

International Developments

ECONOMIC REPORT



Overview

Amidst heightening uncertainties threatening to derail world economic recovery, world growth improves moderately...

The world economic performance in the first half of 2003 took a dive on account of the war in Iraq and the outbreak of the Severe Acute Respiratory Syndrome (SARS). With the end of the Iraq war and containment of SARS, global economic performance in the second half of 2003 is expected to improve, supported by indications of an upturn in the major economies towards the end of the second quarter. The expected return of investor and consumer confidence, resulting from accommodative monetary policies and fiscal easing in major economies, will further boost demand. However, there exist downside risks arising from continued global current account imbalances, inadequate structural reforms in some economies and security concerns in several parts of the world.

The prevailing global current account imbalance has arisen out of the world's over-reliance on the United States (US), which since 1995 has been the only real engine of world economic growth. The gap in global external accounts reached close to 2% of global Gross Domestic Product (GDP) in 2002. While the current account deficit in the US continued to worsen, its main trading partners, particularly in Europe and Asia, built up large surpluses. By the first quarter of 2003, the current account deficit of the US had grown to an unprecedented USD544 billion or 5.1% of GDP.

Even though world economic growth was lethargic, the financial markets were active in the first half of 2003. With prevailing low interest rates and high liquidity in the market, funds sought for equities in the hope for higher yields on the

expectations that the global economy would recover towards the second half of 2003. Consequently, the major bourses did relatively well, with the Dow Jones and the Nikkei performing 12.4% and 20.6% better respectively, in the eight months from end-2002 to end-August 2003.

In a global economic environment weighed down by uncertainties and lacklustre global demand, the concern in all international fora continues to focus on the need to stimulate economic growth and maintain financial stability. At the same time, countries are increasingly looking towards regional and bilateral arrangements to spur trade and economic growth. In this respect, regional groupings such as ASEAN and ASEAN+3 (China, Japan and Republic of Korea) have initiated various efforts, which include enhancing financial and monetary cooperation to further facilitate and promote intra-regional trade as well as deepening regional economic integration. One such on-going effort is towards the fostering of Asian bond markets.

World Economy

Early indications signal recovery...

World output growth is expected to improve marginally to 3.2% in 2003 (2002: 3%) given the weak economic environment, as shown in *Table 3.1*. Weaknesses still persist in the euro area and Japan although some positive signs have emerged. Global growth continues to be dependent on the US, whose growth is expected to be slightly lower than the previous year at 2.2% (2002: 2.4%).

In the first six months of 2003, the US economy recorded a real GDP growth of 2.3% arising from higher personal consumption expenditure, federal defence spending and both residential and non-residential fixed investments. The pace

TABLE 3.1

**Global Economic Indicators
2002-2004**

	Real GDP (%)			Inflation (%)			Unemployment (%)		
	2002	2003 ¹	2004	2002	2003 ¹	2004	2002	2003 ¹	2004
World	3.0	3.2	4.1	n.a	n.a	n.a	n.a	n.a	n.a
Advanced countries	1.8	1.9	2.9	1.5	1.9	1.7	6.4	6.6	6.5
Developing countries	4.6	5.0	5.8	5.4	5.8	5.1	n.a	n.a	n.a
Newly industrialised Asian economies	4.6	4.1	4.5	1.0	1.8	1.9	4.1	4.0	3.9

¹ Estimate.

n.a. not available.

Source: IMF World Economic Outlook, April 2003 and various sources.

of economic activity edged up, fuelled by low interest rates and tax cuts. Nascent signs of recovery in the manufacturing sector after a period of decline, provided optimism in the remaining six months for the sector and the economy as a whole. Current low mortgage rates also continue to spur housing starts and sales.

In the euro area, real GDP growth was maintained at 0.1% during the first quarter of 2003 (Q4 2002: 0.1%). This was supported mainly by growth in private consumption, as was in the previous quarters of 2002. However, initial data showed that there was no growth in the second quarter, mainly because Germany experienced a negative growth of 0.1%. The economic sentiment indicator (ESI) did not show any change from May to July due to improvements in the consumer, construction and retail trade confidence indicators, being offset by a decrease in the industrial confidence indicator. While there are no signs of a worsening economic climate in the euro area, current developments indicate that a sustained upturn in economic activity is still doubtful. Thus, the euro area is expected to register a mild growth of 0.7% in 2003.

In Japan, economic growth continued to pick up with second quarter GDP growth recording 0.6% (Q1 2003: 0.3%). This has been spurred by improved industrial output, housing investments, and imports as well as pockets of recovery in the job market as sentiments improved. However, Japan is still plagued with declining prices and the value of its exports fell for the first time in 15 months in June. Nevertheless, the fledgling

recovery of the US lifted share prices in Japan. Expectations that the US recovery will be sustained and stoke demand for Japanese products augurs well for further improvement in the second half of the year.

World trade growth slowed down in late 2002 as global economic activity lost some of its strength and world ICT markets relapsed. Subsequently, the non-economic shocks to the world economy, that is, threat of and eventual war in Iraq and the outbreak of SARS, have all been detrimental to world trade, especially trade in services, such as travel and tourism. The lack of progress in the Doha round of trade negotiations and the lingering risks associated with heightened geopolitical tensions also cast a pall over the immediate prospects for improvements in global trade. The key to the recovery of world trade is contingent upon the recovery of the US economy. China and other Asian economies are also anticipated to continue to be significant contributors to growth in world trade. As world economic growth recovers, trade is also expected to pick up to 4.3% in 2003 (2002: 2.9%).

Inflation is currently not a policy concern in a large number of economies. Inflation in the US rose at an annual rate of 2.2% in the first seven months of 2003, mainly because of higher oil prices. However, in the face of retreating oil prices after the Iraq war, the outlook for inflation is benign. At the same time, depreciation of the US dollar reduced the possibility of deflation in the US, but made it more likely in the economies

with appreciating currencies, notably Germany in the euro area. Japan continued to be in deflation amidst mixed signs of sectoral performance. In the case of developing countries, consumer prices are expected to increase by just below 6%. In the wake of a weak global recovery and uncertainties, several Asian markets such as Hong Kong SAR, Singapore and Taiwan experienced periods of falling prices without widespread detrimental effects but this may prove problematic if deflation becomes entrenched. World inflation, therefore, continues to remain low, as the upturn in the global economy remains weak.

Worldwide **equity markets** which had been trending downwards in 2002 due to lower corporate earnings, fallout from accounting irregularities and concern about geopolitical instability and its impact on petroleum prices, continued to do so into the first two months of 2003. However, the quick conclusion of the Iraq war coupled with the preservation of oil supplies buoyed market confidence. Consequently, equity prices in major bourses began an upward rally from early March, which has been sustained until now. The Nikkei, however, only rallied from the later part of April 2003 after recovering from reports of weak earnings of electronics chipmakers and software companies due to slowing demand.

Compared to 1 September 1998, when Malaysia pegged the ringgit to the US dollar, the equity market in Malaysia has performed the best in relation to other countries in the region. The rise in the KLCI has more than doubled from 262.70 points to 743.30 points on 29 August 2003, while the increases in other bourses were less significant, such as Singapore (94.24%), Jakarta (62.55%) and Manila (0.09%).

Compared to the end of 2002, the stock markets in the region fared better than the major bourses. While the Bangkok bourse, the star performer, rose by 50.84%, others in the region performed reasonably well, with the Taipei stock exchange rising by 26.92%, Jakarta, 24.64%, Singapore, 19.25%, and Kuala Lumpur, 14.63%. In comparison, the Tokyo, New York and London bourses rose by 20.57%, 12.38% and 6.54% respectively, as shown in *Table 3.2*.

In **foreign exchange markets**, the US dollar further declined into the first quarter of 2003. The range of decline varied with 7.3% against the euro and 2% against the pound sterling. The dollar, however, appreciated marginally by 0.7% against the yen. While the lower dollar may make US exports more competitive and help accelerate economic recovery in the US, the stronger euro may further slow down growth in the euro area.

