Senate Economic Planning Office

Economic Report

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IMPACT OF HIGH OIL PRICES ON GROWTH
First Quarter Economic Report

This paper presents the Philippines' economic performance for the first quarter of 2005. It presents briefly the components of growth both by industry origin and expenditure accounts. The report later focuses on the impact of high oil prices to the country's economic growth and provides a general outlook on oil prices.

Economic Performance in the First Quarter

Consistent with expectations that growth will slow down this year, the country's gross domestic product (GDP) in the first quarter of 2005 grew by 4.6 percent, lower than its 6.4-percent growth in the same period in 2004. The slower pace was a combined effect of higher oil and consumer prices, weak external demand, and the poor performance of the farm and mining sectors. The gross national product (GNP) likewise decelerated, posting only a 4.7-percent growth compared to 6.4 percent last year.

Sources of Growth

Services still the major growth driver. Accounting for almost half (48%) of the total GDP and contributing 3.3 percentage points to total growth, the services sector continued to push the economy's growth by 6.9 percent.

All subsectors under services, except trade and private services, grew at faster paces compared to the first quarter last year. Transportation, communications and storage grew by 9.6 percent, and was mainly boosted by the 18.5-percent growth in communications. Aggressive marketing and continuous expansion in the provincial areas sustained the strong consumer demand for mobile phone services in the said period.

Table 1. First Quarter 2005
Economic Growth Rates (at constant prices)

	2004 Q1	2005 Q1
Gross National Product	6.4	4.7
Gross Domestic Product	6.4	4.6
Net Factor Income from Abroad	7.0	6.7
Production Side		
Agriculture, Fishery and Forestry	**8.6**	**-0.1**
Agriculture	5.5	-1.5
Fishery	19.5	5.9
Forestry	96.5	-40.5
Industry	**4.7**	**4.2**
Mining and Quarrying	21.7	-4.4
Manufacturing	3.9	4.2
Construction	1.7	7.9
Electricity, Gas & Water	5.1	5.6
Services	**6.6**	**6.9**
Transport, Communications & Storage	9.2	9.6
Trade	7.1	6.0
Finance	7.0	11.1
Ownership of Dwellings & Real Estate	4.0	6.8
Private Services	6.5	4.6
Government Services	3.5	4.3
By Expenditure Account		
Personal Consumption	5.7	5.0
Government Consumption	4.1	-0.9
Capital Formation	7.7	-4.1
Exports	11.6	3.1
Imports	4.5	-4.0

Source: NSCB

Financial services also exhibited vigorous growth from 7.0 percent to 11.1 percent on a spate of initial public offerings and a strong banking sector, which shot up from 6.2 percent to 12.4 percent. Banks were propped up by the surge in interest income, trading gains from investment in securities and higher earnings from fee-based transactions. Likewise, government services grew faster from 3.5 percent in the first three months of 2004 to 4.3 percent in 2005.

Private services, on the other hand, decelerated by 4.6 percent as private educational services contracted by 3.2 percent from 5.0 percent last year.

Industry held up. Contributing 1.4 percentage points to total GDP growth, the industry sector grew steadily at 4.2 percent. Construction rose at a faster pace of 7.9 percent from 1.7 percent in 2004 while electricity and water similarly expanded by 5.6 percent from 5.1 percent in the first quarter of last year. Manufacturing, which contributed almost 1 percentage point to GDP growth, grew by 4.2 percent explained mainly by the double-digit growth rates in the production of petroleum products and coal and miscellaneous manufactures[1].

The sector's growth, however, was weighed down by mining and quarrying whose year-on-year growth slumped from a hefty 21.7 percent to -4.4 percent because of the substantial decline in gold production. Also pulling down growth in the sector was the production of machineries and tobacco. Cigarette production was observably lower as manufacturers anticipated the increase in excise tax for tobacco products and built up inventory last year.

