monthly Integrated Survey of Selected Industries (MISSI), showed an uptick in manufacturing value of production in April 2004, from a decline in March.

Figure 1. Manufacturing Value of Production, Growth Rate in %



Source: NSO

The business sector likewise showed optimism, as results of this year's second quarter Business Expectations Survey (BES) reveal continued business confidence in the economy in the second and third quarters of 2004. The survey indicates that more businessmen foresee favorable business conditions as the business outlook index[1] shows an increase from 19.9 percent in the second quarter to 32.4 percent for the third quarter.

Table 4. Business Outlook Indices, By Sector Second and Third Quarters, 2004

Sector	Index Points (Total)	
	Current Quarter (April – June)	Next Quarter (July – Sept)
All Sectors	19.9	32.4
Industry	22.3	30.6
Manufacturing	22.9	31.2
Construction	(17.4)	23.9
Wholesale and Retail Trade	13.3	30.5
Services	26.7	39.6
Financial Intermediation	18.0	34.0
Business Activities	45.6	71.0
Community and Social Services	19.2	36.9
Hotel and Restaurants	40.0	26.1

Source: BSP

Businessmen in industry particularly manufacturing (refer to Table 4), also expressed

[1] The index is computed as the percentage of firms that answered in the affirmative less the percentage share of firms that answered negative.

optimism as their indices showed increases in business outlook from second to third quarter.

However, several factors threaten industry's recovery. The same survey cites that most businessmen consider stiff competition and low demand as major factors that constrain production and business activity. These factors are also seen to linger on for the second quarter.

Table 5. Factors Limiting Production/ Business Activity of All Sectors, Second Quarter 2004

Factors	Percent Share
High Interest Rate	33.1
Unclear Economic Laws	35.2
Lack of Equipment	21.5
Insufficient Demand	57.2
Access to Credit	25.4
Financial Problems	31.1
Competition	66.8
Labor Problems	20.8
Lack of Materials	24.2
Others [1/]	19.0
None	6.2

Source: BSP
Notes : 1. Other factors that limit production or business activities are political and economic climate, lack of investor confidence and government regulations.
2. This survey covers 429 respondents from the NCR and Regions I, VII and XI.

Services

The services sector is expected to sustain its growth driven by the communications sector. This sector has consistently shown steady growth per quarter of 5.5-6.0 percent since last year. And for this year, there are no imminent threats to the industry. This is underlined, again, by the results of BES, where firms in the service sector registered the highest diffusion index/ net positive outlook for both Q2 and Q3 of this year. The services sector registered substantially higher net positive outlook rates of 39.6 percent than the average of 32.4 percent for all firms.

Personal Consumption Expenditure

Personal consumption spending may slow down due to rising prices. Oil prices are unlikely to go below USD 30 per barrel (Dubai) given the continued security risk arising from the tension in the Middle East[2]. Moreover, transport fares have increased and power hikes are inevitable. This will bring the inflation rate to an average of between 4 percent to 5 percent for the year, as estimated by the Bangko Sentral. Inflation for June 2004 rose to 5.1 percent from 4.5 percent in May 2004, primarily due to higher oil prices.

Nonetheless, increasing OFW remittances, and increased farmer incomes brought about by the improvements in agriculture's productivity may sustain personal spending. OFW remittances for the first four months of the year increased by 1.4 percent compared to the same period in 2003.

Table 6. Inflow of Compensation (in million USD)

	Q1 2003	Q2 2003	Q3 2003	Q4 2003	Q1 2004
Remittances	2086	2093	2065	2061	2153
Share to GNP (%)	10.6	10.0	10.0	8.7	10.3

Source: NSCB

Based on a recent study done by an international research and marketing firm ACNielsen Philippines,[3] Filipino consumers are more optimistic that the economy would improve within the next 12 months. Its results showed that consumer confidence increased to 49 percent from 36 percent reported in a similar study done in October last year (***Businessworld,*** June 30, 2004). Higher consumer confidence raises the odds of higher consumer spending.