TABLE 3.2

Stock Markets

	1 September 1998	31 December 2002	29 August 2003	Change ¹ (%)	Change ² (%)
Stock Markets					
Bangkok	211.09	356.48	537.71	154.73	50.84
Hong Kong SAR	7,062.47	9,321.29	10,908.99	54.46	17.03
Jakarta	325.85	424.95	529.68	62.55	24.64
Kuala Lumpur	262.70	648.43	743.30	182.95	14.63
London	5,118.70	3,940.40	4,198.00	-17.94	6.54
Manila	1,191.76	1,018.41	1,192.83	0.09	17.13
New York	7,827.43	8,341.63	9,374.21	19.76	12.38
Seoul	309.71	627.55	759.47	145.22	21.02
Singapore	823.33	1,341.03	1,599.25	94.24	19.25
Taipei	6,335.09	4,452.45	5,650.83	-10.80	26.92
Tokyo	14,369.63	8,578.95	10,343.55	-28.02	20.57

¹ Percentage change between 1 September 1998 and end-August 2003.

² Percentage change between end 2002 and end-August 2003.

Source: Kuala Lumpur Stock Exchange and various sources.

TABLE 3.3

Foreign Exchange

	2 September 1998	31 December 2002	20 March 2003 (War in Iraq begins)	End-August 2003	Change ¹ (%)
Currencies (Against USD)					
Euro ²	—	1.05	1.06	0.92	-12.28
Indonesian rupiah	10,750.00	8,955.00	9,025.00	8,539.33	-4.64
Japanese yen	136.98	118.69	120.15	117.15	-1.30
Korean won	1,344.50	1,186.05	1,245.95	1,178.66	-0.62
Malaysian ringgit	3.80	3.80	3.80	3.80	0.00
New Taiwan dollar	34.77	34.75	34.77	34.16	-1.70
Philippine peso	43.04	53.28	54.49	54.96	3.15
Singapore dollar	1.73	1.74	1.77	1.75	0.57
Thailand baht	40.55	43.14	42.93	41.18	-4.54

¹ Percentage change between 31 December 2002 and end-August 2003.

² USD against euro.

Source: Bank Negara Malaysia and various sources.

Advanced Countries*Indications of nascent growth after the Iraqi conflict...*

Advanced countries continued to register anaemic growth in the first few months of the year weighed down by the after-effects of the burst of the IT bubble, weak equity markets, soft labour market conditions, low capacity utilisation, concerns about terrorism as well as risks of mild deflation spreading beyond Japan. Risks to growth were exacerbated by geopolitical tensions in the Middle East, a strong euro as well as volatile oil prices which peaked at USD39.99 per barrel in late February in the build-up to the war. Oil prices, which rose on account of supply disruptions in Venezuela, cutbacks in Nigeria as well as the war in Iraq, averaged about USD28 per barrel in the first six months of the year. However, the easing of monetary and fiscal policies by major economies to offset faltering business and consumer confidence provided impetus to growth.

Growth in advanced countries remained slow, uneven and below trend even after the conclusion

of hostilities in Iraq. As global growth prospects continue to remain overly hinged on the US, indications of a rebound in the latter's economy at the end of the second quarter are expected to generate optimism and boost global confidence for accelerated economic activity. Sustained by supportive macroeconomic policies put in place to spur growth, in addition to moderating oil prices as well as reduced military uncertainties in the Middle East, growth is anticipated to pick up momentum towards the second half of the year with real GDP growth forecast to improve marginally at 1.9% (2002: 1.8%), as shown in *Table 3.4*. Further, structural and institutional reforms currently undertaken by major economies in the financial and corporate sectors are also expected to support and enhance growth prospects. Barring any false starts, the strengthening of the US economy in the third quarter will be catalytic to global growth.

The **United States** enjoyed better-than-expected strong economic growth in the second quarter at 3.1% following a 1.4% tepid growth in each of the two previous quarters. The second quarter growth was led by resilient household spending, business investment, as well as military

TABLE 3.4

**Advanced Countries:
Major Economic Indicators
2002-2004**

	2002	2003 ¹	2004
Gross Domestic Product² (%)			
Advanced countries	1.8	1.9	2.9
France	1.2	1.2	2.4
Germany	0.2	0.0	1.5
Italy	0.4	1.1	2.3
Japan	0.3	0.8	1.0
United Kingdom	1.6	2.0	2.5
United States	2.4	2.2	3.6
Euro area	0.8	0.7	2.3
Inflation (%)			
Advanced countries	1.5	1.9	1.7
France	1.9	2.0	1.6
Germany	1.3	0.6	0.7
Italy	2.6	2.4	1.6
Japan	-0.9	-0.7	-0.6
United Kingdom	2.2	2.8	2.7
United States	1.6	2.3	2.3
Euro area	2.3	2.0	1.5
Unemployment (%)			
Advanced countries	6.4	6.6	6.5
France	8.8	9.1	9.1
Germany	8.2	10.5	8.8
Italy	9.0	9.3	9.1
Japan	5.4	5.5	5.4
United Kingdom	5.2	5.4	5.3
United States	5.8	6.2	5.9
Euro area	8.3	8.8	8.7
Current account balance (USD billion)			
Advanced countries	-217.2	-270.4	-261.9
France	29.7	36.1	33.4
Germany	49.6	59.5	63.4
Italy	-6.8	0.3	5.1
Japan	112.8	115.5	131.3
United Kingdom	-29.7	-35.3	-41.9
United States	-503.4	-576.7	-583.1
Euro area	72.1	91.0	94.1

¹ Estimate.

² Real GDP.

Source: IMF World Economic Outlook, April 2003 and various sources.

expenditure, which saw a 44.1% increase, the biggest since the Korean War in the early 1950s. The growing confidence in the economy was also reflected in better corporate earnings as well as significant gains in equity markets. The Dow rose 12.5%, the Standard & Poor's 500 Index, 14.9% while the Nasdaq Composite gained a robust 21% in the second quarter, after a mild downturn in the first quarter.

Despite positive indications in the second quarter, the overall growth was not broad based. Industrial production remained sluggish with unemployment rising to a nine-year peak of 6.4% in June. Consumer spending, which accounts for two thirds of all economic activity, remained lacklustre. Consequently, monetary policy was eased with interest rates slashed by 25 basis points to 1.00% in late June (November 2002: 1.25%), the lowest since 1958.

With the dissipation of risks following the end of the Iraq war, signs of an upswing in the economy emerged indicating growth in the overall economy as well as the manufacturing sector, which grew two months consecutively in July and August since contracting in February 2003. The Institute for Supply Management (ISM) factory index registered 54.7 points in August (July: 51.8 points) after having recorded 45.4 points in April, the lowest reading for the first seven months of the year. While demand for factory goods increased, the employment index, in sharp contrast, continued to remain below the breakeven point of 50 for the past 35 months, recording 45.9 points in August (July: 46.1 points) signalling that job creation was not growing in tandem with growth in the manufacturing sector. However, the depletion of inventories is expected to stimulate new investments, boost consumption and ultimately generate employment as companies replenish stocks.

After contracting to 47.9 points in March 2003, the ISM Non-Manufacturing Business Activity Index has been on the rise since April, reflecting an upward trend in the services sector. The Index surged in July to register 65.1 points (June: 60.6 points) reporting brisk economic activity in construction, agriculture, finance and banking, retail trade and communications while health services contracted. Indications of recovery were

also reinforced in the employment index, which rose to 50.7 points in July (June: 50.3 points) after decreasing for four consecutive months, beginning February, when it stood at 49 points.

Real GDP growth for the year is expected to moderate at 2.2% (2002: 2.4%) with the pace and momentum of recovery aided by low inflation, strong productivity growth and a 45-year low interest rate of 1.00% which is anticipated to bolster business investment that was lagging in the first six months of the year. In addition, tax relief worth USD35 billion for the year, aimed at boosting disposable incomes of households, is expected to strengthen consumption.

Despite a second quarter upturn in the economy, solid signs of sustainable growth have yet to emerge. While unemployment fell for the first time in July to 6.2% (June: 6.4%) and capital spending, the laggards in economic recovery, have only just improved, real GDP growth has to exceed 3% to generate new jobs which are crucial to sustain the pace and momentum of growth. Apart from unemployment, concerns also remain with regard to the widening current account and fiscal deficits estimated to be 5.3% (2002: 4.8%) and 4.6% of GDP (2002: 3.6%), respectively, for the year. In addition, oil and natural gas prices which have yet to stabilise and slack demand from its major trading partners, the euro area and Japan, continue to pose some risks to the nascent recovery in the economy.

