



Economic Report

SENATE ECONOMIC PLANNING OFFICE

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1st Semester figures herald challenging times in 2008

After capping the year 2007 with its highest growth in the last 30 years, the domestic economy bowed to external pressures and soaring food and fuel prices in the first half of 2008. The deceleration will likely continue for the rest of the year as risk aversion in the global financial markets remain.



The SEPO Economic Report is a quarterly publication of the Senate Economic Planning Office. Its purpose is to provide useful information on the current state of the economy to the Senators and Senate Officials. The SEPO Economic Report is also available at www.senate.gov.ph.

I. Gross Domestic Product

After its very impressive performance in 2007, the Philippine economy is now wobbling under the pressure of soaring inflation and weak external demand. Gross Domestic Product (GDP) in the first semester of 2008 was a lackluster 4.6 percent growth. Although there is no danger of a recession, economic growth for this year will certainly be slack compared to its 2007 levels. Moreover, meeting the full-year growth target of at least 5.5 percent will be tough as the economy will need to grow by 6.4 percent in the second half.

Production side

Services sector. The services sector, which accounts for 49.2 percent of GDP, is still the foremost economic growth driver. It grew by 5.4 percent during the first semester of the year, a pale contrast to the 8.4 percent growth it posted the previous year.

With the exception of ownership of dwelling and real estate (ODRE), all other services subsector contracted during the first half of the year. ODRE averaged at a robust 7.3 percent for the first semester of 2008 on the back of strong demand for residential units by OFWs and for mall leasing requirements. The high real estate growth also manifested itself in the strong performance of the electricity, gas and water (EG&W) subsector, which registered an 8.6-percent growth in the first semester of the year.

Rising interest rates and heightened risk aversion in the global financial markets contributed to the significant decline of the finance subsector. It posted a 2.4-percent growth during the second quarter, a marked slowdown compared to its 14.2 percent growth during the same period last year and to its 12.2 percent growth in the first quarter of 2008.

Table 1. GDP and GNP Growth Rates at Constant Prices, (in percent)

Indicators	1st Quarter		2nd Quarter		1st Semester	
	2007	2008	2007	2008	2007	2008
Gross Domestic Product	7.0	4.7	8.3	4.6	7.6	4.6
<i>Net Factor Income from Abroad</i>	11.3	18.3	25.3	14.1	18.7	15.9
Gross National Product	7.3	5.8	9.8	5.5	8.6	5.7
by Industry						
1. Agriculture, Fishery and Forestry	4.0	2.7	4.2	4.9	4.1	3.7
Agriculture & Fishery	4.1	2.7	4.3	4.9	4.2	3.7
Forestry	-6.3	2.4	-8.4	-1.6	-7.6	-0.1
2. Industry	6.6	3.0	10.3	4.8	8.6	3.9
Mining & Quarrying	14.7	14.1	38.9	-18.5	28.0	-5.3
Manufacturing	4.1	2.4	3.4	6.1	3.7	4.3
Construction	21.7	-3.4	37.0	8.3	30.4	3.7
Elect, Gas and Water	4.4	9.5	5.4	7.9	5.0	8.6
3. Service	8.4	6.5	8.4	4.3	8.4	5.4
Transport., Comm., Storage	10.5	5.6	9.6	3.3	10.0	4.4
Trade	7.2	5.8	7.6	4.3	7.4	5.0
Finance	16.3	12.2	14.2	2.4	15.2	7.2
Ownership of Dwellings & Real	5.5	7.3	6.0	7.3	5.8	7.3
Private Services	8.4	5.7	9.1	6.2	8.8	6.0
Government Services	1.7	4.0	2.4	2.4	2.0	3.2
by Expenditure						
1. Personal Consumption	5.9	5.2	5.6	3.4	5.7	4.3
2. Government Consumption	9.5	1.9	11.9	-5.1	10.8	-1.9
3. Capital Formation	8.7	4.0	17.6	14.7	13.0	9.4
Fixed capital	10.3	2.9	20.9	5.6	15.7	4.3
Construction	20.4	-3.1	34.4	8.1	28.2	3.5
Durable equipment	4.3	8.6	8.8	4.0	6.4	6.4
Breeding stock & orchard dev't	2.0	-2.0	7.1	-5.0	4.4	-3.5
4. Exports	10.8	-6.1	4.9	7.7	7.6	1.2
Merchandise exports	8.2	-11.0	6.3	5.5	7.2	-2.2
Non-factor services	23.1	14.8	-1.4	18.3	9.4	16.5
5. Less: Imports	-1.8	-5.8	-10.5	-1.0	-6.5	-3.4
Merchandise imports	-3.0	-7.3	-11.6	-2.5	-7.6	-4.8
Non-factor services	14.5	12.3	12.0	21.6	13.3	16.6

