



Economic Report

Q1 GDP Growth: Better But Not Enough

The Philippine gross domestic product (GDP) posted a 5.5 percent growth in the first quarter of 2006 from 4.2 percent growth during the same period last year. The gross national product (GNP) grew modestly to 5.8 percent from 4.9 percent in the same period even as net factor income from abroad (NFIA) slowed down to 8.8 percent in this quarter from 12.9 percent a year ago. This deceleration is attributed to the slower growth in the inflow of compensation income from abroad.

Production Side

Agriculture rebounded with a 3.8 percent growth in the first quarter of 2006 from a negative growth in the same quarter last year. The growth was driven by the increase in production of palay, corn, sugarcane, banana, livestock, and other agricultural services. The growth in agriculture is attributed to favorable weather conditions and improved seed varieties.

Table 1. 2006 First Quarter Economic Performance
(growth rates, constant prices)

Particular	Q1 2005	Q1 2006
GDP	4.2	5.5
GNP	4.9	5.8
NFIA	12.9	8.8
BY INDUSTRY		
Agriculture, fishery & forestry	-0.5	3.8
<i>Agriculture & fishery</i>	-0.1	3.7
<i>Forestry</i>	-55.6	46.4
Industry	3.4	5.5
<i>Mining & quarrying</i>	-4.2	1.7
<i>Manufacturing</i>	4.9	6.0
<i>Construction</i>	-0.9	5.3
<i>Electricity, gas & water</i>	2.0	4.2
Services	7.0	6.2
<i>Transportation, communication & storage</i>	10.7	6.8
<i>Trade</i>	5.6	5.3
<i>Finance</i>	12.5	14.8
<i>Ownership of dwellings & real estate</i>	6.6	3.5
<i>Private services</i>	4.7	5.5
<i>Government services</i>	3.7	2.8
BY EXPENDITURE		
Personal consumption	5.0	5.1
Government consumption	2.2	9.4
Capital formation	-8.9	-2.7
<i>Fixed capital</i>	-8.1	-3.4
<i>Construction</i>	-2.9	3.1
<i>Public</i>	-13.3	9.4
<i>Private</i>	2.6	0.3
<i>Durable equipment</i>	-12.3	-8.1
<i>Breeding stock & orchard dev't</i>	-0.1	-1.3
Exports	1.4	12.2
<i>Merchandise exports</i>	3.1	11.4
<i>Non-factor services</i>	-7.3	17.0
Imports	-2.2	0.6
<i>Merchandise imports</i>	-3.2	0.2
<i>Non-factor services</i>	18.0	8.2

Source: National Statistical Coordination Board

However, coconut production and fisheries slightly declined while poultry production fell sharply.

Industry registered 5.5 percent growth in the quarter from 3.4 percent a year ago due to the increase in manufactured goods. The manufacturing sector grew 6.0 percent from 4.9 percent during the same period. Other industry sectors such as mining and quarrying, construction, and utilities grew as well.

Leading the high growth manufacturing industries are food, textile, and electrical machinery. The increase in food manufactures is largely domestic demand-driven. Exports of apparel and clothing accessories picked up as well in February and March 2006, spurring the increase in textile manufactures. The falling investment on new textile machineries, however, may undermine the growth of the industry. The electrical machinery is back to double-digit growth due to increase in exports.

Another industry group posting exceptional growth is leather products which is primarily export-oriented. Whether the growth is sustainable in the long-run is uncertain as the industry has an uncompetitive cost structure compared to other low-wage countries such as China and Vietnam (Intal and Hernandez, 2006). Other labor-intensive export-oriented industries such as footwear and wearing apparel, furniture, and wood products registered double-digit negative growths.