Ending on a weak note in 2002, growth in the **euro area** continued to remain sluggish in the first half of 2003 on account of the geopolitical situation in the Middle East, weak external environment and a slump in domestic demand due to low business and consumer confidence that deterred spending. Growth stagnated in the second quarter after a subdued first quarter growth of 0.1% (Q4 2002: 0.1%), contributed by a marginal increase in household spending.

To arrest sliding business and consumer sentiments and stimulate economic activity in the face of difficulties exacerbated by geopolitical uncertainties in Iraq, the European Central Bank (ECB) pared its benchmark refinancing rate from 2.75% held since December 2002, to 2.50% in early March. The euro, which has appreciated

by about 20% against the US dollar, while keeping in check import costs and inflation, further dampened export performance, adversely affecting Germany, France and Italy which rely on exports to fuel growth and business investments. In a bid to revitalise the ailing economy amidst fears of deflation and renewed recession, monetary policy was further eased when the interest rate was slashed to 2.00% in early June. While room for fiscal stimulus is somewhat constrained by the EU's Stability and Growth Pact which caps budget deficits of members to 3% of GDP, this all-time low interest rate, is anticipated to boost capital spending and support employment.

The outlook for the euro area economy for the second half of the year is expected to improve as growth in the US economy, which absorbs 20% of its exports, gathers momentum. Led by an environment of low interest rate, low inflation (July: 1.9% against ECB's target 2%), softening oil prices and improving financial markets, real GDP growth is expected to stabilise at 0.7% (2002: 0.8%). However, downside risks to this growth prospect include rising unemployment, which stood at 8.8% in July 2003 (2002: 8.3%), a strengthening euro, weak corporate profits, as well as a fragile German economy, which accounts for a third of the euro area output. In addition, the slow pace of reform in the labour and capital markets is also expected to inhibit a quick rebound in domestic demand.

Germany, the largest economy in the euro area slipped into recession after contracting 0.1% (Q1 2003: -0.2%) in the second quarter on account of weak global demand and a strong euro which eroded its competitiveness abroad. The economy, which stalled at the end of 2002, was negatively impacted in the first quarter when surging oil prices, the impending war in Iraq and the appreciating euro restrained business spending. Sluggish demand from its key trading partners, France, US, United Kingdom (UK) and Italy for its automobiles, industrial machinery and electrical appliances further worsened export prospects.

Falling producer and energy prices as well as flat industrial output have raised concerns that deflation is threatening the German economy. Adding to deflationary pressures is rising

unemployment hovering at 10.6% (2002: 8.2%) which has further curbed consumer spending. Inflation is forecast at 0.6% for the year (2002: 1.3%).

With limited flexibility in policy options, Germany is expected to breach the 3% ceiling on fiscal spending under the Stability and Growth Pact for the third consecutive year and record a deficit of 3.9% (2002: 3.6%) in order to invigorate the economy. However, signs of an upturn in the US economy, which accounts for 10% of its exports, is expected to boost external demand as reflected in the increase in German factory orders in June. The broad economic reform package on labour, welfare, and healthcare currently underway is also anticipated to provide the much-needed impetus to consumption and business investment. For the year, Germany is expected to stagnate at 0% (2002: 0.2%), well below 1% for the third year running.

Outside the 12-nation euro area, the **United Kingdom** registered the weakest growth rate in a decade, at 0.1% in the first quarter (Q4 2002: 0.4%) as concerns over the Iraqi conflict and a sluggish world economy eroded business and consumer confidence. Slowdown in household spending, which has been the engine of growth in recent years and industrial output, was offset in part by government spending on defence, health, transport and other key public services as well as net growth in exports of goods and services. However, the UK economy registered a modest 0.3% in the second quarter supported by an upturn in the services sector, particularly retail, hotel and catering, post and telecommunications as well as computing services. While consumer spending has been resilient and the housing market buoyant, manufacturing output, which accounts for 20% of the economy, remained flat due to weak external demand especially from the euro area and the US which buy about 50% and 15% of British exports, respectively.

Faced with uncertainties in the external environment, the Bank of England (BOE) eased monetary policy twice in the first six months of

the year, to counter the effects of slowing demand both at home and abroad. The benchmark interest rate was trimmed for the first time since November 2001, in early February from 4.00% to 3.75% when it became evident that a war in Iraq could hurt growth prospects. However, when growth was slower than expected, even after the Iraqi conflict, the BOE lowered interest rate by a further 25 basis points to 3.50% in July, the lowest since 1955, to further boost business investment and foster broader economic growth.

The unemployment rate in July stood at 5% while inflation at 2.8%, was well over the Government's target of 2.5%. Reflective of prevailing low interest rates as well as softening oil prices, inflation is expected to dip below the target in the coming months. Sustained by accommodative macroeconomic policies, an improving external environment with the cessation of hostilities in Iraq, signs of recovery in the US economy as well as resilient consumer spending which accounts for two thirds of GDP, growth is projected to strengthen to 2% for the year (2002: 1.6%).

After a better-than-expected last quarter expansion of 0.5% in 2002, **Japan** recorded a slower real GDP growth of 0.3% in the first quarter of the year led by a slight increase in household spending mainly on automobiles in anticipation of increased taxes in the new fiscal year beginning April. However, persistent concerns over unemployment presently at 5.3%, declining real incomes and weak equity markets have dampened consumer spending which accounts for 55% of GDP. Weak consumer sentiment continued to weigh heavily on wholesale prices, which have been declining for the past four years since September 1999, resulting in severe deflationary pressures on the economy. Compounding the slump in the domestic market was poor export demand from the US, its biggest trading partner.

Despite the outbreak of SARS, exports to China, its second largest trading partner, have remained robust. Exports comprised mainly automobiles, machinery and machine tools, steel, chemicals, organic compounds and raw materials. The effects of SARS on the Japanese economy have so far

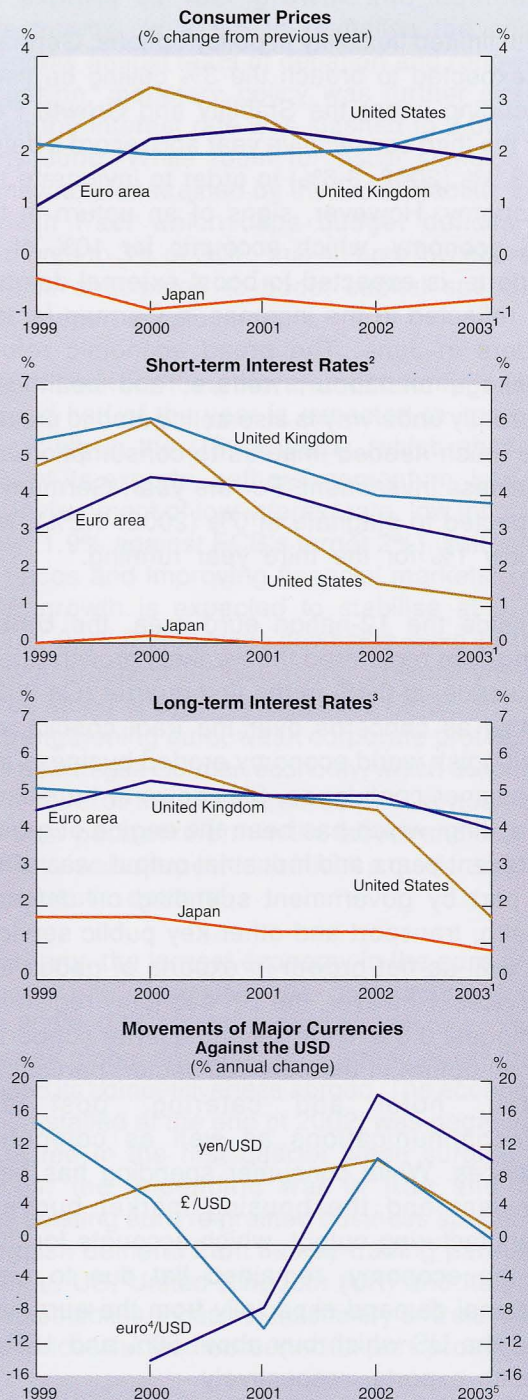
been limited to the travel and tourism sectors as well as minor disruptions to the supply chain for high-tech products and components.