NSCB: National Income Accounts

Mounting oil prices contributed to the contraction of both land and air transportation bringing the transportation, communication, and storage (TCS) subsector growth down to 4.4 percent in the first half from 10.0 percent last year. Inflation likewise adversely affected consumer demand, resulting in a sluggish performance of the trade sub-sector. In particular, retail trade posted a languid 3.0 percent in the first semester compared to the 8.8 percent in the previous period.

Table 2. Top Gainers and Losers in Manufacturing First Semester 2007 and 2008

Top 5 Gainers	First Sem 2007	First Sem 2008
Leather & leather products	9.6	47.0
Beverage	21.7	2.6
Footwear & wearing apparel	13.0	15.9
Metal industries	13.5	11.0
Food	5.6	7.5
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Top 5 Losers	First Sem 2007	First Sem 2008
Textile manufactures	1.2	-10.5
Wood and cork products	21.6	-18.1
Furniture and fixtures	20.7	-0.5
Publishing and	7.1	-7.9
Non-metallic mineral prod.	18.3	4.7

NSCB: National Income Accounts

Table 3. Losers in Mining & Quarrying Sub-sector First Semester 2007 and 2008

Sub-sectors	First Sem 2007	First Sem 2008
Nickel	191.0	-39.1
Crude	26.0	-10.7
Chromium	-10.9	-51.9
Other non-metallic	39.5	-0.3

NSCB: National Income Accounts

Table 4. Top Agricultural Sub-sectors First Semester 2007 and 2008

Sub-sectors	First Sem 2007	First Sem 2008
Palay	2.9	5.8
Corn	5.7	19.6
Banana	7.3	20.8
Sugarcane	-6.5	25.0

NSCB: National Income Accounts

Industry sector. The industry sector accounts for 34.2 percent of GDP. It posted a positive, albeit reduced, growth of 3.9 percent and contributed 1.6 percentage points to total GDP growth in the first half of 2008.

Despite weak external demand, the manufacturing sector still managed to grow by 3.4 percent in the first quarter to 6.1 percent in the second quarter. Footwear and wearing apparel and food manufactures propelled the manufacturing subsector by their double-digit second quarter growth of 18.7 percent and 12.7 percent, respectively. The depreciation of the peso, which made imports more expensive, helped strengthened domestic demand for food manufactures. Increasing capacity utilization and, in turn, production volume also explains the growth of the food, beverage, and leather manufactures.

Construction also expanded but at a decelerated pace of 8.3 percent during the second quarter, largely brought about by the considerable 25 percent growth of private construction. Public construction, however, served to dampen construction growth as it fell to -6.4 percent in the first half of 2008 from 59.4 percent during the same period in 2007.

The dismal performance of the mining and quarrying (M&Q) sub-sector resulted from the slump in nickel mining, crude oil, chromium mining, and other non-metallic mining.

Agriculture, fishery and forestry sector. The agriculture, fishery and forestry sector grew by 3.7 percent in the first semester, slower than last year's 4.1 percent, and contributed 0.67 percentage point to over all GDP growth.

Agriculture's growth was boosted by the strong performance of the palay, corn, banana and sugarcane sectors. Palay, corn and banana reaped the benefits of favorable weather and full support from the government. The growth of palay and banana sectors was also attributed to an increase in area harvested. Sugarcane's harvest likewise increased as the price of sugar in the world market soared.

