International Developments

3

ECONOMIC REPORT

Overview

World growth firms up...

World output, projected to grow by 4.6% in 2004, is close to matching the strong global growth of 4.7% at the beginning of the new millennium, the highest in the last two decades. The global economy recovered from the adverse effects of the 11 September incident, which drove the world into recession in 2001, and the subsequent fallout from the Severe Acute Respiratory Syndrome (SARS) epidemic, as well as the war in Iraq to attain broad-based growth. This recovery was supported by the accommodative monetary and fiscal policies pursued by major economies which revived confidence to fuel global growth.

The continued strengthening of the global economy is mainly driven by sustained consumption and export growth in the United States (US) and Japanese economies. Elsewhere, the vibrant economies in the Asia-Pacific region, in particular China and to a lesser extent India, further supported the strengthening of global growth. Amidst this optimistic development, world inflation continued to remain benign despite concerns over rising oil prices.

Trade, Investment and Financial Market Performance

Encouraging trade and investment performance, while markets were mixed...

The gradual pick-up in **world trade** contributed in a big way towards global growth. World trade, which practically came to a standstill in 2001 (0.1%), slowly gained strength in subsequent years, supported by strong import demand from developing Asia, the transition economies and the US, to record a growth of 4.5% for 2003. World trade is projected to strengthen even further in 2004 at 6.8% as global growth becomes more broad based.

Global **foreign direct investment** (FDI) inflows, which reached USD1,160.7 billion in 2000, have since been on a declining trend. Inflows of FDI fell by 29% to USD823.8 billion in 2001 when the world went into recession, further declining by 20% to USD651.2 billion in 2002, driven by weak economic growth, tumbling stock markets and institutional factors such as the winding down of privatisation in several countries. These conditions continued into 2003 when world FDI stagnated at USD653 billion, with developed countries attracting higher FDI inflows than developing countries. The largest increase was to the US, while flows into the European Union (EU) declined slightly. Among the developing countries, higher inflows were recorded for Africa and Asia-Pacific, while inflows into Latin America and the Caribbean slowed down.

Global FDI inflows are, however, expected to increase in 2004, bolstered by the strengthening global economy, higher corporate profits, a revival in mergers & acquisitions (M&As) and enhanced investor confidence. This was supported by a United Nations Conference on Trade and Development (UNCTAD) survey of 158 national Investment Promotion Agencies (IPAs), conducted in the first quarter of 2004, which revealed that IPAs were optimistic of higher FDI this year and the next. Leading sources of FDI will continue to be the developed countries led by the US, Germany, United Kingdom and France. China, whilst a magnet for investment, is now the fifth largest source of FDI, replacing Japan.

The pattern of FDI flows is expected to remain unchanged with developing countries attracting

TABLE 3.1

Global Economic Indicators
2003-2005

	Real GDP (%)			Inflation (%)			Unemployment (%)		
	2003	2004[1]	2005[2]	2003	2004[1]	2005[2]	2003	2004[1]	2005[2]
World	***3.9***	***4.6***	***4.4***	***3.7***	***3.7***	***3.5***	***6.2***	***n.a.***	***n.a.***
Advanced economies	*2.1*	*3.5*	*3.1*	*1.8*	*2.0*	*1.9*	*6.6*	*6.4*	*6.3*
Developing economies	*n.a.*	*n.a.*	*n.a.*	*6.1*	*5.7*	*5.0*	*n.a.*	*n.a.*	*n.a.*
Newly industrialised Asian economies	*3.0*	*5.3*	*5.0*	*1.4*	*2.1*	*2.4*	*4.3*	*4.1*	*3.8*

1 Estimate.
2 Forecast.
n.a. not available.

Source: IMF World Economic Outlook, April 2004 and various sources.

investments in production activities. Favoured destinations are Latin America and the Caribbean, followed by Africa and Asia-Pacific. In developed countries, investments are expected to focus on logistics and other support services, distribution and sales, research and development, as well as operational headquarters, although in recent years, Asia-Pacific countries have succeeded in attracting multinational corporations to relocate their operational headquarters to the region. Among developing countries, India is increasingly becoming an important destination, with investments expected to more than double from USD5,000 million in 2003 to USD13,000 million in 2008. Modes of investment will also remain unchanged with predominantly greenfield investments in developing countries, and M&As in developed countries.

The performance of major **equity markets** in 2004 was mixed, dominated by rising interest rates, concerns over geopolitical developments and higher oil prices; and for the region, China's economic slowdown. Among the major bourses, Japan's equity market performed best, supported by its improved economic performance. Nikkei posted a 3.8% gain by end-August 2004. In the US, the Dow hit its low for the year in early August on news of lower-than-expected job growth, but recovered after the Federal Reserve Board (Fed), when raising interest rates, reassured investors that the pace of growth in the US economy continued to be on course. In the Asian region, bourses in Manila, Jakarta, Singapore, Kuala Lumpur and Hong Kong fared better, while bourses in Bangkok, Taipei and Seoul were down, as shown in *Table 3.2*.

In the **foreign exchange markets**, the US dollar strengthened against the major currencies during the period of February to May 2004, with the US economy gaining momentum and rising expectations of a US monetary tightening over the course of the year. Subsequently, the dollar fluctuated, influenced by a number of developments, including movements in the oil market, release of US economic data and the expected pace of monetary tightening. Compared to end-2003, the dollar gained 3.3% against the euro and 1.8% against the yen but fell 1.3% against the pound, as shown in *Table 3.3.*

Advanced Economies

All round better-than-expected recovery...

Real GDP growth in advanced countries is expected to improve significantly to 3.5% in 2004 (2003: 2.1%), led by the robust growth in the US and a broad-based recovery in Japan. Growth in the euro area is beginning to firm up, while UK's growth is expected to stengthen further, as shown in *Table 3.4*.

TABLE 3.2

Performance of Selected Equity Markets

Equity Markets/Indices	1 September 1998	End-2003	End-August 2004	% Change vs 1 September 1998	% Change vs End-2003
DJIA, USA	7,827.43	10,453.92	10,173.92	*30.0*	*-2.7*
Nikkei-225, Japan	14,369.63	10,676.64	11,081.79	*-22.9*	*3.8*
FTSE-100, UK	5,115.70	4,476.90	4,459.30	*-12.8*	*-0.4*
DAX, German	4,791.81	3,965.16	3,785.21	*-21.0*	*-4.5*
CAC, France	3,646.29	3,557.90	3,594.28	*-1.4*	*1.0*
HSI, Hong Kong	7,062.47	12,575.94	12,850.28	*82.0*	*2.2*
KOSPI, South Korea	309.71	810.71	803.57	*159.5*	*-0.9*
TWSE, Taiwan	6,335.09	5,890.69	5,765.54	*-9.0*	*-2.1*
KLCI, Malaysia	**262.70**	**793.94**	**842.04**[1]	***220.5***	***6.1***
STI, Singapore	823.33	1,764.52	1,918.34	*133.0*	*8.7*
SET, Thailand	211.09	772.15	624.59	*195.9*	*-19.1*
JCI, Jakarta	325.85	691.89	754.70	*131.6*	*9.1*
PCOMP, Philippines	1,191.76	1,442.37	1,579.83	*32.6*	*9.5*

[1] As at 2 September 2004.