In an effort to end deflation and reflate the sluggish economy, the Bank of Japan (BOJ) reviewed its policy framework, eased monetary conditions as well as launched a programme to buy asset-backed securities and expanded its plan to buy more shares from banks beset with bad debts, thus raising their liquidity for fresh lendings. Credit-starved small- and medium-sized businesses, which were previously shunned by risk-wary banks and struggling to stay afloat, are to be the biggest beneficiaries, as this move allows them to undertake new capital investments, boosting domestic demand. Further, to strengthen the financial and corporate sector, the BOJ set up the Industrial Revitalisation Corporation (IRC) in April to tackle the problem of non-performing loans in the banking sector. The IRC is to conduct its activities over a five-year period within which a workout plan will be implemented with viable companies to address the problems of excessive debt or capacity as well as facilitate restructuring.

Signs of a turnaround in the stagnant economy have emerged towards the end of the second quarter. The Japanese economy posted a better-than-expected growth of 0.6% (Q1 2003: 0.3%) aided by an increase in consumer spending as well as growth in exports which account for 10% of GDP. Unemployment, which peaked at 5.5% in January, fell slightly and remained at 5.3% with job losses in the manufacturing sector easing. Industrial output was up in May on account of strong demand for electronic products from the US. Buoyed by indications of a US recovery, machinery and equipment orders rose in June in anticipation of demand from the latter. Improved business and consumer confidence was also reflected in household spending, which accelerated for the first time in a decade, rise in capital spending, improved corporate earnings as well as gains in the equity market as foreign investments in Japanese stocks hit its peak in June, with the Nikkei rising over 30% since April. A full fledged recovery in the US economy would be a boon for the Japanese economy as it would accelerate business investment, generate new jobs as well as improve corporate balance sheets. For the year, Japan is expected to register a firmer GDP growth of 0.8% (2002: 0.3%).

CHART 3.1

Current Trends in Key Economic Determinants in Industrial Countries 1999-2003



¹ Estimate.

² Averages of interest rates weighted by the average US dollar value.

³ Average yield on government bonds.

⁴ The euro was introduced in 1999.

⁵ Up to August 2003.

Source: IMF World Economic Outlook, April 2003.

East Asia

Post-SARS prospects point to moderate growth...

In the face of a weak external environment and the SARS outbreak, GDP growth of most developing countries in East Asia slowed down in the first half of 2003. Nevertheless, overall growth for the year is expected to be moderate at 2.4% (2002: 2.3%) as a result of the tentative improvement in the external environment as well as measures undertaken by governments to contain the SARS outbreak.

The **People's Republic of China** (China) weathered the difficulties posed by the SARS outbreak, slowing down from an exceptionally high rate of 9.9% posted in the first quarter of 2003, to 6.7% in the second quarter. As the SARS outbreak was confined to some specific locations in China and did not affect the overall economy, China is expected to achieve growth of 9%-10% for the year (2002: 8%), as shown in *Table 3.5*. The expected robust growth is also due, in part, to the post-WTO accession effect that resulted in increased foreign investment to China as well as energised urban consumer demand for services and products such as automobiles and upscale real estate. China's exports in the first half of 2003 also increased further by USD190.3 billion, up 34% from the same period the previous year, while imports registered USD185.8 billion, up 44.5%. Sustainability of the high growth rate hinges on the Government's effectiveness in keeping SARS from recurring, resolving bad loans of the banking sector and reforming inefficient state-owned enterprises, while promoting private enterprise.

The **Republic of Korea** (Korea) recorded a growth rate of 6.3% in 2002, driven by growth in private consumption and very strong export performance. However, towards the end of the year there was a marked deceleration in consumption growth due, in part, to earlier measures to curb the rapid growth in consumer borrowings. This was further compounded by a decline in consumer confidence in domestic economic prospects due to lingering uncertainties as a result of geopolitical tensions in the Korean peninsula. In addition, growth was affected by a series of domestic

TABLE 3.5

Selected East Asian Economies: Major Economic Indicators 2002-2004

	2002	2003 ¹	2004
Gross Domestic Product² (%)			
China	8.0	9.0-10.0	7.5
Republic of Korea	6.3	3.3	5.3
Taiwan	3.5	3.2	3.7
Inflation (%)			
China	-0.8	0.2	1.5
Republic of Korea	2.8	3.5	3.2
Taiwan	-0.2	0.3	0.8
Current account balance (% of GDP)			
China	1.9	1.4	1.1
Republic of Korea	1.3	0.3	0.5
Taiwan	9.1	8.6	8.8

¹ Estimate.

² Real GDP.

Source: IMF World Economic Outlook, April 2003 and various sources.

problems, such as the corporate accounting scandals and incidents of labour unrest. As a result, Korea registered negative growth in the first two quarters of 2003, the first time since its recovery from the 1997/98 Asian Financial Crisis. In response to the slowdown in private consumption and to arrest a further decline in the overall economy, a USD3.5-billion supplementary budget was approved to boost spending in social infrastructure projects, public welfare and provide financing for small companies. Korea is expected to register moderate growth of 3.3% for 2003.

In **Taiwan**, the economy is expected to pick up slightly in the second half of 2003 to record a growth rate of 4.3% (H1 2003: 3.1%). Domestic

demand is envisaged to strengthen during the second half of the year following the lowering of interest rates and containment of the SARS outbreak. As a result, industrial production in the second half of the year is anticipated to grow by 5% - 7% (H1 2003: 3%), further propelled by external demand on the part of its major trading partners. The relatively low rate of inflation is also expected to boost domestic demand. To ameliorate the lingering impact on the economy of the SARS outbreak, as in the case of other SARS-affected countries, the government instituted a SARS relief package amounting to USD1.5 billion as well as two employment creation plans totalling USD2.3 billion. Export growth is projected to pick up with the easy monetary and fiscal policies providing support for recovery. The overall growth for 2003 is expected to be 3.2% (2002: 3.5%).

Developing Countries

Growth strengthening amidst difficulties...

Developing countries as a group are expected to continue to grow stronger at 5% (2001: 3.9% and 2002: 4.6%), performing better than advanced countries at 1.9% (2002: 1.8%) and countries in transition at 4% (2002: 4.1%). Growth from developing countries would have been even stronger had it not been for the impact of the SARS outbreak, which moderated growth in developing Asia to 6.3% (2002: 6.5%). Other developing countries not so affected are anticipated to perform better than the previous year, with growth in Africa projected at 3.9% (2002: 3.4%), Middle East and Turkey, 5.1% (2002: 4.5%) and the Western Hemisphere turning around to 1.5% after a contraction of 0.1% in 2002.

While many more developing countries are beginning to realise their full growth potential, many other countries could not do so as they are still plagued by difficulties. Middle East countries, while benefitting from the rise of crude oil prices during the early part of the year attributed to the uncertainty in oil supplies leading to the Iraq war, had to contend with the serious security

situation in the region. Growth in Latin America continued to be weighed down by vulnerabilities in the economies of Argentina, Brazil and Uruguay, while the political crisis in Venezuela continued to impact on the economy. Compared to other regions, Africa has been able to achieve commendable growth, attributed mainly to its discipline in implementing improved macroeconomic policies and resolving regional conflicts while assisted by rising commodity prices and debt relief under the Heavily Indebted Poor Countries Initiative (HIPC). The continent, however, continues to be exposed to shocks related to bad weather, the HIV/AIDS pandemic and political instability in Zimbabwe and Cote d'Ivoire, which will have implications on their neighbours.

ASEAN

Resilient economies, supported by domestic consumption and greater intra-regional trade...

ASEAN economies are expected to perform reasonably well in 2003, despite the adverse external environment in the first half of the year, the SARS outbreak and sporadic acts of militancy in the region. With higher agricultural prices boosting incomes in Southeast Asia, coupled with the wealth effects from the improved stock market performance, regional economies continue to be largely sustained by domestic demand, particularly private consumption and investment. The economic recovery in 2002 which carried over into the first quarter of 2003, but slowed down in the second due to SARS, is expected to pick up again in the latter half of the year.