Fishery's growth, particularly commercial fishing, stalled on account of high oil prices.

Expenditure side

Personal consumption expenditure. Inflation took a toll on consumer spending as it fell from 5.7 percent last year to 4.3 percent in the first half of 2008. While demand for other consumer goods has gone down, spending on household furniture has accelerated. This mirrors the increasing demand for residential units.

Government expenditure. Despite the government's earlier pronouncements that it will increase spending to counter the contractionary effects of higher inflation and interest rates, government expenditure still petered out to -1.9 percent in the first half of 2008. The low absorptive capacity of agencies tasked to implement infrastructure projects is often cited as a factor that contributed to the 1.9 percent contraction of government spending. This reflects, in part, the agencies' inability to carry out activities for project planning and feasibility and engineering studies. For instance, efforts to rationalize the bureaucracy have reportedly resulted in operational bottlenecks in the Department of Transportation and Communication such that there is an insufficient number of technical staff available for the implementation of programmed infrastructure projects.

Capital formation. Investment accelerated to 14.7 percent in the second quarter from 4.0 percent in the first quarter due to the considerable hike in private construction activities. Durable equipment contributed to investment's growth, maintaining its first semester 6.4-percent growth. This growth was mainly driven by agricultural machineries, sugar mill machineries, transport equipment (particularly road and water), and mining and construction machineries.

Exports. Total exports posted a bleak 1.2 percent growth in the first semester of 2008. The economic slowdown currently being experienced by other major trading partners resulted in the slowdown in export growth.¹

Merchandise exports contracted by 2.2 percent during the first half of 2008. Top export earners -- semiconductors and electronic microcircuits and finished electrical machinery -- both recorded downturns, with a negative 5.8 percent and a negative 30.5 percent, respectively.

Services export, on the other hand, grew vigorously by 18.3 percent during the second quarter, primarily derived from the expansion of

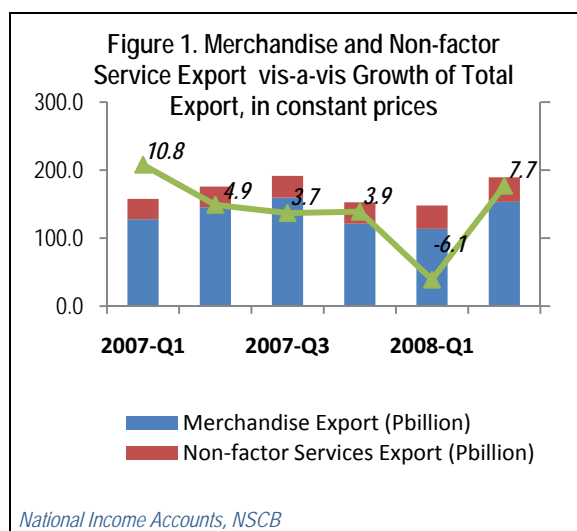


Table 5. Top 10 Exports, Growth Rates, First Semester 2007 and 2008

Items	First Sem 2007	First Sem 2008
1. Garments	-12.3	-1.5
2. Semiconductors and electronic micro circuits	3.9	-5.8
3. Finished elect'l machy	32.1	-30.5
4. Other prods. manufactured	9.6	-16.0
5. Ignition wiring sets	7.8	6.5
6. Crude coconut oil	-43.2	59.4
7. Cathodes, section of cathodes, of refined copper***	13.0	-18.0
8. Shrimps and prawns	-4.7	-15.2
9. Gold from copper ores	-6.3	26.6
10. Banana and plantains	-2.9	-1.7

*** Formerly bars, rods of copper

National Income Accounts, NSCB

¹ The global economic slowdown that started in the US is now slowly spreading across the Euro zone, Japan, and possibly China.