Source: Bursa Malaysia.

TABLE 3.3

Performance of Selected Currencies Against US Dollar

Currencies	Selected currency to one unit of USD			% Change vs	
	2 September 1998	End-2003	End-August 2004	2 September 1998	End-2003
Euro[1]	-	1.26	1.22	-	*3.3*
Hong Kong dollar	7.75	7.76	7.80	*-0.6*	*-0.5*
Deutsche mark	1.75	1.55	1.61	*9.1*	*-3.4*
French franc	5.88	5.20	5.39	*9.1*	*-3.4*
Indonesian rupiah	10,750.00	8,420.00	9,370.00	*14.7*	*-10.1*
Japanese yen	136.98	107.22	109.17	*25.5*	*-1.8*
Korean won	1,344.50	1,192.10	1,152.45	*16.7*	*3.4*
Malaysian ringgit	**3.80**	**3.80**	**3.80**	***0.0***	***0.0***
New Taiwan dollar	34.77	33.97	34.05	*2.1*	*-0.2*
Philippines peso	43.04	55.54	56.16	*-23.4*	*-1.1*
Pound sterling[2]	1.67	1.78	1.80	*7.9*	*-1.3*
Singapore dollar	1.73	1.69	1.71	*1.1*	*-1.2*
Thailand baht	40.55	39.62	41.63	*-2.6*	*-4.8*

[1] USD to one unit of euro. Euro was introduced in January 1999.
[2] USD to one unit of pound sterling.

Source: Bank Negara Malaysia.

TABLE 3.4

Advanced Economies: Major Economic Indicators 2003-2005

	2003	2004[1]	2005[2]
Gross Domestic Product[3] (%)			
Advanced economies	***2.1***	***3.5***	***3.1***
France	*0.2*	*1.8*	*2.4*
Germany	*-0.1*	*1.8*	*1.9*
Italy	*0.3*	*1.2*	*2.0*
Japan	*2.5*	*4.5*	*2.4*
United Kingdom	*2.3*	*3.5*	*2.5*
United States	*3.1*	*4.5-4.7*	*3.5-4.0*
Euro area	*0.4*	*2.0*	*2.3*
Inflation (%)			
Advanced economies	***1.8***	***2.0***	***1.9***
France	*2.2*	*1.8*	*1.6*
Germany	*1.1*	*1.0*	*0.9*
Italy	*2.8*	*2.1*	*2.0*
Japan	*-0.2*	*-0.4*	*-0.1*
United Kingdom	*1.4*	*1.6*	*1.8*
United States	*2.3*	*2.3*	*2.2*
Euro area	*2.1*	*1.7*	*1.6*
Unemployment (%)			
Advanced economies	***6.6***	***6.4***	***6.3***
France	*9.3*	*9.4*	*9.1*
Germany	*9.9*	*10.2*	*10.0*
Italy	*8.7*	*8.4*	*8.2*
Japan	*5.3*	*4.9*	*4.9*
United Kingdom	*5.0*	*4.9*	*4.9*
United States	*6.0*	*5.5*	*5.4*
Euro area	*8.8*	*9.1*	*8.9*
Current Account Balance (USD billion)			
Advanced economies	**-241.9**	**-184.1**	**-191.7**
France	14.7	6.3	13.4
Germany	57.5	82.7	73.9
Italy	-13.1	-14.1	-9.2
Japan	136.4	144.0	152.5
United Kingdom	-42.7	-46.3	-47.0
United States	-541.8	-495.8	-510.1
Euro area	53.2	68.3	75.0

[1] Estimate.
[2] Forecast.
[3] Real GDP.

Source: IMF World Economic Outlook, April 2004 and various sources.

Building upon the strong growth momentum since the second half of 2003 and continuing improvements in productivity, real GDP in the **United States** (US) expanded strongly by 4.5% in the first quarter of 2004. Weighed down by weak consumer spending and a swelling trade deficit, the pace of growth sharply decelerated to 2.8% in the second quarter. Consumer spending, which accounts for about two thirds of all economic activities, grew at a much slower pace of 1.6% (Q1 2004: 4.1%) with spending on big ticket items such as cars and appliances flat. The surge in imports contributed to the worsening trade deficit position. While exports in the second quarter grew at a slower rate of 6.1% (Q1 2004: 7.3%), imports climbed sharply by 14.1% (Q1 2004: 10.6%), indicating a tapering off in overseas demand for US goods. Despite weak consumer spending and the worsening trade deficit position, business fixed investment rose strongly by 12.1% in the quarter (Q1 2004: 4.2%) contributed by significant spending on software and equipment, while residential fixed investment also increased strongly by 14.7% (Q1 2004: 5%).

The most significant feature of the US growth was the gain made in employment, with 1.5 million jobs added to non-farm payroll employment since the pick-up in jobs in August 2003. The expectation for job growth to be sustained, however, did not fully materialise. Job growth, which averaged close to 300,000 jobs monthly during the months of March to May 2004, slackened to 78,000 jobs in June and slowed further to 32,000 jobs in July. Counting on a solid job growth that can translate into higher disposable income and spur consumer spending which can in turn keep the US economic recovery self-sustaining, the dismal job growth numbers for July triggered a fall in the US equity markets to hit the year's low. While attributing the moderation in output growth and a slowing down in the pace of job creation to the temporary increase in energy prices, the Fed nevertheless remained optimistic and maintained its projection of a real GDP growth of 4.5%-4.7% in 2004. To ensure price stability while keeping monetary policy still accommodative, the Fed raised the target federal funds rate from 1.00% to 1.25% in June, and 1.50% in August.

Economic activity in the USD8.5-trillion **euro area** continued to gather pace after an encouraging 1.3% GDP growth in the first quarter of 2004 (Q4 2003: 0.7%), bolstered by a recovery in world trade and improved corporate earnings amidst an all-time low and stable interest rate of 2.00% since June 2003. Growth momentum continued into the second quarter, registering 2% following a rebound in household spending and a pick-up in tourist arrivals to France, improved domestic demand in Italy, as well as strong demand from the US and Asia for Germany's capital goods. The improved business confidence was reflected in increased demand for the services industries, including banking, business, travel, maintenance and transportation. With signs of a spillover from a strong export sector into the broader economy, interest rates were kept steady in August to boost recovery.