Table 2. Contributors to Growth in Manufacturing

	Growth Rates Q1 2005 (in %)
TOP GAINERS	
Products of Petroleum and Coal	21.0
Miscellaneous Manufactures	33.7
Electrical Machinery	6.1
TOP LOSERS	
Machinery except electrical	-37.3
Tobacco manufactures	-30.8
Food manufactures	-0.5

Source: NSCB

Growth reversal in agriculture. Contrary to the National Economic Development Authority's (NEDA) earlier assessment that the impact of El Niño will only be mild due to government interventions in irrigation and cloud seeding,[2] agriculture, fisheries and forestry recorded a negative growth of 0.1 percent in the first quarter of the year. This is a complete turnaround from the phenomenal 8.6 percent growth it registered in the first quarter of 2004.

Almost all major crops, except coconut and banana, contracted because of El Niño. Both palay and corn productions posted negative growth rates of 1.5 percent and 18.3 percent from a robust growth of 13.1 percent and 13.4 percent in the first quarter of 2004, respectively. There was also a decline in the production of mango, coffee, tobacco, garlic and onion, among others. The 40.5-percent drop in forestry production, on the other hand, was due to the Department of Environmental and Natural Resources order that cancelled and suspended logging permits in the country.[3]

The fisheries sector remained strong with a growth rate of 5.9 percent, albeit much lower than its 19.5-percent growth in the first quarter of 2004. The 7.5-percent expansion in poultry also mitigated the slide in agriculture.

On the Expenditure Side

Growth in personal consumption expenditure (PCE) continued to drive the domestic economy although it slowed down to 5 percent from 5.7 last year. Consumer spending was supported by strong inflows of remittances from overseas Filipino workers, who sent home US$2.3 billion in the first three months of 2005, up by 16.6 percent from a year ago. According to the Bangko Sentral ng Pilipinas (BSP), the continued deployment of higher-paid workers,

[1] Miscellaneous manufactures include jewelry and related articles, musical instruments, sporting goods, games and toys and other manufactures not elsewhere classified.

[2] NEDA Economic Prospects for 2004-2005, 17 January 2005

[3] NSCB's Press Release, May 30, 2005

such as nurses, engineers and musicians and the rising demand for Filipino seamen, resulted in the increase in remittances.[4]

Table 3. OFW Remittances, January-March 2004 and 2005 (in US$ '000)

Month	2004	2005	%Inc/Dec
January	624,267	723,160	15.8
February	609,116	719,931	18.2
March	724,460	839,586	15.9
Total	1,957,843	2,282,677	16.6

Source: BSP

Higher commodity prices dampened PCE growth as the inflation rate averaged 8.5 percent in the first quarter. The increase in food expenditures, which comprise more than half (53%) of total PCE, slowed to 5.1 percent from 5.6 percent last year. The decline in PCE was most observable in clothing and footwear whose growth plunged from 7.1 percent to 2.3 percent; and fuel, light and water expenditures whose growth decreased from 2 percent to -2.6 percent.

Table 4. Personal Consumption Expenditure by Purpose, Growth Rates (in %)

Expenditure Group	Q1 2004	Q4 2004	Q1 2005
Personal Consumption Expenditure	5.7	5.7	5.0
Food	5.6	5.7	5.1
Beverages	5.1	5.1	1.3
Tobacco	2.1	1.0	2.3
Clothing and Footwear	**7.1**	**4.5**	**2.3**
Fuel, Light and Water	**2.0**	**1.0**	**-2.6**
Household Furnishings	3.2	2.7	1.3
Household Operations	2.9	2.8	2.8
Transportation and Communications	13.5	14.0	17.5
Miscellaneous	6.3	5.9	4.0

Source: NSCB

Public consumption also slowed down from 4.1 percent in the first quarter of last year to 0.9 percent this year as the government continued implementing austerity measures to rein in the budget deficit. Capital formation, likewise, contracted by 4.1 percent, from 7.7 percent the previous year on account of reduced investments in durable equipment and breeding stocks.

Sluggish external trade. Total external trade in the first three months shrank due to faltering exports and reduced imports. It now stands at US$18.92-billion, down 0.1percent from US$18.95 billion in the same period last year. Overall, total exports still went up by 3.1 percent.[5] This, however, pales in comparison to last year's 11.6 percent export growth rate. Exports weakened due to the slowdown in global demand for electronics as a result of inventory buildup and cost pressures from higher fuel. Electronics account for almost two thirds of the country's total merchandise exports.