Exports

Latest exports figures showed a 15.3-percent increase in exports to USD 3.26 B in May, which is an 18-month high. Allaying fears that the country has lost its competitiveness in electronics, exports of electronics surged by 18.7 percent to USD 2.16 billion. National Economic and

[2] See "Assessment of Oil Prices," June 2004 prepared by the SEPO.
[3] AC Nielsen Philippines is a subsidiary of VNU N.V., a Dutch company with headquaters in New York and the world leader in consumer market research, information and analysis.

Development Authority (NEDA) Director General Romulo Neri explains that the electronic sector suffered last year due to global slump in electronics in 2003, which is currently on an upswing, thus benefiting the country's export sector (***Inquirer***, July 7, 2004).

For the rest of the year, exports will be greatly dependent on world economic dynamics. If the economy of our major exports markets (US, Japan, Netherlands, Singapore, etc.) continue to grow, then the country's exports will likely perform better. The US grew at 4.4 percent during the first quarter of 2004 and is expected to continue on its growth trajectory. Moreover, Japan grew by 6.1 percent for the first quarter of the year. The IMF projects world economy to grow by an average of 4.6 percent in 2004. Given below are the projected growth rates of the country's top major trading partners.

Table 7. Major Trading Partners of the Philippines, GDP Growth Projections in %

Country	2003	2004
1. United States	3.1	4.6
2. Japan	2.7	3.4
3. Netherlands	(0.8)	1.0
4. Hong Kong	3.3	5.5
5. Singapore	1.1	5.0

Source: IMF WEO

The country's intra-regional trade to other Asian economies, particularly Malaysia, Hongkong, China, Singapore and Taiwan posted higher growth rates in the first quarter of 2004 compared to the same period last year. Economists urge Philippine economic planners to expand trade with other Asian countries. In terms of volume and value, trade with the regional partners already accounts for more than a third of Philippine total exports and continues to grow (***Philippine Star***, June 24, 2004).

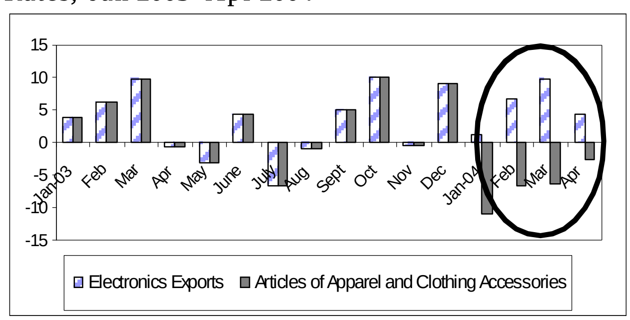
Table 8. Direction of Trade: Philippine Exports (In million USD)

	Q1 2003	Q1 2004	Growth Q1 2004	% share Q1 2003	% share Q1 2004
Japan	1315	1700	29.3	15.3	18.2
US	1785	1563	(12.4)	21.4	16.8
Netherlands	800	968	21.0	9.3	10.3
Hongkong	699	777	11.2	8.2	8.5
Singapore	537	620	15.5	6.2	7.1
Taiwan	549	588	7.1	6.5	6.5
Malaysia	497	569	14.5	6.2	6.1
China	361	496	37.4	4.2	5.2
Korea(South)	229	92	(59.8)	3.7	2.8

Source: NEDA

As the country's top dollar earner, electronic exports continues to surge, while the country's garments industry is declining as evidenced by the negative growth rates registered by garment exports during the first four months of 2004 compared to the same period last year.