Table 6. Inflation Rates of Selected Asian Countries

Countries	2007	2008	
		Q1	Q2
Indonesia	6.4	7.6	8.9
Korea	2.5	3.7	4.1
<i>Philippines</i>	<i>2.8</i>	<i>5.6</i>	<i>9.7</i>
Thailand	2.3	5.0	6.2
Vietnam	8.3	8.0	21.4

Source: BSP for 2008 data, ADB for 2007 data

offshoring and outsourcing services in the country.² Exports of crude coconut oil, gold from copper ores, and copra oil also grew considerably as these products benefitted from the high prices they fetch in world commodity markets.

The BSP anticipates that the country's trade deficit to rise to US\$11.5 billion, equivalent to 6.0 percent of the country's GDP, from US\$8.24 billion last year. This is a reflection of the country's rising import bill due to high global prices of oil and rice and a decline in export earnings. The Bangko Sentral ng Pilipinas' (BSP) earlier forecast was pegged at US\$9.31 billion deficit.

Imports. Total imports continued to contract to -3.4 percent in the first semester of 2008. The contraction, however, is smaller compared to the -6.5 percent posted last year due to the increase in both merchandise and non-factor services imports. The increase in merchandise imports was due to massive importation of cereals and cereal products (e.g. rice), which grew by 33.5 percent. Imports of non-factor services grew by 16.6 percent, driven by robust demand for government (63.8%), miscellaneous services (20.5%), and travel (9.7%).

II. Inflation

Surges in global prices of oil and food have largely been driven by supply constraints during the second half of last year. Headline inflation rates continued to rise sharply during the first half of this year even as economic growth moderated across the Asian region.

In the Philippines, headline inflation in the first quarter of 2008 reached 5.6 percent, much higher than the first quarter 2007 figure of 2.9 percent. It hit double figure at 11.4 percent last June, bringing the second quarter average to 9.7 percent. Last July, headline inflation was recorded at a 17-year high of 12.2 percent, leading some economists to expect a peak of 13 percent in October of this year.

Core inflation has also risen.³ Core inflation for the second quarter was 6.2 percent, significantly higher than the 2.6 percent posted during the same period last year. This implies that the dynamics of food and oil prices has fed into other prices. Thus, a much more broad-based,

Figure 2. Headline and Core Inflation
1st qtr. 2006 - 2nd qtr. 2008

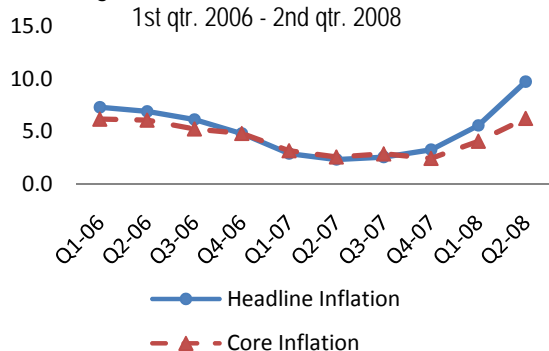
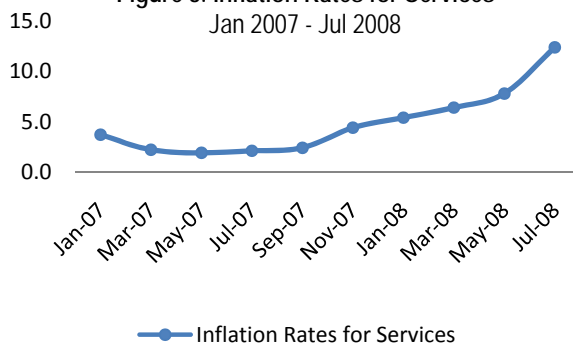


Figure 3. Inflation Rates for Services
Jan 2007 - Jul 2008



Source: National Statistics Office

² Growth drivers in non-factor services comprised of insurance; government services; and miscellaneous services that include contract centers, medical transcription, and software development.

³ Core inflation measures the change in average consumer prices *excluding* certain items in the CPI with volatile price movements (e.g. agricultural food supplies and international oil prices). As such, core inflation may be viewed as a measure of underlying long-term inflation and as an indicator of future inflation (NSCB).

second-round effect is already underway as inflation expectations drift upwards.