Supported by an accommodative monetary policy, improved external environment, as well as pick-up in business investments, the 12-nation euro area is forecast to post a better-than-expected growth although uneven across the area. In Germany, France and Italy, wide-ranging reforms in labour, welfare and healthcare, as well as tax cuts are also expected to boost efficiency, productivity and enhance competitiveness. Private consumption, which has been trending downwards since 2000 and remained flat much of 2003, is expected to recover gradually in tandem with higher disposable income and improved employment prospects. Spurred by broad-based global recovery, the euro area is anticipated to register a stronger growth of 2% for the year (2003: 0.4%), after three years of lacklustre performance.

Following three consecutive years of flat growth, **Germany's** export-led recovery registered a stronger-than-expected GDP growth of 0.8% in the first quarter of the year (Q4 2003: 0%), offsetting the continued decline in household and business spending. The upswing in the US and Asia, particularly China since late 2003 boosted demand for its capital equipment, mainly machinery and energy equipment, which accounts for almost half of its exports. Furthermore, the prevailing low interest rate is a boon to investments in plant, machinery and equipment. Buoyed by external demand and improved business confidence, growth accelerated in the second quarter to register 1.5% as industrial production and factory orders rose for the seventh straight month. The economy, nevertheless, remains vulnerable to developments in the external sector.

Concerted efforts are being made to accelerate fiscal consolidation, as well as address long-standing structural problems in the economy through the implementation of the Agenda 2010 economic reforms. As the largest economy in the euro area contributing to a third of its output, the reforms are also expected to be catalytic to overall growth in the region. For the year, the German economy is poised to reap benefits from the strengthening global economy with its outlook revised upwards from 1.6% to 1.8% (2003: -0.1%).

Europe's second biggest economy, the **United Kingdom** (UK), has turned out a sterling performance of uninterrupted growth for 48 quarters, pushing unemployment level to a 29-year low of 4.8%, the second lowest in the G7, after Japan, at 4.6%. Real GDP growth strengthened further to 3.4% (Q4 2003: 2.9%) in the first quarter of 2004, led by a resilient services sector which accounts for 70% of GDP, while industrial output remained weak. The growth momentum strengthened further in the second quarter to 3.7% when the industrial sector rebounded with substantial gains in manufacturing, mining and quarrying. Within the services sector, distribution, transport and communication, business services, as well as hotels and restaurants grew steadily. The simultaneous expansion in both services and industrial sectors, the first time since 1999, marks a broad and balanced growth across all sectors. As in the previous quarter, growth momentum was also sustained by solid household spending, business investment, as well as government expenditure.

Although unemployment rate has remained steady since the last quarter of 2003 and inflation well below the government's target of 2% (June 2004: 1.6%), concerns over unsustainable consumer debt at one trillion pounds, and an overheating housing market prompted the Bank of England, the first among the world's top four central banks, to tighten monetary policy four times, from 3.75% in November 2003, to 4.50% in June 2004. The benchmark interest rate was, however, left unchanged in July to assess its full impact on household spending and house prices which had increased 22% over the past year, as well as to address earlier concerns of its dampening effect on the manufacturing sector, which accounts for 20% of GDP. However, when signs of recovery emerged from the manufacturing sector, interest rates were raised by 25 basis points to 4.75% in August to prevent the buoyant growth from fuelling inflationary pressures.

For the year, the UK economy is expected to post a robust growth of 3.5% (2003: 2.3%). Risks to growth include uncertain oil prices as well as an appreciating pound *vis-à-vis* the US dollar.

The recent acceleration of **Japan's** economic growth has raised expectations that it is on the path of sustainable recovery. Japan's growth in the fourth quarter of 2003 at 7.3% and the first quarter of 2004 at 6.6% has been the highest among the G7 countries. This growth has partly been driven by the robust economies of China and the US, both being Japan's largest export markets, and partly by structural reforms carried out in the post-bubble era. The Bank of Japan's (BOJ) effort in holding short-term interest rates near zero since February 1999, followed two years later by the more extreme step of quantitative easing, which enabled banks to restart lending, also helped to stimulate economic growth and contain falling consumer prices.

The Japanese economy continued to expand for the ninth consecutive quarter, but at a lower-than-expected annualised rate of 1.7% in the second quarter of 2004, mainly because capital investment has levelled off. The latest monthly statistics point towards a softening in growth in industrial output and household spending, while exports continue to be firm. Industrial output increased by 2.6% in the second quarter compared to the first quarter, the fourth straight quarter of gains, though it fell by 1.3% in June from May. Household spending rose 4.8% year-on-year in May for the seventh consecutive month but dipped slightly by 1.3% in June 2004. In the first half of 2004, exports remained the main engine of growth, increasing by 12.5% as global growth stimulated demand for electronic products. Growth is expected to be on track despite some indications of slowing down. Aided by an improving labour market, consumption is expected to recover and remain buoyant for the rest of the year. Furthermore, the BOJ's quarterly Tankan Survey released in July showed that business confidence rose to a 13-year high, affirming that the current two-year economic recovery remained on track. A wide range of businesses from conglomerates to real estate companies and restaurants expressed optimism, reinforcing the view that recovery is spreading beyond the export sector, the main source of growth, thus far. Based on this more optimistic outlook, growth for 2004 is forecast at 4.5% (2003: 2.5%).

Despite the recovery, the economy remains under mild deflationary pressure as the nationwide core consumer price index continued to fall. As such, the BOJ is expected to maintain its loose monetary policy until year-on-year changes in the consumer price index stabilises above zero.

Going forward, growth for the economy will be vulnerable to a slower growth in the US and China as well as rising oil prices. With private consumption accounting for more than half of Japan's GDP, the expected strengthening of household spending will help to counter any vulnerability to external shocks.

Developing Economies

Increasing significance of developing countries in the global economy...

Developing countries have in recent years increasingly become important in the world economy, outperforming developed countries in terms of growth in real GDP and trade. Developing countries as a whole are expected to register a robust growth of 6% in 2004, with China and India expected to record impressive GDP growth rates of 9.7% and 8.2%, respectively in the first quarter. China's vibrant economic growth coupled with its low labour costs and huge domestic market, as well as India's thriving information and communications technology (ICT) sector, serve as the two largest recipients of FDI among the developing countries. In fact, China surpassed the US as the largest recipient of FDI in 2003.