Figure 2. Electronics and Garments Exports Growth Rates, Jan 2003- Apr 2004

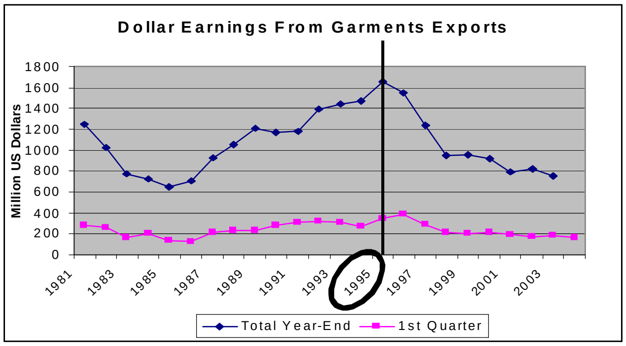


Source: NEDA
Note: Computed using data in million US$

Moreover, the expected end of the Multi-Fiber Agreement (MFA) on January 1, 2005 poses a further threat to the country's garment exports. In 2003, the garments sector accounted for 13.2 percent of merchandise exports in terms of value. In the first quarter of 2004, it accounted for 9.2 percent of total merchandise exports.

Furthermore, the sector's ability to earn dollars has declined since the relaxation of the MFA quotas in 1995. Following the trend across years, the first quarter of 2004 showed a continued decline of garment exports in dollar value compared to the same period last year.

Figure 3. Dollar Earnings From Garments Exports



Source: BSP, NSO
Note: Authors converted units from pesos to dollars.

Thus, the impending end of the quota that guarantees the country's garments industry a market is expected to lead to a further decline of the Philippine garments industry by January 1, 2005. China, India and other developing countries have continued to do well in producing cheaper garments and textiles across quality types and product lines, thus the complete abolition of the quotas may signal the demise of our garments industry unless it improves its competitiveness.

With regard to call centers, which hold 69 percent of all IT investments in the country, it looks like a sustainable source of growth and employment. The Department of Trade and Industry (DTI) foresees that in the next two years there will be a doubling of call center seats from 40,000 to 80,000 by the end of 2005 (***Inquirer***, May 13, 2004). Presently, the country captures 20 percent of the Asian market share of call centers and has a recorded investment of PhP1.897 B as of April 2003. This is a substantial increase from PhP 556 M in 2000 and PhP 1.59B in 2002 (***Inquirer,*** May 13, 2004 and IT Matters). However, amidst such exponential growth, it is imperative to move into solutions provision which is more skill-intensive and has a larger value-added than contact centers.

Threats to Growth

For 2004, we see risks both at the external and domestic fronts which could affect the overall growth prospects of the country. On the external front, we see two factors which could impact on overall macro-economic growth such as the impact of higher world oil prices and US interest rates. The high fiscal deficit problem and low investment, on the other hand, are seen as domestic macroeconomic concerns.

Higher world oil prices. Oil prices have increased by 20 percent as of June 8, 2004. It is projected that global oil prices will remain between USD 30 - USD 40 per barrel for the remainder of the year as uncertainties surrounding the peace and order situation in the Middle East are expected to persist. This will have an adverse impact on growth.

Research conducted by the Association of Southeast Asian Nations (ASEAN) shows that Asian economic growth will decrease by at least 1 percentage point should crude oil prices stay at USD 35 per barrel. They estimate a 1.6 percentage point reduction in the Philippines' GDP growth. On the other hand, NEDA projects a lower impact. GDP growth is expected to slow down by 0.5 percentage point if an increase of USD 10 per barrel in oil prices prevails for as long as one year.

High fiscal deficits. The national government fiscal deficit in May 2004 rose to PhP 12.7 B from PhP 7.8 B in April 2004. This brought the government's five-month budget deficit to PhP 77.3 B, just PhP 2.3 B below its ceiling for the first semester. At the rate government is spending, by the end of the year, government will likely overshoot its budget deficit target of PhP 197.8 B.