Mounting core inflation is due to the acceleration of the services index, which rose considerably during the first half of the year.⁴ It increased from 2.1 percent during the second quarter of 2007 to 8.2 percent during the same period in 2008. Tuition fee hikes, increments in the price of school supplies, textbooks and medicines, increases in transport fares and higher charges for personal services – all contributed to the acceleration of the services index.

III. Financial Sector and Investments

The current inflationary environment has led the BSP to raise its key policy rates starting June when it initially raised rates by 25 basis points. The BSP again increased rates by 50 basis points in July, and then by 25 basis points last August. To date, the rate for reverse repurchase (RRP or overnight borrowing) is 6 percent and the rate for repurchase facility (RP or overnight lending) is 8 percent. Interest rates on term RRP, RPs, and special deposit accounts (SDAs) were adjusted accordingly.

However, market response to monetary tightening was rather subdued. While policy rates increased by 100 basis points (bps), markets rates went up by an average of only 40 bps. Moreover, commercial banks' lending continued to accelerate by 24.2 percent year-on-year last June. During the same period, production loans increased by 15.7 percent, while consumer loans grew by 22.0 percent. Acceleration of bank lending tells of a healthy credit environment.

Worries over a global economic slowdown heightened uncertainty and risk aversion in financial markets. Stock market activity turned bearish. Total value of stock market transaction amounted to PhP55.7 billion in June, 64.2 percent lower than the value in June of last year. Stock market activity is expected to further deteriorate as the US Congress rejected the bailout plan in September 30.

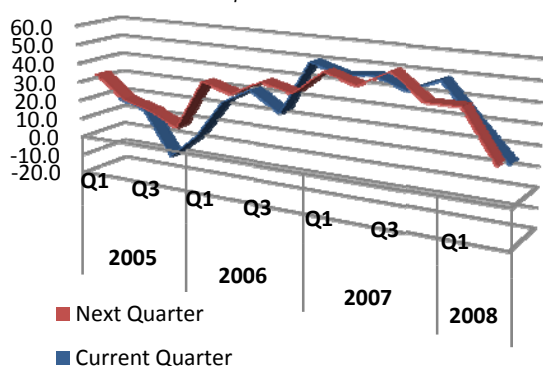
Moreover, a significant change in business sentiment occurred within the last four quarters. Although business outlook remained positive during the first semester of 2008, the overall business confidence index indicated a sharp decrease from 40.9 percent in the third quarter of 2007 to 12.6 percent in the second quarter of this year.

Table 7. Treasury Bill Rates (in percent)

	91-day	182-day	364-day
2007			
Q1	3.149	3.688	4.165
Q2	2.973	3.713	5.174
Q3	3.680	4.776	5.530
Q4	3.706	4.715	5.589
2008			
Q1	3.673	4.670	5.384
Q2	3.673	4.670	6.600

Source: Bangko Sentral ng Pilipinas

Figure 4. Overall Business Confidence Index, Q1 2005 - Q2 2008



Source: Bangko Sentral ng Pilipinas

⁴ The services index carries a consumer price index (CPI) weight of 12.28 percent (NSO).

Foreign direct investments (FDI) and portfolio investments also registered substantial decreases. Total FDI during the first five months amounted to US\$725 million, 31.5 percent of the US\$2.3 billion during the same period in 2007. The BSP is expecting lower investment inflows this year, with FDI forecast at only US\$2.6 billion, down from last year's US\$2.7 billion.

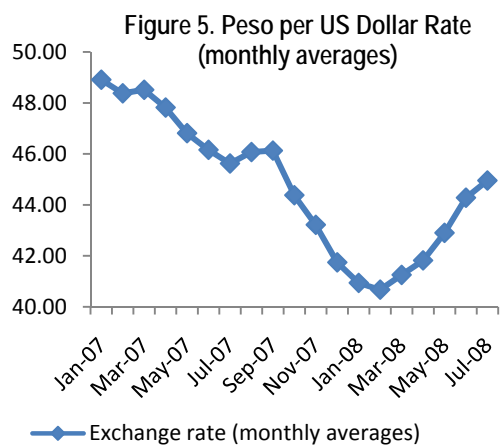
Table 8. Foreign Direct Investments and Portfolio Investments (in US\$ million)