Most ASEAN economies also saw their exports beginning to rise significantly during the second half of 2002. The improvement in export performance, which continued in 2003, came on the back of the recovery in global trade and commodity prices as well as the rebound in high-tech industries and from greater inter- and intra-regional trade among ASEAN economies and East Asia, particularly China. Higher inter-regional trade is reflected in the increase

in the volume of trade between China and ASEAN by 45.3% to USD34.24 billion in the first half of 2003. The current trading pattern also reinforces China's emergence as a major market for ASEAN exports.

Fiscal policy remained generally expansionary and monetary policy, accommodative, continuing the momentum set during the first quarter of 2003 in response to the Iraq war and, later, the SARS outbreak. This easing was further supported by the region's benign inflation when prices stabilised following the relatively quick conclusion of the Iraq war, and the return to stable oil prices at around USD27.00 - USD29.00 per barrel. At the same time, stock markets in the ASEAN economies, which were generally volatile in 2002, rallied during the first half of 2003. Against this backdrop, financial and corporate restructuring continued at a steady pace.

The economic performance for the rest of 2003 is expected to be more positive given improved prospects for a global and regional pick up. Globally the quick end to the Iraq war, positive economic news on the US since May 2003, and better-than-expected economic performance of Japan augur well for stronger growth prospects among ASEAN economies.

In the region, policies already in place to strengthen domestic demand and add new vigour in intra-regional trade continued to sustain economic growth. The economic stimulus packages implemented to mitigate the effects of SARS in Malaysia, Singapore and Hong Kong SAR, combined with the policies already in place in other regional economies, were targeted towards increasing domestic investment, especially in small- and medium-enterprises (SMEs) that utilise domestic resources. These measures were aimed at improving the purchasing power of both consumers and enterprises, increasing the income potential of the rural economy as well as strengthening institutional capacities.

The rapid containment of the SARS outbreak in the region further augmented investor and consumer sentiment, thereby improving prospects for higher growth. The overall growth rate for ASEAN economies in 2003 is expected to range between 4.3% and 4.9% (2002: 4.4%).

The **Indonesian economy** is expected to grow at a steady rate of 3.5%-4% in 2003 (2002: 3.7%), as shown in *Table 3.6*, despite difficulties caused by militant activities in the archipelago and unrest in Aceh. A number of measures were undertaken by the government to sustain growth, improve security and attract foreign investment. Government spending continued to expand at 10.7% as a result of an increase in salaries in the civil service to offset the slower private consumption, as well as expenditure on security and defence in the light of the bombings in Bali and Jakarta. The government is nevertheless serious about budget consolidation, initiating bold policies toward reducing subsidies on fuel and utilities. To further encourage investment and consumer spending, the Central Bank of Indonesia reduced its overnight intervention rate on rupiah deposits further by 75 basis points to 9.00% in early July 2003, marking the eighth reduction in the rate for the year.

The increasing stability of the rupiah is one of the factors expected to help the country attract foreign investment, while falling interest rates are envisaged to stimulate economic activities. Exports are also likely to improve in the second half of the year in tandem with the expected improvement in the US, as in other regional economies. Inflationary pressure is also likely to ease in the second half of 2003 bringing inflation down to 9%. The government, in announcing that it would not be renewing its USD5-billion loan from the International Monetary Fund (IMF) that expires at the end of 2003, also reiterated its commitment to continue reforms in the corporate and financial sectors.

Real GDP growth in the **Philippines** is anticipated to grow within the range of 4.2%-5.2% in 2003 (2002: 4.4%) due to the global slowdown that began in late 2002. Nevertheless, its economy continues to be relatively strong with inflationary pressure likely to remain low during the second half of 2003, domestic consumption continuing to be supported by remittances from some 5 to 8 million overseas workers and the balance of payments broadly in equilibrium. In the external sector, the expected improvement in regional economies in the second half of 2003 is likely to boost the country's export sector.

Government consumption slowed down as a result of the fiscal consolidation programme juxtaposed against the effort to strengthen tax administration. Nevertheless, growth prospects continue to be affected by domestic security and political concerns, which, in turn, have affected the inflow of foreign investment.

To help stimulate economic activities, the central bank reduced its overnight rate by 25 basis points in early July 2003. This brought the overnight borrowing rate and the overnight lending rate to an 11-year low of 6.75% and 9.00%, respectively.

Singapore was badly affected by the SARS outbreak, registering the fifth-highest number of SARS cases in the world. This epidemic slashed visitor arrivals and retail sales, leading the economy to its biggest contraction of 4.2% in the second quarter of 2003. Amidst generally cautious consumer sentiments and a weak labour market, almost all other areas of the economy were hit in the second quarter, with the transport and communications sector, a direct casualty of SARS, contracting by 10.5%, construction sector down by 9% and manufacturing sector by 7.2%. Although the wholesale and retail trade sector expanded by 0.5% year-on-year, this was sharply down from the 5.6% growth recorded earlier in the first quarter.

The financial services sector, however, turned around after five consecutive quarters of contraction to grow by 4.3% in the second quarter. Stockbroking activities rose as the stock market rebounded after the SARS and Iraq war, while currency trading improved. Nevertheless, performance of the business services sector did not match that of the financial services, contracting by 3% as demand for real estate services fell.

To stimulate the economy, while targetting the SARS-affected industries, the government implemented a number of fiscal measures with effect from April 2003 covering direct public sector spending, reduction of tax rates and increase of income transfers. Further, in late August 2003, the government unveiled a USD570.7 million package of financial relief measures to ease the impact of an overhaul of the social security system on workers and their families. The package, which includes direct rebates and income-boosting measures, is aimed at lowering business costs and enhancing the nation's economic competitiveness.

The stimulus packages, coupled with free trade agreements (FTAs) recently concluded with a number of countries and anticipated improvements in the global economy, are expected to help the economy avoid another recession year. Based on the fact that the SARS epidemic has been contained and global demand for electronics products is expected to rebound, Singapore's economy is likely to do better in the second half of the year. The overall growth rate for the year is, therefore, expected to hover between 0% and 1% (2002: 2.2%).

Thailand, Southeast Asia's second largest economy after Indonesia, is likely to continue to grow within the range of 4%-5% in the second half of 2003 following growth of 4.5%-5.5% in the first half of the year. Overall growth, driven by the domestic economy and private consumption supported by loose monetary and fiscal policies, strong external balances, low inflation and a mild impact from SARS, is expected to be 4.2% (2002: 5.3%).

Domestic demand is anticipated to continue to gather strength during the second half of the year given the low interest rate environment. Output of vehicles is likely to continue to post a strong growth in the second half of the year as consumers take advantage of a record low interest rate to purchase motor vehicles. Despite the forecast strengthening in domestic demand, the rise in inflation is likely to remain low at 1.5% - 2.5% in the second half of 2003, following a rise of 1.8% in the first half.

To inject confidence in the economy, Thailand repaid the final balance of the USD1.6-billion IMF loan on 31 July 2003, two years ahead of schedule. In an effort to further boost growth, Thailand also accelerated the implementation of its dual track policy aimed at stimulating domestic demand in parallel with export promotion. Boosting domestic demand was primarily through strengthening and empowering those at the grassroots who are deprived of opportunities. The programmes include a nationwide Village Fund that extends credit to small enterprises, provision of micro credit facilities and an incentive scheme for SMEs, the One Village-One Product scheme as well as housing, health and education schemes for the poor.

TABLE 3.6

**Selected ASEAN Countries:
Major Economic Indicators
2002-2004**

	2002	2003 ¹	2004
Gross Domestic Product² (%)			
Brunei Darussalam	3.2	5.0-6.0	n.a
Indonesia	3.7	3.5-4.0	4.0
Malaysia	4.1	4.5	5.5-6.0
Philippines	4.4	4.2-5.2	4.0
Singapore	2.2	0.0-1.0	3.5
Thailand	5.3	4.2	4.3
Vietnam	5.8	6.2	7.0
Inflation (%)			
Brunei Darussalam	-0.3	1.0	1.3
Indonesia	10.0	9.0	8.4
Malaysia	1.8	1.2	-
Philippines	2.6	4.0	4.0
Singapore	0.4	0.9	1.7
Thailand	1.6	1.0-2.0	0.9
Vietnam	4.0	3.8	3.3
Current Account Balance (% of GDP)			
Brunei Darussalam	37.9	n.a	n.a
Indonesia	4.2	2.2	2.2
Malaysia	7.6	9.5	9.8
Philippines	5.4	0.3	0.5
Singapore	21.5	22.2	20.5
Thailand	6.0	2.8	2.6
Vietnam	-2.5	-2.1	-1.5

¹ Estimate.