Table 3. Manufacturing (growth rates, in %)

	Q1 2005	Q1 2006
Winners		
<i>Leather products</i>	-2.7	54.8
<i>Textile manufactures</i>	17.1	25.6
<i>Electrical machinery</i>	6.1	10.9
<i>Food manufactures</i>	-1.8	9.4
Losers		
<i>Wood and cork products</i>	-15.6	-30.8
<i>Furniture & fixtures</i>	75.8	-28.5
<i>Footwear & wearing apparel</i>	12	-24.8

Source: National Statistical Coordination Board

Table 2. Agriculture, Fishery & Forestry (growth rates, in %)

	Q1 2005	Q1 2006
Agriculture, fishery & forestry	-0.5	3.8
<i>Palay</i>	-1.5	6.9
<i>Corn</i>	-18.3	22.1
<i>Coconut/copra</i>	4.9	2.1
<i>Sugarcane</i>	-4.3	1.5
<i>Banana</i>	3.4	14.6
<i>Other crops</i>	-2.6	-1.0
<i>Livestock</i>	0.3	2.2
<i>Poultry</i>	6.7	-3.7
<i>Agricultural activities & services</i>	-0.9	9.0
<i>Fishery</i>	5.3	4.7
<i>Forestry</i>	-55.6	46.4

Source: National Statistical Coordination Board

Services slowed down to 6.2 percent growth in the first quarter of 2006 from 7.0 percent in the same period last year. All sectors, except for finance and private services, posted lower growth figures. The banking sector growth is driven by an upsurge in non-interest income, particularly from trading gains from government securities (NSCB). It is however, notable that banks, though growing, have not contributed significantly to the real economy since growth in credit has been slow. Commercial bank lending declined in March by 0.5 percent. Credit growth in January and February were also slower than last year's.

Table 4. Finance, by Industry Group (growth rates, in %)

	Q1 2005	Q1 2006
Finance	12.5	14.8
<i>Banks</i>	14.4	21.6
<i>Non-banks</i>	11.3	4.5
<i>Insurance</i>	6.7	-5.1

Source: NSCB

Demand Side

Exports are back again as the engine of economic growth, posting a double-digit growth in the first quarter of this year. Merchandise exports surged by 11.4 percent this quarter from 3.1 percent a year ago with semi-conductors and finished electrical machinery steering the growth. Agriculture-based products like crude coconut

oil and banana as well as miscellaneous non-electronic merchandise exports showed signs of recovery. Electronic products continue to be the leading merchandise exports followed by garments, crude coconut oil and copper rods and bars. The growth of non-factor services jumped to 17 percent this quarter from -7.3 percent a year ago. The growth has largely been due to better accounting of the contribution of business process outsourcing (BPO) industry to the economy in the National Income Accounts. Improvement in the performance of imports which registered 0.6 percent growth in this quarter from a negative growth a year ago is also a sign that the export sector is recovering.

Table 5. Merchandise Exports (growth rates, in %)

	Q1 2005	Q1 2006	Contribution to growth
Top contributors to growth			
<i>Finished elec'l machinery</i>	58.5	52.0	4.17
<i>Semiconductors, etc.</i>	22.7	14.0	2.53
<i>Bar, rods & copper</i>	14.0	27.8	0.54
<i>Crude & coconut oil</i>	-16.4	12.9	0.36
<i>Banana & plantains</i>	-3.9	26.5	0.28
Least contributors to growth			
<i>Centrifugal sugar</i>	-31.6	-37.6	-0.34
<i>Carments</i>	27.2	-1.4	-0.16
<i>Canned pineapple</i>	9.6	-31.9	-0.14
<i>Prepared tuna</i>	-35.8	-32.4	-0.06
<i>Shrimps and prawns</i>	-5.4	-12.1	-0.03

Source: National Statistical Coordination Board

Personal consumption expenditure, comprising more than two-thirds of total spending, barely increased in the first quarter of 2006. The sluggish growth of 5.1 percent reflects the restrained spending in household furnishing, clothing and footwear, and transportation and communication which is consistent with the lower performance of these industries in the manufacturing sector. This decline is brought about by the increase in the VAT rate and rising oil prices. The appreciation of the peso may have also dampened consumption of OFW families.