	2007	2008
FDIs (Jan to May total)	2,300	725
Net Portfolio Investments (Jan to June total)	2,552.5	-417.4

Source: Bangko Sentral ng Pilipinas

Despite a dimmer picture for 2008, continuing reforms in the financial sector is directed towards maintaining a strong banking system and a robust domestic capital market. In terms of resources, the Philippine banking system's assets base has grown steadily by 50 percent, from P3.4 trillion in 2001 to P5.1 trillion as of the first quarter of 2008 on the back of sustained increases in deposits and capitalization. Overall asset quality of Philippine banks has made a dramatic turnaround, with NPL ratio dropping from 16.9 percent in 2001 to 5 percent as of March 2008. Structural reforms have also been put in place including: (1) the adoption of international accounting standards; (2) the enforcement of stricter governance standards; and (3) the fast track implementation of risk-based supervision technology. These have made the domestic banking system more resilient to withstand volatilities in financial markets.

IV. External Sector



Source: Bangko Sentral ng Pilipinas

The peso was the strongest performing Asian currency in 2007, but rising risk aversion among global investors together with high inflation affected the peso-dollar exchange rate. The peso has depreciated by 9 percent since the start of the year – a reversal from the 18 percent appreciation last year. Such reversal was somehow anticipated given the steep climb of the peso's value last year.

Despite this, the country may still be able to achieve a balance of payment (BoP) surplus this year. First quarter balance of payments yielded a surplus of US\$1.7 billion. This is 20.8 percent higher than the surplus in the same period last year, as both the current and the capital and financial accounts continue to post surpluses. A BoP surplus will (once again) be supported by strong remittance inflows, robust receipts from export of services, and hefty tourism receipts.

Gross international reserves (GIR) as of July reached US\$36.9 billion, equivalent to six months of import cover. Most of the inflow was accounted for by the deposits made by the Power Sector Assets and Liabilities Management Corporation (PSALM) and the BSP's net foreign exchange operations and income from investments abroad.

Also, total remittances totaled US\$8.2 billion for the first semester, 17.2 percent higher than the amount registered a year ago. The robust growth in remittance inflows is largely explained by the continuing rise in the number of deployed Filipino workers⁵ and by the expanding number (and networks) of local banks and non-bank remittance agents in countries with large concentration of overseas Filipino workers. Major sources of remittances include the USA, which accounted for 48.3 percent of the total amount, followed by Saudi Arabia, Canada, and the UK.

Furthermore, the weakness of the peso against the dollar of late is expected to help boost tourist spending. Department of Tourism (DoT) data shows that tourist receipts in the first five months of the year totaled US\$1.4 million, 7.4 percent higher than the US\$1.3 million recorded last year.⁶

V. Employment

Labor force participation rate from January to July 2008 averaged at 63.6 percent, lower than the 64.3 percent reported during the same period last year. Employment levels improved to 92.6 percent in July 2008 from 92.2 percent in July 2007.

An average of 420,000 jobs were generated year-on-year from January to July, yet again well below the annual target of 1.2 million to 1.6 million jobs. Employment in the agricultural sector grew by 5.3 percent, generating an equivalent of 270,000 jobs. Employment in the service sector also grew by 4.3 percent, equivalent to 234,000 jobs.

However, employment in the manufacturing sector decreased by 4.1 percent, equivalent to 132,000 jobs. This perhaps mirrors the adverse effect of slowing external demand on the country's export manufacturing sector. The displacement of manufacturing workers may partly explain the recent results of a survey by the Social Weather Stations (SWS) last July, indicating that 59 percent of the population rated themselves as "poor."⁷

Table 9. Employment Indicators

Industry	Employment in '000		Growth in %
	Jan-Jul 2007	Jan-Jul 2008	
Total employed persons ('000)	33,522	33,943	3.84
Agriculture	11,666	11,936	5.34
Industry	5,140	5,035	-1.49
- Manufacturing	3,062	2,930	-4.06
Services	16,738	16,972	4.25
Labor Force Participation (%)	64.3	63.6	
Employment (%)	92.3	92.4	
Unemployment (%)	7.7	7.6	
Underemployment (%)	20.8	19.9	

Data is average of January, April, and July figures

Source: NSO, Labor Force Survey, January to July rounds

⁵ Preliminary data from the Philippine Overseas Employment Administration (POEA) showed that for the first half of 2008, the number of deployed Filipino workers rose by a considerable 33.5 percent to 640,401 from 479,725.