² Real GDP.

n.a. not available.

Source: IMF World Economic Outlook, April 2003 and various sources.

and financial crises. In addition to reform efforts at the national level, important initiatives have since been taken to enhance regional resilience in the face of possible future crises, such as the SARS outbreak and the fight against terrorism. These initiatives are geared towards the expansion of trade and production networks, and the management of financial flows and reserves, all of which have national, regional and global dimensions. The pressing financial issues raised at various fora and levels included, among others, financial stability and integration, capacity building and skills training as well as trade liberalisation.

Regional Financial Cooperation

Considerable progress was made in a number of initiatives to enhance financial and monetary integration among ASEAN economies. Regional cooperation on customs made headway with the signing of the Protocol Governing the Implementation of the ASEAN Harmonised Tariff Nomenclature (AHTN), aimed at facilitating regional trade and investment by simplifying and streamlining customs processes. The AHTN Protocol was signed at the **Seventh ASEAN Finance Ministers Meeting** held in early August 2003 in Manila. Progress was also attained in the area of insurance, with ASEAN insurance regulators signing a Memorandum of Understanding (MOU) to establish the ASEAN Insurance Training and Research Institute.

In addition, the **Roadmap for the Integration of ASEAN in Finance** was finalised, aimed at achieving the free flow of goods, services and investments and a freer flow of capital by 2020. The areas covered under the Roadmap include the following:

- Capital Market Development - to adopt a two-pronged approach, the first covering institutional capacity building, and the second, initiatives to foster greater cross-border collaboration between capital markets in the region in areas such as the establishment of training networks, development of products and market linkages as well as the harmonisation of capital market standards;

Financial Cooperation and Trade Developments

Towards sustaining regional financial stability and integration...

The 1997/98 Asian Financial Crisis highlighted cross-border relationships in the region and brought to the fore the importance of collaborative regional approaches to complement the efforts of individual governments in overcoming economic

- Capital Account Liberalisation - to adopt an orderly approach with adequate safeguards against volatility and systemic risks;
- Financial Services Liberalisation - to adopt a Positive List modality with designated milestones to facilitate negotiations; and
- Currency Cooperation - to focus on areas of currency cooperation that would further facilitate and promote intra-regional trade and deepen regional economic integration.

To further enhance monetary and financial cooperation, **ASEAN+3 Finance Ministers** established the ASEAN+3 Finance Cooperation Fund to underwrite the cost of hosting ASEAN+3 meetings. In terms of regional self-help and support initiatives, new Bilateral Swap Arrangements (BSAs) were concluded under the Chiang Mai Initiative (CMI). The number of BSAs concluded more than doubled from six in 2002 to 13 this year, while the total commitment to the network increased from USD17 billion to USD 32.5 billion. Three more BSAs are expected to be concluded by year end. In addition, the USD1-billion ASEAN Swap Arrangement (ASA) was renewed in November 2002 for an additional two years.

In an effort to diversify regional sources of funds, making Asian economies more resilient in the event of possible financial crises, ASEAN+3 member countries agreed to work towards fostering regional bond markets. The Asian Bond Markets Initiative (ABMI), which capitalises on the high savings rate and the large pool of reserves in many Asian countries, is premised on the principle of using Asian savings for Asian investments. To ensure the successful conclusion of this Initiative, voluntary working groups were established to discuss various key issues such as securitisation, credit guarantees as well as foreign exchange transactions and settlement issues. The establishment of the Asian Bond Fund (ABF) in May under the aegis of the

Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) is a significant step in fostering regional cooperation in Asia, facilitating the reinvestment of a small portion of Asia's reserves back into the region, while at the same time, aiding the further development of regional capital markets. Among the eleven members contributing to the USD1-billion fund were the ASEAN member countries of Indonesia, Malaysia, the Philippines, Singapore and Thailand.

The **Tenth APEC Finance Ministers Meeting**, which was held in Phuket, Thailand in early September 2003, focussed on the need to achieve balanced, broad based, equitable and sustainable growth through strengthening financial linkages and fostering closer economic ties among APEC economies. Guided by the policy theme, *Local/Regional Link, Global Reach: A New APEC Financial Cooperation*, efforts were focussed on financial cooperation through enhancing financial alternatives and improving financial management of grassroot and SMEs development, regional bond market development and fiscal and financial aspects of regional trade arrangements (RTAs).

In recognising the critical role played by SMEs in the sustainable development of an economy, and to complement the work of SME Ministers in APEC, there will be greater exchange of information and expertise as well as efforts to improve trade facilitation and securitisation of SME debts to accelerate the development of SMEs and intensify their contribution to economic growth. Towards this end, a network among APEC SME financial institutions to promote regional financial and technical cooperation will be set up. Similar efforts to develop a regional bond market in the APEC region to complement the ABMI are also being considered.

Much progress has also been made in capacity building and skills enhancement through initiatives and work plans undertaken in areas such as improving surveillance, financial disclosure and corporate governance as well as reviewing the regulatory and legislative framework with a view to improving the formal financial system. Since

ASIAN BOND MARKETS INITIATIVE: ASIAN SAVINGS FOR ASIAN INVESTMENTS

Background

The idea to foster Asian bond markets, initially mooted in the '80s, gained additional impetus in the aftermath of the 1997/98 Asian Crisis. The crisis exposed the vulnerability of Asian economies to massive short-term reversals in capital flows due, in part, to currency speculation, and compounded by their underdeveloped capital markets. Having relied excessively on short-term financial borrowings from both domestic and foreign markets for their sizeable, long-term capital development requirements, some crisis-affected economies found themselves saddled with a substantial portion of public and corporate debt with maturity of less than a year. The problem of maturity mismatches, which underscored the dangers of mismatching borrowings to cashflow, was further compounded by currency mismatches when such borrowings were inadequately hedged. This dual mismatch highlighted the urgent need to develop new instruments of resource mobilisation to finance public and private sector investments in infrastructure and other development projects.

In acknowledging the need to formulate appropriate long-term financial sector development strategies to deepen and modernise capital markets, Asian economies have since focussed on the development of bond markets. Given the high domestic savings rates in the region, there is immense potential for this venture.

Accordingly, ASEAN and ASEAN+3 member countries have agreed that the large pool of domestic savings and reserves, amounting to more than USD1 trillion in East Asia, would be better utilised for the benefit of all through the fostering of viable domestic and regional bond markets - hence, the thrust for the Asian Bond Markets Initiative (ABMI).

ABMI: What is it?

The ABMI is yet another collaborative effort by East Asian member countries to establish a **regional self-help and support mechanism that would promote economic development and enhance financial stability in the region**. The Initiative is a further step up the value chain in ASEAN+3 financial cooperation that began with the ASEAN Swap Arrangement (ASA), evolved into the Bilateral Swap Arrangement (BSA), and which, in turn, progressed into the Chiang Mai Initiative (CMI). The CMI, a network of bilateral swap arrangements, allows ASEAN and ASEAN+3 member countries with bilateral swap agreements to avail themselves to 10% of the swap amount, free of International Monetary Fund (IMF) conditions, in the event of short-term liquidity problems in their balance of payments. The easier access to funds undoubtedly provides confidence to foreign investors, thereby contributing towards maintaining regional financial stability. In this respect, however, the ABMI goes much further.

While BSAs focus on the provision of temporary relief in the event of short-term liquidity problems, the ABMI aims to strengthen member countries' financial systems through the broadening and deepening of domestic capital markets. The Initiative, in providing for more diversified financial markets and instruments, is consequently better placed to render regional economies more resilient to systemic risks in the event of future shocks as well as lay a firmer foundation for more sustainable development. Furthermore, it also allows for currency diversification through providing for the issuance of local currency-denominated bonds by Asian issuers for sale to investors in the region. This would allow governments, corporations and financial institutions in the region access to long-term funding in their respective domestic currencies, thereby avoiding the dual mismatch in both maturity and currency for Asian issuers.