Africa, which has been achieving steady growth, averaging 3.8% per annum over the preceding three years, is expected to continue recording higher growth of 4.2% in 2004 in tandem with the global economic recovery. The substantial increase in oil production, especially in Angola, Chad and Equatorial Guinea is one of several factors contributing to the growth, together with favourable weather conditions, accommodative monetary and fiscal policies in place, as well as higher commodity prices.

The Western Hemisphere, which includes Latin America, the Caribbean, Central America and Mexico is expected to register 3.9% growth in 2004 (2003: 1.7%), on account of encouraging exports, strong domestic investment and low international interest rates. Major economies in the group are expected to perform better, with Brazil growing at 3.5% (2003: -0.2%), Mexico 3.3% (2003: 1.3%) and Chile 4.6% (2003: 3.3%). Although growth in Argentina is expected to moderate, it will register a high of 5.5% (2003: 8.7%). The region continues to face the challenges of high unemployment, wide income disparity and heavy external debt burden.

East Asian Economies

Growth in East Asian economies increasingly boosted by intra-regional trade…

With continuing improvement in the external economic environment beginning from the second half of 2003, brought about by a synchronised global upswing, growth in East Asia is expected to broaden and strengthen in the course of 2004. Generally, economic activities accelerated in most countries in the region, particularly among members of the Association of Southeast Asian Nations as well as China, Japan and the Republic of Korea (ASEAN+3), driven by continued strength in domestic demand and buoyant intra-regional trade.

East Asian economies are expected to register GDP growth of 7.3% in 2004 (2003: 6.5%), benefitting from the more diversified growth in both the US and Japan. The region's strong macroeconomic fundamentals, as reflected in the healthy balance of payments position and record level of foreign exchange reserves in excess of USD1.3 trillion, as well as stronger banking and corporate sectors following their successful restructuring after the financial crisis, have also lent credence to the optimistic forecast, as shown in *Table 3.5*.

China, which has grown consistently at high average rates of 8.1% for the 2000-2003 period, has provided the impetus for intra-regional trade and contributed to regional growth. China's robust growth contributed to the huge demand for, among others, steel, cement and automobiles, which in turn led to the problem of over-investments in these industries. As such, the government has instituted appropriate measures to rein in the economy and put it on a more sustainable growth path of 7% for 2004, through a series of administrative measures, such as curbing indiscriminate investment and capacity expansion in overheated sectors, restraining local governments from undertaking redundant projects, as well as tightening bank loans and land use. At the same time, measures to boost the agriculture sector were also adopted.

These measures instituted by the government have to some extent succeeded in containing the trend of excessive investment growth, as indicators which include fixed-asset investment, industrial output, money supply and bank lending have shown signs of a slowdown in growth over the past few months. Nevertheless, in the first half of 2004, China continued to record a strong real GDP growth of 9.7% boosted by exports and retail sales of consumer goods, which increased by 36% and 12.8%, respectively. The effectiveness of the government's efforts in bringing about the desired soft landing will enable Asian economies to gradually adjust to the slower growth and avert the negative impact of a sharp decline.

The return of the **Republic of Korea** (Korea) to high growth following the 1997 crisis has been exemplary with annual growth averaging 7.4% during the period 1999-2002. However, the recession in the first half of 2003, which caused real GDP to only expand by 3.1% for the year, indicated that underlying weaknesses still remained in the economy, including the liquidity and solvency problems of credit card companies arising from the highly promoted policy of boosting consumption and the difficult industrial relations faced by some major firms. Notwithstanding this, China's huge import requirements triggered Korea's strong export growth of 39.6% year-on-year to USD21,900 million in June 2004, particularly in automobile and spare parts, semiconductors, wireless telecommunications and computers. At the same time, industrial production continued to grow by 12.3% in June, pushing real GDP up by 5.4% in the first half of 2004.

The high level of household debt and the bursting of the credit bubble in 2003, brought down consumption. This was seen in the big decline in the contribution of consumption to real GDP growth. Whilst domestic consumption contributed to about 50% of real GDP growth in 2002, this share shrank to less than 10% in 2003. However, latest data point towards early signs of recovery in domestic consumption and corporate capital spending, with wholesale and retail sales posting a positive growth of 1.6% and facility investment continuing to increase by 7.9% in June 2004.

In order to bolster economic growth, the government spent a record USD75,900 million to assist credit card defaulters, lower taxes on cars and luxury items, as well as on measures to promote job creation and support the small- and medium-enterprises and the construction industry. In August, the Bank of Korea trimmed its key interest rate from 3.75% to 3.50%, reflecting its concern about the country's economic growth amidst increasing oil prices. With such measures, the government is counting on increasing domestic demand and investment in the second half of 2004 to achieve a commendable 5.2% growth for the year.

As with the rest of East Asia, ASEAN economies also performed better in 2003, as shown in *Table 3.6*. The improved performance was supported by robust commodity prices, rising exports and firmer domestic demand, particularly private consumption and investment. Trade between ASEAN and China intensified in recent years, reflecting closer regional integration. China's total trade share to ASEAN-5 (Indonesia, Malaysia, Philippines, Singapore and Thailand), for example, rose significantly from 5.6% in 2001 to 9.2% in 2003. As a whole, ASEAN economies are expected to register higher real GDP growth of 5.5%-5.9% in 2004 (2003: 5%).

Indonesia's economic performance that began strengthening in 2003 was largely propelled by private consumption expenditure, as well as buoyant growth in exports due to the global rebound and rising commodity prices. Domestic consumption is expected to remain robust in 2004, supported by a stronger economy, sustained agricultural commodity prices, as well as the recently announced pay rise for public servants and easier access to credit as a result of lower interest rates. There have also been signs of a pick-up in domestic investment in tandem with higher business activity, particularly in transportation, telecommunications and construction. Inflation is expected to trend downwards during the course of the year to 5% (2003: 6.6%) largely due to a good harvest which helped contain food prices, as well as the excess spare capacity in the economy. These helped counteract the price pressures caused by election spending and imported inflation exacerbated by a weakening rupiah.

To date, Indonesia's exports, both petroleum and non-petroleum, have performed better (Q1 2004: 0.9%, Q2 2004: 8.8%), with a larger volume of crude oil being exported to reap gains from the rise in oil prices. Non-petroleum exports of wood and pulp, metal ores, as well as machines and electrical appliances also increased in

TABLE 3.5

Selected East Asian Economies: Major Economic Indicators
2003-2005

	2003	2004[1]	2005[2]
Gross Domestic Product[3] (%)			
China	*9.1*	*7.0*	*8.0*
Republic of Korea	*3.1*	*5.2*	*5.2-5.3*
Inflation (%)			
China	*1.2*	*3.5*	*3.0*
Republic of Korea	*3.5*	*3.7*	*3.4*
Current Account Balance (% of GDP)			
China	*2.1*	*1.6*	*1.9*
Republic of Korea	*2.0*	*1.5*	*0.9*

[1] Estimate.
[2] Forecast.
[3] Real GDP.