Government spending rose to 9.9 percent in the first quarter of 2006, from 2.2 percent in the same period a year ago. Despite the absence of

Table 6. Personal Consumption Expenditure (growth rates, in %)

	Q1 2005	Q1 2006
Personal Consumption	5.0	5.1
Food	5.1	5.3
beverages	1.3	3.9
Tobacco	2.1	1.2
Clothing & footwear	2.3	-2.2
Fuel, light & water	-3.5	2.0
Household furnishings	1.3	-0.9
Household operations	2.8	3.1
Transportation/communication	17.5	14.1
Miscellaneous	4.1	4.7

Source: National Statistical Coordination Board

a 2006 budget, the government was able to increase spending on account of better revenue performance.

Investment still posted negative growth, although there was modest growth in construction. The increase in construction spending is public sector-driven, from big-ticket government projects and increased capital expenditures from government-owned and -controlled corporations (GOCCs).

Prospects

The Arroyo administration believes that the economy is on track to attain its revised targets. The government revised downward GDP growth forecast between 5.5 to 6.2 percent and GNP growth forecast between 5.9 to 6.5 percent on account of the rising oil prices and strengthening of the peso. Agriculture is expected to grow between 3.5 to 4.0 percent with the increase in hybrid rice production, strong external demand for high value crops, and sustained growth in fisheries. Industry is projected to rise between 5.4 to 6.2 percent due to upbeat mining sector, big-ticket public construction projects, and increase in exports. The services industry is expected to climb by 6.4 to 7.0 percent driven by growth in BPO, increase in tourist arrivals, and improvement in finance, and wholesale and retail trade.

The continued negative performance of investments will be a drag to the economy. Capital formation has been declining since last

Table 7. 2006 Macroeconomic Targets (growth rates, in %)

Particular	MTPDP 2004-2010	DBCC- approved as of 9/20/2005	DBCC- approved as of 3/27/2006
GNP	6.5 - 7.5	5.9 - 6.9	5.9 - 6.5
GDP	6.3 - 7.3	5.7 - 6.6	5.5 - 6.2
Agriculture	4.2 - 5.2	4.0 - 5.0	3.5 - 4.0
Industry	7.2 - 8.2	5.1 - 6.1	5.4 - 6.2
Services	6.5 - 7.5	6.7 - 7.7	6.4 - 7.0

Sources: MTPDP, DBCC

year. Having a reenacted budget for 2006 will further worsen this as the government's plan to increase spending for public infrastructure in 2006 by 38.1 percent or P21.8 billion will be derailed. Hence, while government is upbeat in their projections, the real economy is not expected to grow significantly without the required investments.

Better but not enough

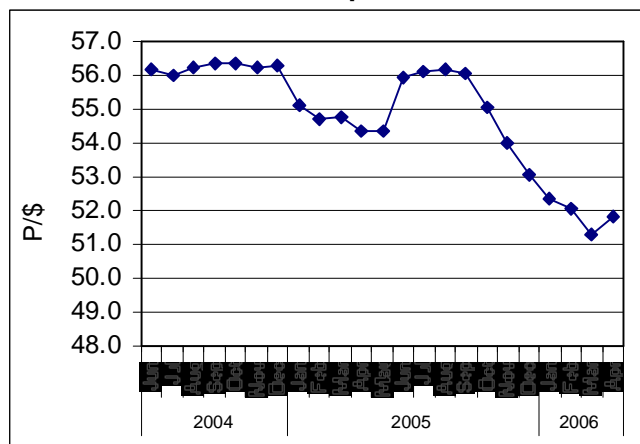
Apart from the economic GDP being high this quarter, other economic indicators showed encouraging signs as well. The peso is strong, the stock market is on a rally, and the fiscal situation is improving. All are signs of a healthy and stable economy. Yet, much of these positive developments are either transient or externally-driven. Unless more lasting reforms are implemented, particularly to attract investments, the prospect of a long-term economic growth that will impact on the lives of ordinary Filipinos will continue to be far-fetched.