With swap arrangements already in place, it is, therefore, timely and appropriate that ASEAN+3 channels its cooperative efforts toward **the ABMI's longer-term objectives of:**

- a. fostering the development of more efficient and liquid bond markets in Asia;
- b. enabling governments and private sector companies to tap savings in the region;
- c. investing long-term capital with reduced currency and maturity risks; and
- d. developing a market through which to channel regional savings for regional investment needs.

ABMI: Challenges

Despite the region being flushed with funds, they are mostly channelled into US and European markets, leaving the region's bond markets largely untapped. Consequently, the banking system continues to be the primary source of funding. To ensure the further development of Asian bond markets, there is, therefore, a need for an enabling environment comprising sophisticated, monetised financial systems supported by an appropriate regulatory framework as well as the relevant domestic financial institutions and instruments.

In the effort to **create an environment conducive to fostering bond markets in Asia**, the ABMI focusses on the following:

- a. provision of credit guarantees through the active use of existing guarantors and the possible establishment of an Asian Regional Guarantee Facility;
- b. strengthening of the rating system by enhancing the role of domestic rating agencies as well as the possible establishment of an Asian Credit Rating Board;
- c. establishment of a mechanism for disseminating information on issuers and credit rating agencies;
- d. facilitating foreign exchange transactions and addressing settlement issues on cross-border transactions;
- e. examining legal and institutional infrastructure; and
- f. enhancing capacity building through the conduct of market research and technical assistance programmes for the promotion of policy dialogue and human resource development among the member countries.

ABMI: Progress

The ASEAN+3 Finance Ministers endorsed the ABMI during their meeting on 7 August 2003 in Manila. It was further agreed that, given the complexity of the proposed Initiative and the diversity of the levels of member countries' capital market development, the ABMI be supported by **six voluntary working groups chaired by the various ASEAN+3 member countries** to address the following areas:

- a. foreign exchange transactions and settlement issues - chaired by Malaysia;
- b. technical assistance coordination - chaired by Indonesia with the Philippines and Malaysia acting as co-chairs;
- c. new securitised debt instruments - chaired by Thailand;
- d. credit guarantee mechanisms - chaired by Korea;

- e. issuance of bonds denominated in local currency by multilateral development banks (MDBs), government agencies and Asian multinational corporations - chaired by China; and
- f. local and regional rating agencies - chaired by Singapore and Japan.

Malaysia's commitment towards ensuring the success of this Initiative is illustrated by the willingness to chair the voluntary working group on foreign exchange transactions and settlement system as well as co-chair the technical assistance coordination group. In this regard, Malaysia has much to share in progressing the work pertaining to the ABMI, having in place the essential building blocks to foster the development of a dynamic domestic bond market. These include a sound regulatory environment, a reliable and well-developed financial system, a re-energised and restructured corporate sector, as well as adequate infrastructure for custody and settlements.

Towards fostering Asian bond markets

It is clear that the way forward for East Asian economies includes the diversification of financing methods to facilitate the mobilisation of financial resources for development projects as well as acceleration of financial sector development. The ABMI encapsulates this effort, taking cognisance of the fact that the development of viable regional bond markets with depth and breadth calls for continued and consistent policy efforts on the part of East Asian economies in consultation with the private sector, to provide the enabling environment that includes strong institutional and regulatory structures for the financial sector.

As the ABMI progresses, the work of the six voluntary working groups would, at some point, need to converge into a **consolidated roadmap for the development of Asian bond markets**. This would facilitate more effective planning and help focus efforts to eliminate gaps or overlaps. At the national level, developments must progress in parallel with those at the regional level towards developing regional bond markets that would mobilise and channel Asian savings to finance long-term investments in Asia.

its inception in 1998, a total of 1,131 participants have benefitted from courses relating to banking supervision, and another 443 on securities regulations under the 'Financial Regulators Training Initiative' aimed at junior and mid-level supervisors and regulators. Further, in the area of prudential supervision of the life insurance and pensions industry, 180 regulators have been trained under the 3-year initiative ending in September 2003.

At the inter-regional level, the **Asia-Europe (ASEM) Finance Ministers** met for the fifth time in Bali, Indonesia in early July. Recognising that capacity building and skills training are crucial building blocks in a sound financial system, an important outcome of the meeting was the Bali Initiative. The Initiative is aimed at enhancing

human resource development through cooperation among fiscal and financial authorities in both regions in the form of internships, staff exchanges, provision of scholarships and training. The Task Force on Closer Economic Partnership, established in response to a call made at the Fourth Leaders Summit in Copenhagen in September 2002 presented its interim report identifying possible areas of cooperation. In a bid to concretise ASEM financial cooperation, among the studies that will be undertaken include the examination in greater detail the more efficient use of Asian savings and the use of euro as a reserves currency and as a means of transaction in Asian financial and commercial sectors.

On **combating the financing of terrorism and money laundering** under the Anti-Money Laundering Act 2001 (AMLA), further progress

has been made of compliance by reporting institutions. Effective mid-April 2003, the required reporting obligations had been invoked on all financial institutions in Malaysia deemed to be reporting institutions under the AMLA including banks, insurance companies, offshore entities, money changing businesses as well as non-financial institutions which are at risk to money laundering and terrorist financing such as licensed casinos and postal remittance services. The AMLA provides for 150 money laundering predicate offences, including predicate offences relating to terrorism. To enhance cooperation in information sharing, including financial intelligence for detecting and deterring criminal activities, Malaysia signed an MOU with Australia in late January 2003 and is also pursuing similar MOUs with other relevant authorities in the Republic of Korea, Indonesia, UK and the US. In this connection, Malaysia was also accepted into the Egmont Group of Financial Intelligence Units in July 2003. Further, the recent establishment of the South-East Asia Regional Centre for Counter-Terrorism in Kuala Lumpur aimed at enhancing the capacity and capability of countries in the region to combat terrorism is testament to Malaysia's on-going efforts and commitment in this area.

To explore the feasibility of coordinated efforts among ASEM members to ensure transparency of payment transactions and vigorous prosecution of illegal financial transactions outside the regulated financial sector, a workshop in Berlin entitled "Transparency of International Payment Flows, Alternative Remittance Services and Underground Banking" will be held in late October 2003. Co-hosted by Malaysia and Germany, the workshop is expected to develop effective counter-measures in the field of financial market supervision and prosecution of illicit financial services providers.

Progress in trade negotiations within the **World Trade Organisation (WTO)** has been less successful, as evidenced by missed deadlines on key issues. Of particular concern to developing countries is the impasse on issues such as agriculture, special and differential treatment, safeguard measures as well as implementation-related issues that are helpful and meaningful towards their national development agendas. The

Fifth WTO Ministerial Conference will be held in Cancun, Mexico from 10 to 14 September 2003, of which the main task will be to take stock of progress in negotiations and other works under the Doha Development Agenda launched in the Fourth Ministerial Conference in 2001.

In the negotiations of trade in services, which includes financial services, 30 member countries comprising both developed and developing countries, have made initial offers. However, the offers from several members are conditional upon other members making reciprocal commitments or commitments deemed sufficient. This is somewhat contrary to the fact that Article XIX of the General Agreement on Trade in Services (GATS) provides flexibility to developing countries to progressively extend market access in line with their level of development. An initial assessment of the offers made by some of these developed countries indicates that they do not reflect the spirit of Article IV of GATS, which specifically states that members should provide market access in sectors and modes of supply of export interests, to developing countries. In comparison to the wide-ranging requests that the developed countries made to developing countries, their offers, which centred mainly on **Mode 4 (movement of natural persons)**, are very poor.

In the light of the slow progress of developments under the multilateral trading system, following the inconclusive 1982 **General Agreement on Tariffs and Trade (GATT)** Ministerial Meeting, countries pursued RTAs to further enhance trade. To date, 259 RTAs have been concluded and the GATT/WTO duly notified, with many more under negotiation. In addition, there is also an increasing number of bilateral free-trade agreements, with overlapping memberships for many countries. A large number of countries are now parties to two or more RTAs, which progressively have taken many different forms, often going beyond the simple removal of tariff barriers and quotas. These include the removal or reduction of non-tariff barriers through harmonisation or mutual recognition of product standards and conformity assessment procedures, and other areas such as trade in services, capital mobility, environmental standards, investment and labour standards.