Export figures would have been much less if not for the 13.4 percent growth of principal merchandise exports, which include the country's other key export items such as garments, finished electrical machinery, and semiconductors, among others. Also contributing significantly was the monetization of gold, which grew by a whopping 754.2 percent from its huge drop of 87.2 percent in the same period last year.

Table 5. Export Growth

	Q1 2005	Q1 2004
TOTAL EXPORTS (Cumulative)		
FOB Value (in Million pesos)	9,519.81	9,193.22
Average Year-on-Year Growth (in %, at current prices)	3.6	5.9
ELECTRONIC PRODUCTS		
FOB Value (in Million pesos)	6,300.4	6,154.16
Average Year-on-Year Growth (in %, at current prices)	2.3	3.3

Source: NSO

The growth of exports of non-factor services slowed down as well from 28.2 percent last year to 2.7 percent in the first quarter this year. The growth of miscellaneous services, which include call centers, customer relations, accounting, and other business services, provided for companies located overseas, dropped to 13 percent from a high of 74 percent. Travel services barely grew at 0.5 percent from 24.0 percent last year.

The decline in first quarter imports to US$9.40 billion from US$9.75 billion a year ago was also a reflection of weak spending for electronic products. Payments for electronic products in March declined by 13.1 percent and

[4] BSP Press Release, May 13, 2005
[5] At constant prices

amounted to only US$1.41 billion compared to US$1.63 billion a year ago. Analysts explain that a lot of manufacturers are trying to limit their imports and production due to higher costs.

External trade is expected to remain sluggish for the rest of the year. Analysts project that the lower merchandise exports for the first quarter is a signal for weaker export performance in the coming months. Lesser import demand, particularly for electronic products, similarly suggests weak demand for Philippine electronics exports as almost all imports of electronic parts are used as raw materials for exports. The Semiconductor and Electronics Industries in the Philippines, Inc. agrees that the electronics industry may not be able to post significant growth this year, and forecasts only a 5-percent growth.[6]

Moreover, unless US and Japan, the country's top trading partners, get out of the global slowdown, trading gains are expected to hold back for the whole year. For the first quarter of 2005, the United States economy has fallen to its lowest growth of 3.1 percent in two years, below the predicted rate of 3.5 percent.[7]

Inflation and Growth

The pressures of higher inflation will continue to moderate growth this year. Inflation in the first five months of the year has doubled compared to the same period last year. NEDA projects inflation to rise to 5 to 6 percent compared to the original targets of 4 to 5 percent in 2005.[8] Behind the high inflation rates is the continued and sustained rise in oil prices.

Table 6. Inflation Rates, in percent

	2004	2005
January	4.1	8.4
February	4.0	8.5
March	4.2	8.5
April	4.3	8.5
May	4.5	8.5
June	5.4	
July	6.6	
August	6.8	
September	7.2	
October	7.7	
November	8.2	
December	8.6	
Average	6.0	8.5
NEDA Target (revised)	4-5	4-5 (5-6)

Source: NEDA

In December 2004, average crude oil prices shot up to US$38 per barrel from just US$29 per barrel in December 2003. This year, oil prices have gone to as high as US$58 per barrel.[9] As such, local pump prices have increased 36 times (versus only 10 price rollbacks) since January 2003. Unleaded and diesel prices went up by 43 percent and 68 percent, respectively during this period.

Table 7. Comparative Petroleum Prices

	Dec 2001	Dec 2002	Dec 2003	Dec 2004	May 2005
Average Crude Oil Import Prices ($/barrel)	18.24	28.95	28.13	38.31	49.27
Domestic Pump Prices					
Unleaded (P/liter)	16.24	17.97	21.02	27.96	30.02
Diesel (P/liter)	12.99	14.25	16.38	23.48	27.48

Source: Department of Energy, International Energy Agency (IEA)

A second round effect will push inflation higher in the coming months resulting from the following:

- Pending increase in jeepney fares of as much as P2 is being contemplated to be implemented this year.
- The Energy Regulatory Commission has approved the increase in generation rates of National Power Corporation (NPC) as a result of adopting new methods for computing generation rates (return on rate base and time-of-use method) as well as to allow the NPC to recover from increasing fuel costs. Of the P1.80/kwh increase in generation rates in Luzon that will be applied in June this year, P0.78/kwh (about 18% of generation rates) is actually due to the increase in fuel costs.
- The petitions for the increase in minimum wage have already been granted in different

[6] Vila, L. (May 11, 2005)
[7] Beams, N. (May 2, 2005)
[8] BSP has likewise revised its baseline average inflation forecast for the year from 6.8 to 7.0 percent to 7.0 to 7.3 percent.
[9] Intra-day trading for US light crude

regions in the country beginning May this year. Recently, 16 regional tripartite wages and productivity boards have approved increases minimum wages by P5 (Mimaropa) to P25 (Metro Manila) per day effective mid-June this year. The BSP estimates that, at most, wages should only increase by 6 percent or P18 per day this year for the economy to keep growing and for workers to maintain their purchasing power.[10]

- The recently enacted expanded value-added tax (VAT) law is expected to further put upward pressure on inflation when it is implemented in July this year. The increase in prices for fuel and power, which were previously VAT-exempt, will have the most significant impact on inflation. NEDA estimates that the VAT law will increase inflation by as much as 0.83 percentage points this year.

How significant is the impact of high oil prices to the economy?

Estimates show that the oil price hikes will slow down global growth by 0.2 to 0.5 percentage points in 2005. The impact of oil price shocks is less during this period compared to the 1970s that caused a world recession. This is because the present conditions in the global economy have provided natural cushions for countries to absorb the oil price hikes. For one, oil intensity or the average oil consumption per economic output, has fallen in many countries. This means that there is lower incremental oil demand for every incremental growth in the economy. Also, prudent monetary policies to curb inflation are applied in more economies, which was not the case in the 1970s. Markets have likewise provided tools for hedging to minimize volatility in the market.

Table 8. Effects of a *Temporary* increase of oil prices by US$10 per barrel in deviations from Baseline on GDP (% points), Inflation (% points) and Current Account (% of GDP)

	2005 (ADB)		2005 (Citigroup)			2006 (Citigroup)		
Country	GDP	Inflation	GDP	Inflation	CA	GDP	Inflation	CA
China	-0.6	0.3	-0.4	0.3	0.4	-0.1	-0.1	0.6
Hong Kong	-0.5	0.2	-0.4	0.1	-0.3	-0.6	-0.1	0.1
Korea	-0.5	0.4	-0.2	0.2	0.1	-0.3	0.2	-0.1
Taiwan	-0.3	0.2	-0.2	0.1	-0.7	-0.1	0.1	-0.1
Indonesia	0.0	0.6	-0.9	0.2	0.1	-0.4	0.3	0.1
Malaysia	-0.7	0.7	-0.6	0.4	0.6	-0.4	0.3	-0.2
Philippines	-1.5	0.7	-0.7	0.6	0.4	-0.3	0.5	0.1
Singapore	-1.2	0.6	-0.1	0.4	0.3	0.1	0.2	-0.3
Thailand	-1.7	0.8	-0.6	0.6	0.2	0.2	0.6	-0.1

Source: ADB, Dowling (2005)

Both the Asian Development Bank and the Citigroup use the Oxford Economic Forecasting Method. Differences in estimates may be due to the varying lengths of time for *temporary* oil increase.

Table 9. Effects of a *Permanent* increase of oil prices by US$10 per barrel in deviations from Baseline

	2005 (ADB)		2005 (Citigroup)			2006 (Citigroup)		
Country	GDP	Inflation	GDP	Inflation	CA	GDP	Inflation	CA
China	-0.6	0.5	-0.7	-0.5	-0.1	-1	0.5	0.7
Hong Kong	-0.6	0.3	-0.6	0.3	-0.7	-1.5	0.2	-0.6
Korea	-0.6	0.8	-0.4	0.3	-0.9	-0.8	0.8	-0.8
Taiwan	-0.4	0.3	-0.4	0.4	-0.6	-0.6	0.5	-0.6
Indonesia	0.1	1.3	-1.1	0.9	1.3	-1.9	1.2	1.5
Malaysia	-0.9	1.4	-1.1	1.5	0.4	-1.8	1.9	0
Philippines	-1.9	1.4	-1.3	1.7	-0.6	-1.8	2.3	-0.5
Singapore	-1.7	1.3	-0.6	1.5	-1	-0.4	1.8	-1.3
Thailand	-2.2	1.5	-1.3	1.8	-1.2	-1.3	2.6	-1.2