Source: IMF World Economic Outlook, April 2004 and various sources.

response to demand from China, Japan and Korea. Indonesia, which made its exit from the International Monetary Fund programme in December 2003, is expected to grow at 4.8% in 2004 (2003: 4.1%).

Economic growth in the **Philippines** strengthened by 6.4% in the first quarter of 2004, fuelled by strong export performance, as well as an increase in private consumption, capital formation and agricultural output. Inflation is expected to creep up, reflecting the impact of rising global oil prices on local transport and energy costs, as well as the weakness of the peso. The economy is likely to register higher real GDP growth of 4.9%-5.8% (2003: 4.7%), bolstered by the stronger global economy.

Singapore's export-driven economy, supported by the upturn in the global economy, is expected to continue expanding strongly, driven by the pick-up in global ICT demand and exports of pharmaceuticals and health products. Strengthening external demand is, in turn, envisaged to push up domestic investment growth as capital spending by semiconductor manufacturers strengthens in line with the recovery in global corporate investment. Trade-related services are also expected to perform better, as are financial services where activities in foreign exchange trading, fund management and corporate financing continue to improve. The generally higher global growth continues to revive tourism activities in Singapore, restoring the hospitality, wholesale and retail sectors to pre-SARS levels.

Exports, which expanded by 26.6% in the second quarter, improving from growth of 17.2% in the first quarter of 2004, are expected to contribute to higher domestic capacity utilisation and employment creation, as well as strengthen domestic demand. Although inflation trended upwards in the first half of the year as a result of demand pressures exerted by the strengthening economy, as well as rising oil prices, it is relatively benign and expected to register 1.2% for the year (2003: 0.5%). Singapore's economy is forecast to expand 8%-9% this year (2003: 1.1%), the fastest pace in four years.

Thailand's economy recorded a growth rate of 6.5% in the first quarter of 2004, on account of the sturdier external environment, robust consumer demand, upturn in private investment, recovery in tourism, as well as supportive fiscal and monetary policies. For the year, higher oil prices remain a challenge for oil-importing Thailand, in addition to the outbreak of avian flu and unrest in the Southern provinces. Inflation reached a 66-month peak in July 2004 of 3.1% year-on-year arising from high oil prices, the reduction in retail petrol price subsidies, drought conditions in early 2004 which led to upward pressures on food prices, and a weaker baht. Nevertheless, premised on improving exports, the growth momentum is likely to continue into 2004 at a rate of 7.1% (2003: 6.8%).

TABLE 3.6

Selected ASEAN Economies: Major Economic Indicators 2003-2005

	2003	2004[1]	2005[2]
Gross Domestic Product[3] (%)			
Indonesia	*4.1*	*4.8*	*5.4*
Malaysia	***5.3***	***7.0***	***6.0***
Philippines	*4.7*	*4.9-5.8*	*5.3-6.3*
Singapore	*1.1*	*8.0-9.0*	*3.0-5.0*
Thailand	*6.8*	*7.1*	*6.7*
Inflation (%)			
Indonesia	*6.6*	*5.0*	*4.5*
Malaysia	***1.2***	***1.5***	**–**
Philippines	*3.1*	*3.9*	*4.0*
Singapore	*0.5*	*1.2*	*1.5*
Thailand	*1.8*	*2.2*	*1.3*
Current Account Balance (% of GDP)			
Indonesia	*3.9*	*2.9*	*2.2*
Malaysia	***12.9***	***13.2***	***13.2***
Philippines	*2.1*	*1.6*	*0.8*
Singapore	*30.9*	*28.0*	*26.7*
Thailand	*5.6*	*4.4*	*2.3*

[1] Estimate.
[2] Forecast.
[3] Real GDP.

Source: IMF World Economic Outlook, April 2004 and various national sources.

WTO: AN UPDATE

Introduction

The World Trade Organisation (WTO), established to replace its predecessor, the General Agreement on Tariffs and Trade (GATT) in 1995, is the negotiating forum where Members deal with rules governing trade. The rules ensure trade is effected on a non-discriminatory basis underpinned by predictability. In ensuring that trade continues to be liberalised, the benefits accruing therein will encourage development and economic reforms. Trade is thus recognised by the WTO as an important tool in raising standards of living, ensuring full employment and developing the use of the world's resources.

Progress

Under GATT, there were eight rounds of trade negotiations, namely, Geneva (1947), Annecy (1948), Torquay (1950), Geneva (1956), Dillon (1960-61), Kennedy (1964-67), Tokyo (1973-79) and Uruguay (1986-94). The Uruguay Round resulted in the Marrakesh Agreement that established the WTO.

The WTO witnessed agriculture being brought under international trade rules for the first time. However, little progress was made and liberalisation of the sector remained minimal largely because agriculture trade remained protected. Many developed countries highly subsidised the agriculture sector and imposed prohibitively high tariffs on agriculture items of interest to developing countries. On their part, developing countries believed that they were unable to fully reap the benefits resulting from the Uruguay Round. Meanwhile, textile and clothing will be governed by WTO rules as of 1 January 2005.

To ensure further trade liberalisation across all sectors, in particular agriculture, WTO Trade Ministers launched a new round of multilateral trade negotiations in Doha in November 2001. Known as the Doha Development Agenda (DDA), one of the primary aims of the current round of negotiations is the need to address the development concerns of developing countries.

Issues under the DDA

The major issues under the DDA are agriculture, market access for non-agricultural products (NAMA), services, development issues, rules in relation to the Agreement on Anti-dumping and Agreement on Subsidies and Countervailing Measures, as well as regional trading agreements. Also included are the New Issues of trade facilitation, trade and investment, trade and competition policy and transparency in government procurement.

The agriculture subsidies of the developed countries remain a contentious issue in the WTO. The sector continues to receive heavy subsidies, resulting in distortions and protectionist measures in agriculture trade that have adversely affected developing countries, in particular, those that are heavily reliant on agriculture for their economic development. Although the WTO Agreement on Agriculture sets disciplines on market access, domestic support and export subsidies, genuine and meaningful reforms did not materialise especially in most developed countries where prohibitively high tariffs and huge subsidies remain intact.

The other contentious areas were the four New Issues, which did not find support from many developing countries. Investment rules and competition policy were considered non-trade issues, which should not be in the WTO. Transparency in government procurement was seen as impinging on development and national objectives while trade facilitation would lead to onerous obligations.