⁶ A tourist is estimated to spend US\$83/day in the country. Tourist spending reached a total of US\$4.88 billion in end-2007, 40.9 percent higher than in 2006.

⁷ The figure, released last July, is higher than the 50 percent released during the first quarter.

VI. Fiscal Sector

Table 10. 1st Semester Fiscal Position

Particulars (in Php million)	Jan - Jun 2008		2007/2008
	Actual	Program	Growth
Surplus/(Deficit)	(18.00)	(40.97)	(56.1)
Revenues	569.99	561.72	11.7
Tax Revenues	512.27	500.15	18.5
BIR	389.76	379.03	16.4
BoC	117.03	116.41	27.0
Non-Tax Revenues	57.63	61.56	(25.9)
BTr Income	29.46	31.67	(11.5)
Others	21.29	21.05	15.5
Privatization	6.89	8.85	(73.5)
Expenditure	587.99	602.68	6.7
Allotment to LGUs	111.24	86.29	11.5
Interest Payments	140.97	145.98	8.7
Subsidy	3.67	4.48	(65.3)
Equity	0.36	0.65	48.8
Net Lending	4.13	5.79	63.6

Source: Bureau of Treasury

Everyone has set their eyes on the fiscal position since the government reset the goal of achieving a balanced budget from this year to 2010. For the first semester of 2008 the national government's cash position amounted to a deficit of Php18 billion, Php23 billion lower than the target deficit. This resulted from the higher-than-programmed tax take collected by both the Bureau of Customs (BoC) and the Bureau of Internal Revenue (BIR) and lower-than-programmed spending.

The BoC collected a total of Php117 billion, Php600 million higher than its target, while the BIR collected Php389.8 billion which is Php10.7 billion higher than its target.

Preliminary data show that for the first half of 2008, total VAT collection amounted to Php53.3 billion, 22 percent more than the Php43.7 billion collected in the same period last year. The BoC accounted for Php28.7 billion, while the BIR accounted for Php24.6 billion. Despite pressures to scrap the value-added tax on oil products, the executive has remained firm on keeping the tax in place. VAT collection from crude and petrol products amounted to Php21.5 billion (or 40.3 percent of the total VAT collection) during the first semester.⁸ This increase in revenues, however, will likely be offset by the rise in expenditures due to the increasing disbursements for subsidies and transfers to augment the poor's reduced purchasing power.

In addition, there are concerns over the expected erosion of the tax base under RA 9504, which grants additional tax relief to individuals and corporations as follows: (1) exemption of minimum wage earners from income tax; (2) increases in the level of personal exemption allowance to a uniform amount of Php50,000 regardless of taxpayers' status; (3) additional exemption allowance for each qualified dependent from Php8,000 to Php25,000; and (4) increase of the optional standard deduction (OSD) allowed to an individual engaged in business and practice of profession from 10 percent to 40 percent. The initial draft of the implementing rules and regulations (IRR) of RA 9504 prepared by the BIR set the effectivity date as July 1, 2009. This negates the law's purpose of granting timely relief to workers/taxpayers.

Government pump-priming efforts remain critical during an economic downturn. However, first semester figures show that expenditures totaled Php588 billion, lower than the programmed Php602.7 billion.

⁸ Sum of amount booked on raw materials for petroleum products reached Php9.4 billion, while that for finished petroleum products stood at Php12.08 billion.