MALAYSIA'S FINANCIAL SERVICES LIBERALISATION

Background

The World Trade Organisation (WTO) was established in 1995 as the successor to the General Agreement on Tariffs and Trade (GATT), which deals with global rules of international trade. Its main function is to ensure that trade flows as smoothly and freely and as predictably as possible. This is achieved through administering trade agreements, acting as a forum for trade negotiations, settling trade disputes, reviewing national trade policies and assisting developing countries in trade policy issues. Under the WTO, members operate a non-discriminatory trading system, that spells out their rights and obligations. Each country receives guarantees that its exports will be treated fairly and consistently in other country markets. Each has to do the same for imports into its own market. The system also provides developing countries some flexibility in implementing their commitments. Decisions in WTO are made by consensus by the entire membership, which as of April 2003 stands at 146. The highest level of decision-making body is the Ministerial Conference, which meets at least once every two years.

The Fourth Ministerial Conference in Doha, Qatar in November 2001 has agreed on the Doha Development Agenda (DDA) which lays out a comprehensive agenda focussing on development issues for the future. Members also agreed to a far-reaching set of negotiations that are to be completed within a three-year timeframe with requests and offers of member countries to be summited by 30 June 2002 and 31 March 2003 respectively.

Negotiations in the Services Sector

In respect of negotiations in the services sector, currently 30 members, mainly from developed and a few developing countries have submitted initial offers. However, the initial offers of some developed countries are minimal in scope and do not commensurate with the long and wide-ranging requests made to developing countries. Furthermore, the offers for market access under Mode 4 (movement of natural persons) fail to match the requests made mostly under this mode by many developing countries. At the same time, the lack of requests from developing countries reflects the asymmetries between developing and developed countries in the area of services as developing countries have limited export capacity.

To date, Malaysia has received requests from 21 countries for market access into the services sector, with 15 countries making specific requests on the financial services sector. Malaysia in turn made requests to 45 countries, which include requests on the financial services sector of four countries. Malaysia did not table initial offers by the 31 March 2003 deadline as it is still evaluating the comprehensive requests received as well as continuing with its internal consultations. Nevertheless, Malaysia remains committed to further enhancing the capacity of its financial services sector with a view to further liberalisation and deregulation in a progressive manner to ensure its long-term competitiveness in an increasingly globalised environment.

Liberalising Malaysia's Financial Services

A careful study of Malaysia's commitments at the conclusion of the financial services negotiations in 1997 will reveal the commitment of the Government to bind its existing liberal policies on foreign ownership. In the banking sector the Government allowed the 13 foreign banks in the country to maintain their 100% equity ownership, but were required to be locally incorporated. It had also bound foreign presence at an aggregate maximum of 30% of the total equity of a domestic banking

institution. In the insurance sector, existing foreign shareholders were allowed to increase their ownership subject to a maximum 51% of total equity. New entry of foreign insurance companies was also allowed through participation of up to 30% of total equity of a locally-incorporated insurance company.

The capital market has been progressively opened up, with gradual increases in foreign equity participation in stock broking, fund management and entry of managers, specialists, experts and professionals. Malaysia is committed to 49% foreign equity in stock broking companies. Under appropriate circumstances, Malaysia allows full foreign ownership, such as in fund management and investment advisory.

Malaysia's liberal policies in the financial services sector has resulted in significant presence of foreign services providers in the country. At the end of 2002, apart from the 13 wholly foreign-owned banks which set up presence in Malaysia, foreigners also owned an average 23% of total equity in four domestically-owned banks. On an aggregate basis, foreigners account for about 33% of total commercial bank assets. In the insurance sector, 23 out of a total of 54 insurance companies are majority foreign-owned. Foreign market share in the insurance industry remains high, accounting for 77% of life insurance premiums and 40% of general insurance premiums. In the capital market, five out of 79 licensed fund managers are majority or wholly foreign-owned whilst in the investment advisory sector, close to half of the licensed advisers are majority or wholly foreign-owned.

Besides equity participation, foreign participation has also taken other forms, such as participation through strategic alliances with local entities. In the insurance sector, there are 10 bancassurance arrangements involving locally-incorporated foreign-owned banks, of which nine were established with domestically-owned insurance companies.

Challenges

To prepare domestic institutions for liberalisation, a timeline of 10 years have been set aimed at building a core of strong and forward-looking domestic players. The timelines are encapsulated in the Financial Sector Masterplan (FSMP) and the Capital Market Masterplan (CMP). Both the FSMP and the CMP, launched in 2002, provide a guide on Malaysia's approach towards financial liberalisation and the strategies that would be adopted.

By end December 2002, 54 domestic banking institutions consolidated into 10 core banking groups. This contrast with 13 foreign-owned commercial banks in the country. In the broking sector, the number of stockbroking companies was 40, compared to 66 before the consolidation programme began in 2000.

The mergers was a first for Malaysia in terms of their scale and complexity as they involved more than 50 banking institutions and 66 stockbroking companies. It is therefore not surprising that the process of restructuring and consolidation is still ongoing, particularly in the broking industry, where some institutions have yet to identify their merger partners.

For institutions that have completed their merger exercises, much still needs to be done to consolidate the corporate cultures of the merged institutions. Difficulties are also faced in merging databases and IT systems without disruption to operational efficiency. Other difficulties have also surfaced, in particular, human resource management and manpower deployment which are still being addressed to ensure minimal social disruption. It is important to monitor and manage these developments to ensure the stability of the financial system, more so in an environment of geopolitical uncertainties and nascent economic recovery.

Malaysia, as a member of the WTO, is certainly committed to long-term gradual and progressive liberalisation of the financial services sector. But at the same time Malaysia must ensure that liberalisation must be in the context of its own domestic imperatives. The financial sector must support the nation's economic development agenda.

Malaysia's stand is that for the benefits of liberalisation to be fully realised, the pace of liberalisation has to be in tandem with the capacity and ability of the system to absorb these changes without undermining financial stability. Liberalisation must be carried out at a pace that is consistent with prevailing conditions, infrastructure and regulatory framework and towards meeting the needs of the economy. It is imperative that liberalisation does not marginalise domestic financial institutions. An important lesson of the last financial crisis is that liberalisation strategies must go hand in hand with effective supervision and enhanced capacity building.

The Government has a responsibility to ensure equitable distribution of wealth. It is necessary that domestic institutions must be given a fair chance to develop themselves to face global competition. This is the basis of Malaysia's approach to liberalisation in a sustainable and progressive manner.

Outlook for 2004

Encouraging signs of strengthening recovery...

Global economic growth for the second half of 2003 is projected to be gradual but firm. This is supported by the more positive economic data on Japan, the euro area and in particular, the US. In the US, low interest rates coupled with the extra cash in the hands of consumers made possible from tax cuts contributed towards the sustained vibrancy in housing construction and growing strength in retail sales, while industrial production rose on account of revival in the high-tech sector and auto production. In Japan, positive results of corporate restructuring were reflected in improvement in corporate profits and a gradual upturn in business fixed investment. Meanwhile, in the euro area, pick-up in personal computer replacements led to higher investment and strengthening consumption. Growth in major economies will also be supported by better performance in Asia as the impact of SARS

fades out. With stronger export growth benefitting from pent-up demand pushing up consumption and the positive impact of stimulus packages introduced by many countries in the region, the pace is expected to gain momentum. The momentum from growth in the second half of this year is expected to be sustained into 2004, when world growth is expected to reach 4.1% (2003: 3.2%).

On a less optimistic note, downside risks remain for the outlook for 2004. Geopolitical tensions and sporadic militant acts will continue to pose security risks and impact on worldwide travel and the hospitality industry. Though the US had in early May 2003 declared an end to the major conflict in Iraq, the longer-than-expected reconstruction of the country as evidenced by the on-going pockets of resistance, is also a cause for concern. A delayed or faltering recovery in the US could also cloud the present optimism and derail the much-anticipated recovery in the rest of the world.