Table 9. Deficit Figures Data (In billion pesos)

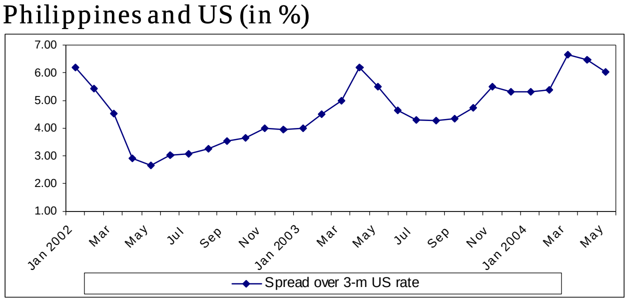
	2003	2004
National Government Deficit	199.9	77.3 (as of May)
Consolidated Public Sector Deficit	245.2	n.d.
% to GDP		
National Government Deficit	4.7%	4.2%*(as of May)
Consolidated Public Sector Deficit	5.7%	n.a.

Source: Bureau of Treasury, DOF
****As percent of GDP(2004 1st quarter multiplied by a factor of 5/3 since NG deficit is as of May)***

There are macroeconomic risks that come with this position of high deficits. Increasing fiscal deficits gives a negative signal to the country's creditors of our ability to pay our debts. Hence, this raises the risk of our borrowings. Private rating agencies have downgraded Philippine Sovereign Credit Ratings and this has raised the spreads of Philippine Bonds. Higher spreads mean higher interest expense for government debt.

Recently, Fitch Ratings stated that it may give the country a downgrade if the government is not able to raise enough taxes to cover for the debt absorbed from the National Power Corporation (NAPOCOR). Bangko Sentral ng Pilipinas (BSP) Governor Rafael Buenaventura warned that another credit downgrade could raise government's borrowing cost by 1 to 2 percent (***Businessworld,*** July 8, 2004).

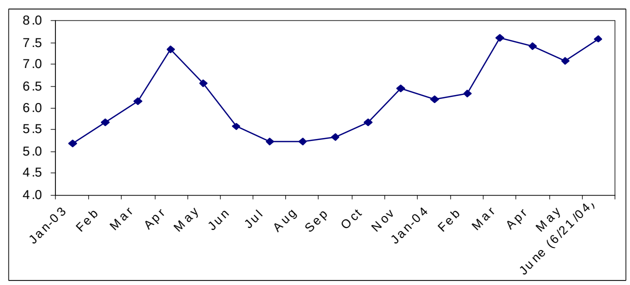
Figure 3. Nominal Interest Rate Spreads Philippines and US (in %)



Source of data: BSP, US Federal Reserve

Private investments are also affected as interest rates in the domestic debt market reflect the foreign debt market. Interest rates measured by the benchmark 91-day Treasury bill rate have averaged 7.0 percent as of June 22, 2004 this year, compared to 6.1 percent for the same period in 2003. Likewise, the bids for our Treasury bills are rising. The premium risk rate for the benchmark 91-day Treasury bill is expected to be between 7.75 percent and 7.875 percent as investors see the national government pushing for a very aggressive borrowing program and the impact of the rise in US interest rates (***Businessworld***, July 5, 2004). This will dampen private investments and consumption, therby threatening the forecast for a higher GDP growth rate.

Figure 4. 91-day Treasury bill rates (in %)
Jan 2003- June 2004



Source: BSP

It is imperative for government to resolve the deficit problem immediately by collecting taxes. Experts estimate substantial revenue leakages brought about by tax evasion and avoidance, and loopholes in the tax law.

The National Tax Research Center (NTRC) estimates show that an average of 68.9 percent of potential business income taxes and 37.7 percent of corporate income taxes are not collected. For the VAT, the uncollected taxes run up to 29.8 percent.