Source: ADB, Dowling (2005)

Both the Asian Development Bank and the Citigroup use the Oxford Economic Forecasting Method. Differences in estimates may be due to the varying lengths of time for *permanent* oil increase.

[10] Fajardo (2005)

The impact will, however, vary from country to country depending on its economic structure, particularly its dependency on oil, current account balance, foreign exchange reserves, access to foreign capital markets, fiscal flexibility and capacity to absorb inflation. In general, developed countries are likely to be less adversely affected by the recent oil price hikes. For developing countries, however, the impact will be more pronounced. The International Monetary Fund (IMF) estimates the impact of the oil price increases on oil-importing emerging economies will be a 1 to 1.5 percentage point reduction in GDP.

Simulations on the impact of high oil price increases on East Asian countries show that the Philippines will be one of the most severely affected countries together with Thailand and Singapore. Table 8 shows that a temporary increase in oil prices of US$10 per barrel will reduce the country's GDP between 0.7 to 1.5 percentage points and will push inflation up by 0.6 to 0.7 percentage points. If the increase of US$10 per barrel would be permanent, the country's GDP would be reduced by 1.3 to 1.9 percentage points in 2005. Inflation would also shoot up by 1.4 to 1.7 percentage points. (Table 9)

A significant factor is the fact that even as oil intensity across the world has generally reduced, it has remained relatively high for Philippines and other Asian countries (Table 10).

Table 10. Oil Consumption as Percentage of GDP, Selected Countries

	Oil Usage (as % of GDP)						
	1975	1989	1995	1999	2000	2001	2002
EU15	3.1	1.5	0.9	1.0	1.8	1.5	1.9
US	4.2	2.1	1.5	1.4	2.1	1.8	1.8
Japan	4.1	1.1	0.7	0.8	1.2	1.2	1.3
Singapore*	10.3	8.3	4.7	5.5	7.5	7.7	7.6
Indonesia	2.8	3.6	2.5	4.6	7.3	6.8	5.9
Thailand	5.0	3.3	2.7	4.0	6.3	5.6	5.6
Malaysia	3.5	4.0	2.7	3.7	5.2	4.2	4.9
Philippines	5.5	3.5	2.9	3.3	4.9	4.4	4.1
China	3.5	3.3	3.0	3.0	4.9	3.9	4.0
S Korea	5.5	2.6	2.6	3.6	5.1	4.8	4.0
Taiwan	5.8	2.4	1.7	1.7	2.8	2.5	2.8
Hong Kong	3.9	1.2	0.9	0.8	1.3	1.1	1.6

Source: BP Statistical Review of World Energy, CEIC, IMF, UOB
*Singapore's ratio is high due to its large oil trade, e.g., marine bunkering and oil refining activities. Actual comparable ratio would be at less than 3% of GDP.

At the heart of the concerns on oil price hikes, thus, are the questions: Until when will prices move upward? And, how high will prices go? A clear understanding of the dynamics of the recent oil price hikes can provide general directions on what the market can expect, and likewise limit any policy mistakes that may arise from adjustments that will be made to mitigate the inflationary impact of rising world oil prices.

Why have oil prices increased?

The increase in oil prices in the last two years has primarily been demand-driven and aggravated by supply concerns.

- ***Demand has been increasing in North America and Asia***. In 2004, global demand for oil grew by 3.3 percent or 2.7 million barrels a day (mbd), the highest in nearly 30 years. This growth in demand is most apparent in Asia, particularly China, where demand has grown three times faster than the growth in OECD countries in 2003. In China, oil demand increased by as much as 16 percent in 2004 and is further expected to increase by 8 percent this year.