Also, first semester figure for subsidies is 65.3 percent lower than last year's PhP10.6 billion and PhP806 million lower than the target amount of PhP4.5 billion. In this light, Administrative Order (AO) 236 was signed last August 6 to fast track the implementation of and spending for infrastructure and social programs. The AO named the Presidential Management Staff (PMS) and the Department of Social Welfare and Development (DSWD) as lead agencies. The Department of Budget and Management (DBM) was also ordered to hasten the disbursement of the Priority Development Assistance Fund (PDAF) or the so-called *pork barrel* to help boost growth and welfare.⁹ Moreover, disbursement is expected to increase in the second half of the year as funds from privatization efforts will push through during this period.¹⁰

Challenges and Policy Implications

Global economic slowdown

The economic growth of the US is expected to slow further to 1.5 percent this year from 2.2 percent in 2007. The housing debacle has spread into broader economic activity. Manufacturing and non-manufacturing indices are falling resulting in an uptrend of unemployment levels. Moreover, the weakened stock market and sluggish consumer spending increased the likelihood of a protracted slowdown. Active monetary tightening at the onset serves to heightened fears of a recession, but the nagging inflation severely restricts the options for further stimulus.

Similarly, the eurozone economic growth may be undermined by a languid export performance due to the strong euro coupled with softening global demand. Inflation concerns have jacked up key rates, which served to tighten the credit environment and dampen consumer and business confidence. Also, growth in the Organisation for Economic Co-operation and Development (OECD) countries is projected to decelerate to 1.8 percent from 2.7 percent last year (OECD, 2008). Japan is also expected to grow slower by 1.5 percent this year. Investment outlook remains cloudy amid slowing exports.

Volume of world trade is expected to slow further to 7.6 percent in 2008 from an estimated 9.2 percent in 2007, as demand from industrial countries slacken and growth prospects were lowered (World Bank, 2008). Despite signs of recovery in the second quarter, economists

¹⁰ The government is hoping to raise PhP30 billion from the sale of its 40 percent stake in Petron, as well as 40 percent of its holdings in Philippine National Oil Company – Exploration Corporation (PNOC).

expect export growth in the Philippines to remain sluggish for some time yet, possibly spilling over into early 2009. The Philippine Exporters Confederation, Inc. is anticipating a slower growth of 3.0 percent to 5.0 percent this year, from the 6.0 percent full-year target set by the government.

Inflation

Several factors have led to the rapid increase of world oil prices. These include the depreciation of the US dollar, political risks in oil-producing countries (e.g. Nigeria), supply constraints coupled with increasing demand from emerging economies of China and India.

World commodity prices have also soared, making *agflation* (i.e., agricultural inflation) the new buzzword in commodity markets. Supply bottlenecks are highlighted given population growth, higher demand in large and fast-growing economies, and shift in the use of agricultural lands (e.g., profitability of biofuels).

Financial market volatility triggered by the US financial crisis may also increase volatility in the commodities market. The increasing uncertainty and risk aversion of investors put more upward pressure on prices. Borrowing spreads have also widened and may likely prompt an inflow of soft money, which, in turn, could further fuel inflationary pressures.

Policy Implications

Monetary authorities may be in a quandary. On the one hand, there is a need to temper inflation by raising key policy rates. On the other hand, raising interest rates may result in a tighter credit environment that stifles investment and therefore, growth. Prudent utilization of such policy will reduce its adverse effect of hampering growth. Monetary tightening must be hinged on a credible monetary authority with the ability to make clear market signals. At present, the direction of monetary policy is uncertain given signs of a slowing economy and unabated inflation.

Fiscal policy can play a crucial role in balancing the risk of monetary tightening. However, provision of subsidies and transfers aimed at helping the poor cope with rising prices may only be useful in the short run. They are viewed as market distortions that could maintain or stimulate demand, when market conditions require it to fall. They could also pose a threat to the targeted fiscal position in 2010. Moreover, the tendency of indexing wages to price movements must be held in check

as this may very well amplify the magnitude of inflation. A better alternative is to improve the capacity of line agencies to implement programmed infrastructure projects as this would enhance productive capacity in the long run.

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