Strong Peso

In the first four months of the year, the peso appreciated by 4.7 percent compared to the same period a year ago. More recent data, however, show the peso on a decline following a downturn in regional currencies. At P52.65 to the dollar by end of May, it is still significantly higher from its year-ago level of P54.36/\$1. The strengthening of the peso is largely attributed to the strong dollar inflows brought about by OFW remittances which surged in time for the

graduation season and tuition fee payments. The rise in portfolio investments and the substantial borrowings of the government also contributed to the increase in the dollar supply in the economy.

Figure 1. Peso –Dollar Exchange Rate (June 2004-April 2006)



Source: Treasury Department-BSP

While the strengthening of the peso is welcomed by many as good news, particularly by the government, not everyone stands to benefit from it. It is a boon to importers and consumers who now spend less for imported goods, oil, in particular. It is also a plus to the government which stands to save billions of pesos in interest payments to foreign debt. Treasury officials estimate that as much as P6.8 billion has, so far, been saved from debt service obligations since the peso's bull run last year.¹

The strong peso, in contrast, is a bane to the export sector which becomes even less competitive relative to other countries. It is also bad for the families of OFWs receiving dollar remittances as it will dampen their consumption.

What is important to highlight though is that the biggest net source of foreign exchange which caused the peso to appreciate is the OFW remittances. This actually represents the inadequacy, and not the strength, of the economy. Had the dollar inflows been sourced from a strong export sector, the strong peso

¹ *Businessworld*, "Treasury details savings from peso," April 24, 2006

would have been more indicative of a robust economy. Unfortunately, the country's export sector has been highly concentrated and dependent on electronics such that weak international demand for electronics drastically diminishes our export earnings. Exports took a beating last year but have started to pick up again, growing by 12.2 percent for the first quarter this year. Diversifying our exports would mitigate the impact of cyclical downturns and help sustain this strong showing.

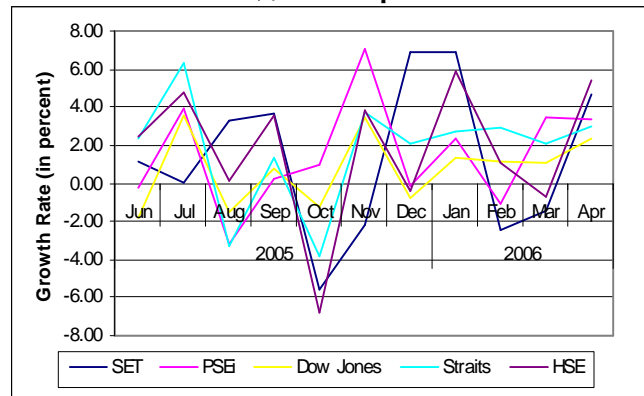
Robust Stock Market

The country's stock market, which has been on an upbeat mode since 2005, continues to rally in the early months of this year. Last April, it nearly hit a seven-year high with the Philippine Composite Index, now known as PSEi, registering a 46 percent year-on-year growth. The mining sector, in particular, enjoyed the biggest gain as prices of precious metals, gold and silver experienced sharp increases.

Analysts explain that while the improvements in the fiscal situation or reports of corporate earnings may have affected the day-to-day movements of the stock market, its recent performance is largely on account of an external phenomenon called *global excess liquidity*. There is just too much money in circulation around the world, and the Philippines, like its neighboring countries, simply benefited from the excess money flowing into the Asia-Pacific region.² Indeed, it is worth noting that the growth rates of the PSEi, the Dow Jones and other stock indices of Asian countries moved generally in the same direction in the last 11 months.