Table 11. Oil Demand for Selected Countries, (in mbd)

	2002	2003	2004	2005
US	19.8	20.0	20.5	20.8
Japan	5.5	5.6	5.4	5.4
China	5.0	5.5	6.4	6.9
Korea	2.2	2.2	2.1	2.2
Canada	2.1	2.2	2.3	2.3
India	2.3	2.4	2.5	2.5
World	78.0	79.7	82.5	84.3

Source: IEA

- ***Spare capacity for oil has been declining***. In terms of volume, the spare capacity for oil production has decreased from 3 mbd in December 2002 to just 1.7 mbd in December 2004. This is a result of the low investments in oil exploration in the 1990s which, in turn, was due to the low real prices of oil during that period. Investors have been fearful of repeating the mistakes of over investments in the 1970s, and are further discouraged by the current volatility in prices. Likewise, contributing to the decrease in spare capacity is the lack of investments in oil refineries and the mismatch between the type of crude that these refineries can process and the type of crude that is actually being produced. Investments in refineries have also become more expensive because of stricter environment laws being imposed.

Table 12. World Oil Supply and Demand, (in mbd)

	Dec 2002	Dec 2003	Dec 2004	Dec 2005	Dec 2010
Capacity	79.9	0.0	81.7	83.3	93
Demand	76.9	78.1	80.0	81.5 – 82	89 – 93
Excess Capacity	3.0	1.9	1.7	1.3 – 1.8	0 – 4.0
Excess Capacity/ Total Capacity (%)	3.8	2.4	2.1	1.6 – 2.2	0 – 4.3
Average Price	25.0	28.9	37.8	46.5	38.8

Source: IMF

- ***Concerns on supply disruption.*** The tight market situation has caused speculative attacks on oil prices. Given the small reserve capacity, prices become more volatile even with small shocks in fuel supply. This was evident in the behavior of the market with respect to political tensions in oil-producing countries as Iraq, the Yukos in Russia, Venezuela and Nigeria. Estimates on the premium that is added on oil prices due to speculation vary between US$3 and US$15 per barrel.[11] A clear example of this happened in April this year when prices jumped by as much as US$2.40/barrel in a day arising from a report from Goldman Sachs that said oil prices could reach as high as US$105.

How will prices move in the future?

Oil prices will stabilize when demand and supply factors show a semblance of predictability in the coming years. While some of these factors may be temporary, such as speculation, many factors, particularly on the demand side, are permanent. On the demand side, both the US Energy Information Administration and the International Energy Agency predict that world demand for petroleum will remain high in the next two decades. The economies of China and India have already created a new level of demand that will be maintained even if their economies slow down. Another reason why demand is not viewed to slow down is the fact that demand for transportation fuel across countries was shown to be more elastic to income rather than price changes. In short, even if fuel prices have been going up, fuel consumption has remained relatively the same.

Factors that are seen to curtail increases in demand will involve shifts in consumption behavior such as the use of alternative sources of energy and the adoption of fuel efficient technologies as hybrid cars. These factors, however, can only affect the oil markets in the long term.

On the supply side, oil investments and explorations are long-gestating such that their produce will come on stream only in the medium to long term. While normally, high prices should encourage more investments in oil exploration, the uncertainties in the oil market currently hinder investors to go further into oil exploration and production. For one, oil producing countries are more cautious in augmenting oil supply lest they repeat the mistakes they did in the 1970s when they drilled too much, created excessive oil capacity and depressed oil prices.

With the foregoing, prices are expected to remain high in the short to medium term considering the rigidities both at the demand and supply sides. Another factor that will keep prices high in the short term is the fact that a significant percentage of oil supply contracts have already been hedged for the next two to three years.

[11] Gonzales sites analysts' estimate of the premium of speculation on oil prices at US$3 to US$5 per barrel while the Economist puts the premium between US$7 to US$15 per barrel.

Even if oil-producing countries respond to calls of increasing oil supply, limitations in spare capacity and price volatilities would still tend to push prices upwards.