Post-Cancun Ministerial Conference

The Ministerial Conference in Cancun in September 2003 failed as the impasse on agriculture could not be overcome. Additionally, developing countries opposed to the New Issues refused calls towards initiating negotiations on them even though the EU offered to drop competition policy and investment from the negotiating agenda.

The run-up to Cancun also saw the formation of a number of groups of countries from the developing world led by Brazil and Malaysia that assumed pivotal roles in the negotiations on agriculture and the New Issues, respectively. These groups, especially on agriculture, were to alter the balance of the negotiations between the developed and developing countries. As a result, the negotiations remained in a limbo until initiatives from certain quarters resulted in a momentum to seek for solutions at the end-July 2004 General Council Meeting in Geneva.

The results of the Meeting have put the DDA negotiations back on track. Members agreed to a Framework Agreement for negotiations on modalities for agriculture and NAMA as well as launched negotiations on trade facilitation.

The Agreement on agriculture highlights the consensus among Members to eliminate all forms of export subsidies on an end date to be agreed upon. Rich countries will also have to make substantial reductions in trade-distorting domestic farm subsidies.

Another positive aspect is the realisation on the part of Members regarding the futility of pressing for negotiations on the New Issues, particularly when many developing countries had fundamental difficulties *vis-à-vis* those issues. Hence, investment, competition policy and transparency in government procurement were dropped from the DDA agenda. Negotiation on trade facilitation was launched with modalities that ensure, *inter-alia*, developing countries would be provided the necessary technical assistance to implement commitments under a future agreement, failing which they will not be expected to assume new obligations.

The General Council Meeting further confirmed the emergence of the Group of 20 developing countries as an influential and positive force in the agriculture negotiation. The emergence of the Group signifies that developing countries could not be coerced to negotiate on issues deemed to be detrimental to their national interests.

While the commitment to eliminate export subsidies and substantively reduce domestic subsidies in agriculture are positive developments, other aspects of the Agreement, such as ambiguous provisions for cutting agriculture tariffs and trade liberalisation in industrial goods, remain areas of concern. Overall, the deal has established pointers from which negotiations can resume. The challenge now is to build on from these.

The July Package

The July package covered the following areas:

In *agriculture*, the framework calls upon Members to eliminate all forms of export subsidies by a target date, which will be determined. The document also agrees that the highest agricultural import tariffs will face the biggest cuts, although no figures have yet been agreed. However, developing countries are allowed to keep higher tariffs on some special products based on criteria such as food security, livelihood security and rural development needs. The EU has pledged to eliminate three billion euros in annual export subsidies, which will be matched by the elimination of trade-distorting elements of US export credit and food aid programmes.

The agreed framework also calls for a substantial improvement in market access for all farm products. In this regard, the WTO members, except the very poorest, will have to make a contribution. This accord also allows countries to shelter some sensitive products from competition from imports. Developing countries will have lower tariff reduction targets, longer implementation periods and more flexible rules concerning sensitive or special products.

On the *services sector*, WTO members have agreed to intensify negotiations on services trade liberalisation. Members who had not tabled initial offers are requested to do so as soon as possible and the submission of improved offers has been set for May 2005.

On *trade facilitation*, negotiations will aim at further easing the release and clearance of goods through customs, where delays and red tape could mean an additional 15% to the cost of exports. The modalities have provisions for the extent and timing of entering into commitments that correspond with the implementation capacities of developing and least developed countries, including provisions for technical assistance. On the other New Issues – investment, competition policy and transparency in government procurement – it was agreed that they will not form part of the DDA. There will be no negotiation on these issues during the Doha Round.

On *industrial products*, the framework was not accepted in totality as developing countries had concerns over some of the elements contained therein. As a compromise, the concerns were detailed out in the framework text and will be taken up during the negotiations on the modalities. The overall text does, however, lay the groundwork for significant tariff cuts and non-tariff barriers to be agreed through negotiation. In this context, developing countries are given special and differential treatment, which could mean having longer implementation periods as well as the possibility for lesser tariff reductions and maintain tariff protection on a limited basis.

Developing countries may encounter some difficulties to effectively participate in the negotiation given the tight deadlines and broad guidelines for the conduct of future negotiations. For example, in the services sector, the last minute decision to have a deadline for revised offers is unrealistic as many developing countries faced with technical and capacity constraints, have yet to submit their initial offers.

Post-General Council Meeting will witness difficulties in negotiations due to the ambiguities in parts of the Agreement. The difficulties notwithstanding, the development concerns of developing countries should be given priority in the negotiations. There is no certainty that liberalisation *per se* will contribute to growth, income or development in each developing country. Hence, WTO should adopt flexibility in its rules to enable each developing country to determine the scope, rate and timing of liberalisation according to its own plan, judgement and schedule.

Conclusion

Trade liberalisation under the WTO will only be meaningful if it ensures that developing countries secure a share in international trade and facilitates economic development. Three quarters of the 147 members of WTO comprise developing countries and countries in transition to market economies, which make it all the more imperative that the needs and concerns of developing countries be given priority in the liberalisation process and rule-making under the auspices of the WTO. The DDA negotiations, with development as its prime objective, need to ensure that this will occur. The liberalisation that will emanate from the DDA has to be geared towards providing market access for goods and services of interest to developing countries. Additionally, new rules that will be developed need to take into account policy space that should not prevent them from fulfilling their development objectives. Only then, would there be progress towards a fair and balanced multilateral trading system with more benefits rather than costs to developing countries.

Financial Cooperation and Trade Developments

Greater regional financial collaboration...

The 1997/98 financial crisis underscored the necessity for international and regional collaboration to ensure financial stability, as well as enhance economic integration and resilience. Malaysia, therefore, continued to participate actively in various regional and international fora, particularly ASEAN, Asia-Pacific Economic Cooperation (APEC) and the World Trade Organisation (WTO).

Financial Cooperation

Focussed on sustaining stability and integration...

In efforts to continue promoting ASEAN as a region and articulating common positions in areas of shared interests, the ASEAN Finance Ministers continued to emphasise regional cohesion and economic integration. Various ongoing initiatives focus on promoting closer consultations on macroeconomic and financial policy issues, as well as cooperation in money and capital markets, tax, insurance and customs matters. Towards further enhancing regional finance cooperation, the forthcoming Vientiane Action Programme (2004 – 2010), to be launched by the ASEAN Leaders in November 2004, will incorporate interim milestones enumerated in the longer-term Roadmap for Financial and Monetary Integration of ASEAN (RIA-Fin) that culminates in 2020. The Roadmap covers financial sector liberalisation, capital account liberalisation, capital market development and currency cooperation. Other finance cooperation initiatives included capital flows monitoring, provision of greater liquidity support or reserve sharing and bond market development.