The more recent moderation of the bullish mood is, again, a regional trend, as investors start to unload their stocks in the emerging markets over possible further increases in US interest rates. Fund managers are reportedly realigning

Figure 2. Growth Rates of the Dow Jones and Asian Indices , June to April 2006



Sources: Various issues of Philippine Star and International Herald Tribune

Note: End of month closing indices were used

their portfolios by going back to the safety of US treasury bonds.³

The size and composition of the Philippine stock market also leave much to be desired to make a significant impact on the economy. To date, there are only 238 listed companies in the Philippine Stock Exchange (PSE), the smallest number of players registered among Asian exchanges. Further, of these 238 companies, less than 150 of their issues are traded actively on a daily basis.⁴ The low contribution of the Philippine stock exchange to the economy is evident in the stock markets' importance indicator as measured by the domestic capitalization as a percentage of the GDP. In 2003, stock market capitalization is only 30 percent of GDP, way behind Singapore's 190 percent, Malaysia's 156 percent, and Thailand's 83 percent market capitalization- to- GDP ratio.

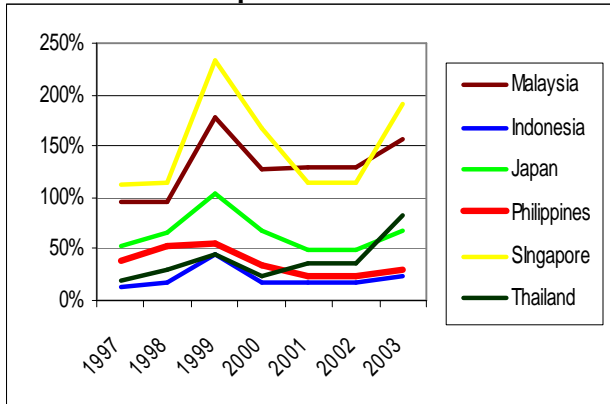
The ease by which investors could move their money also makes the stock market (or portfolio investments in general), highly susceptible to capital flight. Unlike direct investments, equity investors could easily withdraw their funds at the slightest, albeit, unfounded hint of impending trouble. Direct investments, in contrast, require a stronger

² See Habito, "Unwarranted gloating," November 20, 2005, *Philippine Daily Inquirer*

³ Ron Nathan, "Foreign investors quit submerging markets," May 30, 2006, *Philippine Daily Inquirer*

⁴ *Business World*, "Reforms needed to modernize domestic capital market," January 26, 2005

**Figure 3. Stock Market Capitalization
(as percent of GDP)**



Source: International Monetary Fund

investor commitment and as such, has more enduring impact on job creation, productivity and output.

Foreign Direct Investment

**Table 8. FDI Flows, Selected Asian Countries
1990 and 2004 (in US\$ million)**

Country	1990	2004
China	3,487	54,936
Korea, Rep of	788	8,189
Indonesia	1,093	1,023
Malaysia	2,332	4,624
Philippines	530	469
Singapore	5,575	16,032
Thailand	2,444	1,412
Vietnam	180	1,610

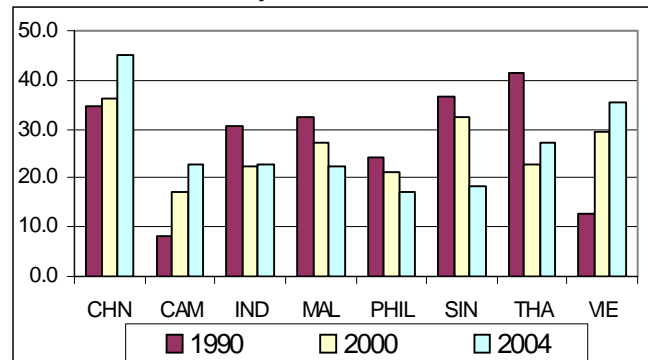
Source: World Development Indicators, 2006

The current level of foreign direct investment in the Philippines, though increasing in the last three years, is only half of its 2000 level. It is actually at the tail-end of the queue of foreign direct investment recipients in Asia, having received the least inflow among Asian countries in 2004. The Medium-Term Philippine Development Plan targets an increase in the investment-to-GDP ratio from 19 percent to 28 percent by 2010. Sadly, the Philippines has not made any headway in the attainment of this vision. Reforms have yet to be implemented

particularly in improving capital formation and infrastructure as this has been perennially cited by analysts as one of the major reasons the economy fails to attract investments and sustain higher growth.