Table 10. Estimated Tax Gap: 1998 – 2002
(Amounts in Billion Pesos)

Particulars	1998	1999	2000	2001	2002	Average
I. Individual Income Tax						
Compensation Income	6.4	4.0	0.6	5.1	6.8	4.6
(% of Potential Income Tax)	11.7	6.7	0.9	7.1	8.6	7.0
Business/Professional Income	24.1	25.1	22.0	29.8	32.5	26.7
(% of Potential Income Tax)	68.8	67.7	58.7	73.5	75.7	68.9
II. Corporate Income Tax	40.6	79.2	54.7	47.8	47.9	54.1
(% of Potential Income Tax)	34.3	50.2	38.9	32.7	32.2	37.7
III. Value-Added Tax	35.7	26.9	34.3	54.3	56.9	41.6
(% of Potential VAT)	31.0	22.6	26.3	33.8	33.0	29.8

Source: NTRC

Collecting more taxes is the only option for government at this point to resolve the deficit problem since our debts have risen to unmanageable levels. Public sector debt as of September 2003 now stands at 114.4 percent of GDP and National Government debt (as of December 2003) amounts to PhP 3.4 trillion or 78 percent of GDP. Further, the budget of the government is so tight since mandatory expenditures (Debt Service, IRA and Personnel Services) comprise 80 percent of the total budget. Any more reductions in expenditures will negatively impact on the economy, as we cannot postpone delivery of basic services and the implementation of various programs for the country's development goals. Legislating new taxes would take some time and its impact will be felt at the earliest in the second semester of next year unless Congress fast-tracks the enactment of the measures before the end of 2004.

Additional pressure brought about by the hike in US Interest rate and domestic inflation. The United States in June 30, 2004 hiked its interest rate by a quarter percentage point to 1.25 percent (Federal Reserve). This will lead to increased borrowing cost as future loans/bond sales will have to increase yields. The higher US interest rates will add pressure to the country's cost of borrowings as the BSP may raise interest rates in tandem with the US rates.

Further, if inflation continues to rise there may be more pressure on the BSP to raise interest rates. The high cost of oil, the increase in wages and transport fare, and the likely hike in power cost will put further pressure on the inflation.

In addition, interest rate hikes in the US and world market may lead to the deterioration of the peso as investors put their money in higher yielding investments abroad.

Low Investments. To sustain a higher GDP growth, the investment rate of the country has to increase substantially. While there are signs of an increase in capital formation, investments have to grow higher than the current levels of 18.7 percent of GDP. Domestic capital need to be augmented by higher capital inflows.

As of March 2004 portfolio investments recorded a meager amount of USD 7 M compared to USD 417 M for the same period in 2003. The same holds true for Foreign Direct Investment, where an outflow of USD 36 M was recorded as of March 2004 relative to total inflows of USD 37 M for the same period in 2003.

Table 11. Portfolio Investments (In million US$)

	Levels in million USD		Growth in %	
	Q1' 03	Q1' 04	Q1' 03	Q1' 04
Portfolio Investment	417	7	(70.1)	(98.3)
Net Foreign Direct Investment	37	(36)	(96.6)	(197.3)

Source: BSP

The country continues to suffer from low foreign direct investment. Across ASEAN, for the period 2001-2003, the country recorded a drop in net foreign direct investment of 20 percent, next from the bottom to Indonesia.

Table 12. Net Foreign Direct Investment, Average Growth Rates (%)

ASEAN	'92-'97	'98-'00	'01-'03
Philippines	64.9	11.3	(20.1)
Malaysia	5.3	(14.8)	84.6
Thailand	16.2	20.0	(6.8)
Indonesia	27.0	(307.8)	(206.2)
Singapore	27.6	145.9	92.1

Source: ARIC-ADB, World Investment Report

In this light, it is necessary for government to institute measures that will improve the investment climate. There is a need to implement measures that will lower the cost and risk of doing business. Important are reducing power cost, improving the efficiency of our financial sector to temper higher interest rates, passing measures to counteract the rising inflation (reducing the cost of food), and creating stability in government policies and a more favorable peace and order situation.

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DATA SOURCES

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Bureau of Fisheries and Aquatic Resources
Bureau of Treasury
Department of Finance
National Economic and Development Authority
National Irrigation Authority
National Statistical Coordination Board
National Tax Research Center
Quedan and Rural Credit Corporation
US Federal Reserve (Statistics Release)

This paper was principally prepared by the Macroeconomics Group, under the supervision of the SEPO Director General.