Table 13. Projection for Oil Price in 2005

Analyst	Oil Price Projection			
	Price (US$/barrel)	% increase (Year on Year)	Forecast Horizon	Type of Crude Oil
EIA (US DOE)	54.74 – 54.83	40.1	2005 – 2006	WTI
IMF	46.50	24.8	2005	Ave. Brent, Dubai, WTI
ADB	39.00 – 41.00	7.0	2005 – 2006	Brent
Economist Intelligence Unit (EIU)	38.00		2005	Brent
Morgan Stanley	42.10 44.10	6.5 10.3	2005	Brent WTI

Source: BSP Inlfation Report

The long-run prospects for oil prices would depend highly on how oil-producing countries will react to the current oil price hikes. The decision of OPEC member nations is of particular importance because they have higher known oil reserves.

In sum, there is a general acceptance that the current high oil prices have established a new supply equilibrium and will more likely not go back to the US$30 per barrel level unless there would be demand shocks as was the case in 1997. For oil-importing countries as the Philippines, it may be more helpful then if policy measures are made under the assumption that oil prices will remain high.

Adjusting to High Oil Prices

As earlier discussed, the impact of high oil prices has already seeped into the prices of domestic goods. Inflation is expected to increase as wages increase and as the recently approved expanded VAT law, which will increase power and petroleum prices, takes effect in July this year. The combination of these inflationary factors may necessitate tightening of monetary policies as a tool to create market stability. Interest rates may have to be increased to stave off inflation.

A more sustainable response to higher oil prices, however, must be directed towards changing the country's consumption behavior under an environment where oil prices will remain high. On the one hand, there must be a general policy to increase the use of alternative sources of energy. This is particularly relevant to the power sector where the energy mix must lean towards increasing power sources from geothermal, natural gas, hydropower and even wind power.

On the other hand, general public consumption patterns will have to change. The government is currently undertaking public awareness programs geared to conserve fuel and energy. While the effectiveness of the program has yet to really bear fruition, the government should avoid subsidizing the consuming public's expenses for fuel amidst the continued increase in pump prices. At best, the government should only strengthen the "Oil Deregulation Act" to check and prevent oil cartels.

Prospects for the rest of the year

Growth forecasts of multilateral agencies for 2005 are lower than the government target of 5.3 percent to 6.3 percent. Both the World Bank and Asian Development Bank project a 5.0-percent GDP growth for the Philippines while the IMF sees it at only 4.7 percent. The latest forecast of The Economist's Economic Intelligence Unit placed the country's 2005 GDP growth at 5.1 percent.

Table 14. Growth forecasts for 2005

Institution/Agency	GDP Forecast
National Economic Dev't Authority	5.3- 6.3
Asian Development Bank	5.0
International Monetary Fund	4.7
World Bank	5.0
Economic Intelligence Unit (The Economist)	5.1

NEDA, nonetheless, remains optimistic that the economy will attain the low-end of the economic growth target for 2005. For the second quarter, it expects GDP growth to stay, if not, slightly improve, at its current level as the country continues to bear the negative impact of El Niño and the high crude oil prices. The uptick will most likely be felt during the second semester, as agriculture recovers with the onset of rains and as foreign direct investment commitments start coming in.

Recent fiscal reforms, particularly the newly signed VAT law, are also expected to further improve the economic outlook of the country. This upbeat view is shared by credit rating agencies and investment companies. After their downgrades early this year, Standard & Poor's and Moody's Investor Service maintain their 'stable' outlook on the economy while Fitch Ratings revised its sovereign outlook from negative to stable. The UBS Investment Research, in its latest report, also expressed optimism in the country's fiscal profile.

However, to sustain these positive developments, there is a need to ensure that reforms are properly implemented and administered. More specifically, there is a need to monitor whether the new tax laws are actually generating the targeted revenues. Apart from this, the government should also keep in check its contingent liabilities, address the undercapitalization problem of banks and their high levels of non-performing loans and assets, among other financial reforms.

Governance reforms also have to be vigorously pursued to further boost growth. Currently, the Arroyo administration is facing corruption charges spawned by *jueteng* and the surfacing of a controversial audio tape implicating the President of rigging last year's elections. These have sowed fear among investors in the country, adversely affecting the stock market and the value of the peso. Governance reforms will help minimize uncertainties such as these from happening again.

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