The Philippines pales in comparison with other countries when it comes to the ratio of gross capital formation to GDP. Cambodia even has a higher ratio at 22.6 percent. The Philippines' 17 percent gross capital formation- to-GDP ratio represents a significant decline from 24.2 percent in 1990.

**Figure 4. Gross Capital Formation, Asia
(as percent of GDP)**



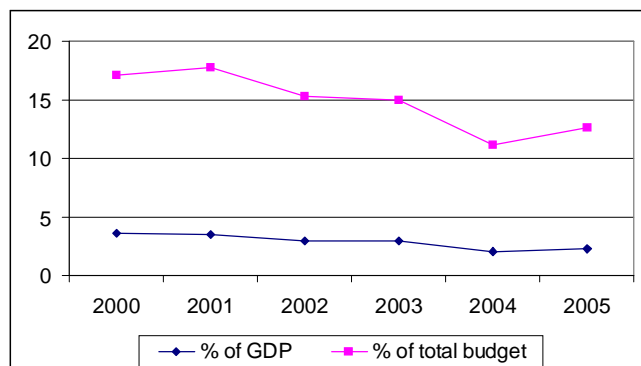
Source: Asian Development Bank

Spending for infrastructure is meager as well. The World Bank estimates that countries like the Philippines will need to spend over 5 percent of GDP on infrastructure to meet their needs over the next 10 years. In 2005, infrastructure-to-GDP ratio of the Philippines was only 2.22 percent, well below this benchmark.⁵ The latest 2006 World Competitiveness Yearbook also reports of the country's deteriorating quality of infrastructure. Out of 60 countries, Philippines' ranking in infrastructure slipped from 55th to 56th.

The government's inability to increase spending for infrastructure can be attributed to its tight fiscal position in the past. Since 1998, the government has been on a fiscal deficit, and as such, had to limit its infrastructure spending.

⁵ World Bank, Meeting Infrastructure Challenges, 2005

Figure 6. Public Sector Infrastructure Budget, 2000-2005



Source: Congressional Planning and Budget Department

Improving Fiscal Position

From January to April this year, the national government posted a fiscal deficit of P49.97 billion, significantly lower than the deficit of P60.1 billion incurred in the same period in 2005. The picture would have been much better had the Bureau of Internal Revenue not fallen short of its targeted collection by P3.6 billion. The shortfall was mainly from the collection of corporate income taxes as tax filers reportedly availed of tax credits.

Table 8. Fiscal Summary (in billion pesos)

Particulars	Full Year 2005	Jan.-Apr.		growth rate (%)
		2005	2006	
Revenues	795.71	254.10	300.02	18.07
Disbursements	942.49	314.23	349.99	11.38
Deficit	-146.78	-60.13	-49.97	-16.90

Source: Bureau of the Treasury

The key challenge is to sustain these improvements in the fiscal situation as it will provide the government the necessary fiscal space to address the country's infrastructure needs.

Pursuing public-private sector partnerships is another strategy needed to improve infrastructure in the country.⁶ The Philippines has already made significant strides in this field, having been one of the first countries to adopt Build-Operate-Transfer (BOT) contracts in the past, yet much more needs to be done, especially in ensuring a favorable business environment to encourage the private sector to come in. The World Bank cites the four Cs – poor cost recovery, high corruption perception, poor competition and low credibility of regulatory and judicial institutions as the four key issues undermining private sector participation. Policies that will address these will go a long way in improving infrastructure and attracting investments in the country.

Conclusion

While growth has recently been better, it is obviously not enough. Reforms still have to be aggressively pursued, particularly to attract direct investments as they produce real economic activities, create jobs and ultimately help the poor rise from poverty. The possible non-passage of the 2006 budget is unfortunate as it would have allowed greater appropriation for capital outlay and infrastructure, boding well for the country's investment climate. This only means that efforts have to be doubled to entice the private sector to come in.

⁶ IMF Regional Economic Outlook Asia and Pacific, May 2006

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