In the area of regional reserves sharing, new Bilateral Swap Arrangements (BSAs) were concluded under the Chiang Mai Initiative (CMI), increasing the number of BSAs from 12 to 15 this year, with the total commitment rising from USD31.5 billion to USD33.5 billion. A review of the main principles and basic framework of the CMI towards improving its long-term efficacy is now currently underway.

Bond market development continued to be explored in various fora, including ASEAN+3, APEC and the Executives' Meeting of East Asia Pacific Central Bankers. The Asian Bond Markets Initiative (ABMI), premised on the principle of using Asian savings for Asian investments, is aimed at deepening local bond markets in ASEAN, China, Japan and Korea, as well as promoting cross-border issuances and investments. Several working groups are currently studying different aspects towards the establishment of bond markets, including work on asset-backed securities, issuance of locally-denominated bonds, credit guarantees, as well as the establishment of credit rating and settlement systems. As part of the ongoing work on the ABMI, Malaysia hosted the *Kuala Lumpur Bond Conference* on 29 March 2004, which focussed on the theme, *Financing Economic Growth in Post-Crisis Asia*.

A milestone achievement by ASEAN Finance Ministers is the ASEAN Investors' Seminar scheduled in New York at the end of September 2004 to promote ASEAN as an asset class. Based on the theme, *The Promise of ASEAN*, the seminar is a pioneer effort by the ASEAN Finance Ministers to collectively promote ASEAN as an attractive destination for portfolio and capital investments.

As a whole, the efforts towards regional economic integration is consistent with the goal of establishing an ASEAN Community by 2020, which comprises an ASEAN Security Community, ASEAN Social Community and ASEAN Economic Community. When realised, the region would have evolved into a single market with a single production base for the free movement of not only goods and services, but also labour, capital, technology and other productive resources.

In consonance with the Bogor Goals to open up the Asia-Pacific region to free trade and financial flows by 2020, APEC Finance Ministers discussed the need to pursue the appropriate macroeconomic policy mix in order to achieve sustainable, broad-based and equitable growth while taking full advantage of the opportunities afforded by such openness. The role of fiscal policy as a counter-cyclical measure based on country circumstances was extensively examined. Further, the importance of a sound regulatory and institutional framework to enhance the resilience of individual economies in the face of freer capital movements was acknowledged.

Malaysia's active participation in APEC capacity building initiatives and skills enhancement saw it hosting two policy dialogues on *Transparency in the Financial Sector* and *Deposit Insurance* which were held in Kuala Lumpur in February 2004. The policy dialogue on transparency in the financial sector explored the importance of high quality financial disclosure in the corporate and financial sectors and the means by which such disclosure could be promoted. The second workshop addressed issues affecting deposit insurers namely, legal protection and indemnification for individuals working for deposit insurers and other financial system safety net participants, governance and interrelationship management among safety net participants as well as trigger mechanisms for prompt corrective action when dealing with troubled deposit taking institutions.

Under the Financial Regulators Training Initiative (FRTI), which is aimed at providing broad-based training to junior and mid-level financial sector supervisors and regulators, Malaysia chaired both the Advisory Groups for banking supervision as well as securities regulation. The Advisory Groups met in Manila on 19 July 2004 to chart the future direction of the FRTI beyond September 2003. In the Corporate Governance Pathfinder Initiative, Malaysia had the opportunity to highlight work done in the areas of corporate disclosure and oversight, as well as its achievements in the training and education of directors in public-listed companies.

Trade Developments

Focussed on liberalising trade flows...

Global trade liberalisation is one of the core objectives of the establishment of WTO in 1995. The quest for an equitable rules-based multilateral trading system to facilitate international trade is further enhanced by the fast pace of economic activities in the globalisation era. After the collapse of the WTO Ministerial Meeting in Cancun in 2003, the recently concluded WTO General Council Meeting in July in Geneva provided the framework for continuing discussions and negotiations. Both developed and developing countries agreed to the Doha Development Agenda framework which charts the future direction of global trade in goods and services. Among the commitments made on financial services, member countries agreed to work towards progressively higher levels of liberalisation. The agreed framework, which will form the basis for further negotiations, particularly on the elimination or reduction of subsidies and tariffs, is expected to widen participation among developing and transition economies.

The failed WTO Ministerial Meeting in Cancun resulted in renewed interest in, and the proliferation of, bilateral and regional free trade agreements (FTAs/RTAs). Taking cognisance of the benefits to be gained, Malaysia also embarked on several FTAs and RTAs.

In the ASEAN region, efforts continued towards liberalising the financial sector under the ASEAN Framework Agreement on Services (AFAS) as well as the capital account. Under the third round of AFAS negotiations, members worked to identify common sub-sectors and services for liberalisation, over and above the commitments made under the General Agreement on Trade in Services (GATS), or GATS-plus, of the WTO. The work on capital account liberalisation focussed on assessing capital account regimes of individual countries, with a view to identifying the appropriate prudential measures towards preparing country programmes.

FREE TRADE AGREEMENTS

Introduction

Free Trade Agreements (FTAs) are on the increase in terms of numbers, as well as scope. The Secretariat of the World Trade Organisation (WTO) has identified some 250 regional trade agreements (RTAs), whether between two countries or among several countries, either being in force or under negotiation. The WTO expects that the number will reach 500 by 2005.

The popularity of RTAs and FTAs gained further momentum after the collapse of WTO talks in Cancun, in 2003. In the South-East Asian region, the race is now on to sign bilateral and regional FTAs, while in Europe, North America and South America, the respective governments have revitalised their interests in FTAs with developing countries. Within ASEAN, Thailand and Singapore are ahead in terms of the number of FTAs that are under negotiation and being planned, with Singapore in particular, negotiating various agreements with unparalleled rapidity. The US has concluded an FTA with Singapore, and Trade and Investment Framework Agreement (TIFA) each with Malaysia and Thailand.

Apart from bilateral FTAs, the region has also witnessed proposals for the establishment of regional-plus FTAs, such as ASEAN-Closer Economic Relations (ASEAN-CER), ASEAN-China FTA, ASEAN-Japan, ASEAN-Korea, ASEAN-India, ASEAN-EU and the US-proposed ASEAN-US Initiative (AUI) with the potential culmination of FTAs with the US by interested members in ASEAN. Other RTAs where Malaysia is a member include the Organisation of Islamic Conference (OIC) Trade Preferential System (TPS-OIC) and D8 Preferential Tariff Agreement (D8-PTA).

Debate continues as to whether regional and bilateral FTAs contribute to, or detract from the multilateral system, as embodied in the WTO system. Studies show that FTAs are generally beneficial for the participating countries since they reduce trade barriers between them. At the same time, by definition, FTAs discriminate against third countries since they give preference to their FTA partners rather than to the rest of the world based on the Most Favoured Nation (MFN) principle. This provides the basis for those who argue that such arrangements are ‘stumbling blocks’ that undermine the multilateral trading system.

Proponents of FTAs

Proponents argue that bilateral and regional agreements can be negotiated much faster than global agreements. This is especially the case when FTAs pioneer new liberalisation ideas that can be subsequently multilateralised. FTAs also create incentives for other regions and individual countries to follow suit, not wanting to be left behind and in this way, ‘ratchet up’ the global process. Hence, FTAs can be said to play a catalytic role in moving the WTO process forward. While WTO negotiations thus far have focussed on more traditional areas, such as agriculture, industrial goods, intellectual property and services, FTAs have included many new areas, such as environment, government procurement, investment, cooperation, business enhancement and competition policies. This further augments the proponents’ arguments that FTAs can be building-blocks of multilateralism in that, once smaller groups of countries are ‘comfortable’ with new trade subjects, they will not oppose the inclusion of these areas into the WTO.

Opponents of FTAs

The most powerful argument against regional and bilateral trade agreements is that they can lead to trade diversions and trade distortions and ultimately undermine the multilateral system because of their discriminatory nature. For example, preferential rules of origin have been found to stifle technological developments, networks and joint-venture manufacturing, and cause trade diversions through undue restrictions on third-country sourcing.

Another concern is that the world will be divided into three big regional groupings – the Free Trade Area of the Americas (FTAA), the EU organically expanding up to the Russian border and Asia – with trade rivalry extending into the political and security spheres.

WTO and FTAs

A fundamental underpinning of the multilateral trade system is that reductions in trade barriers should be applied on the MFN basis to all WTO members. This means that no WTO member should be discriminated against by another member's trade regime. However, Article XXIV of the General Agreement on Tariffs and Trade (GATT) for trade in goods and Article V of the General Agreement on Trade in Services (GATS) for trade in services, do provide important exceptions to this rule, thereby permitting FTAs and RTAs. Essentially, this means that reductions in trade barriers will be applicable to the countries that sign such agreements.

Compatibility with the WTO

GATT Article XXIV, together with the Uruguay Round Understanding on the Interpretation of Article XXIV of GATT 1994, provide the criteria for WTO compatibility of FTAs and customs unions. In turn, Article V of GATS regulates the compatibility of preferential agreements for the services sector. The formal requirements of GATT Article XXIV are as follows:

- FTA is defined as 'a group of two or more customs territories in which the duties and other restrictive regulations of commerce are eliminated on substantially all the trade between the constituent territories in products originating in such territories.'

- The 'substantially all trade' criteria is understood to have both the qualitative and quantitative dimensions, meaning that 90% of all trade between the parties is covered, with no major sector being excluded. It should be noted that only products subject to total trade liberalisation count for the 'substantially all trade' criteria.

- Asymmetrical agreements, where preferences are not strictly reciprocal – for example, one party may be allowed longer than another to implement certain preferences.

As for trade in services, Article V of GATS allows WTO members to enter into preferential agreements on trade in services as long as they comply with a number of substantive and procedural requirements, namely:

- The agreement should have substantial sectoral coverage, including the number of services sectors, volume of trade affected and modes of supply. No services sector or mode of supply may be excluded *a priori*.

- The agreement should provide for a standstill, i.e., no new discriminatory measures could be established while those already in place should be eliminated either at the entry into force of the agreement or according to a reasonable timetable.

Since the WTO entered into force in 1995, no economic integration agreement has been tested against these criteria.

Types of Trade Arrangements

There are two major types of trade arrangements under the WTO, namely customs unions and free trade areas.

Customs Unions

Under a customs union, parties to the agreement eliminate tariffs and other trade barriers between themselves but maintain a common external tariff against non-parties. These arrangements are more complex to negotiate than free trade areas, because all countries in the union must agree on joint external trade policies. However, because they generally lead to a greater degree of economic integration between the countries, there can be substantial benefits as well. The European Union (EU) is an example of a customs union.

Free Trade Areas

Parties to a free trade area agreement eliminate tariffs and other trade barriers between themselves. However, each individual country maintains its own tariff policy against non-parties to the agreement. The North American Free Trade Area (NAFTA) is an example of a free trade area.

Issues in FTAs

Developing countries, which are late participants of RTAs and FTAs especially with industrialised countries, have found that they lose on any first-mover advantage, as the more recent agreements will be based on 'established templates' of the predecessor agreements. This creates difficulties for many developing countries that find themselves bound by advanced provisions that are beyond their capacities and capabilities.

The proliferation of FTAs has also resulted in a 'spaghetti' or overlapping effect. FTA relationships between different sets of groupings and countries will only add complexity to the international trading system. For example, assuming success in all negotiations among the 21 APEC economies, there will be 80 FTAs/RTAs at some point although the potential is 190 such agreements.

At country borders these agreements tend to complicate tariffs and trade rules, which are applied to the same products but for different partners under different agreements. Quite apart from creating obstacles to trade facilitation by increasing administrative complexity at customs, the proliferation of different preferential rules of origin will result in higher trade costs. In today's global markets where companies depend on the rapid delivery of products and components from multiple overseas sources, these effects can be costly to businesses.

Also, the time and effort spent on negotiating and implementing a series of bilateral and trilateral FTAs may divert scarce resources from the WTO multilateral rounds. Furthermore, there is concern that the opportunity to exclude 'sensitive sectors' in these kinds of agreements may encourage some important trading nations to increasingly give priority to preferential alternatives rather than the multilateral approach to trade liberalisation and hence marginalise the WTO.

Benefits of RTAs

Appropriately designed, FTAs and RTAs complement the WTO and help stimulate further global trade liberalisation. At the same time, customised arrangements between two trading partners can address country-specific elements such as issues relating to the movement of labour and investment.

Many governments have also used FTAs as vehicles to lock in domestic reforms, especially in situations where such governments are undertaking significant structural reforms. For example, a country may use FTA negotiations to speed up specific sectoral reforms or economic/trade reforms of a general nature. In other words, rules negotiated under FTAs will serve to reinforce compliance.

Another important benefit of FTAs is the creation of a larger market for products and services, and the possibility of extensive production networks. This is especially the case for small countries with small market size, relying heavily on trade. Through FTAs, participating countries enjoy an expansion of market access not only by making low cost inputs or finished products available but also, an enhancement of production efficiency through a shift of resources into more productive areas. Additionally, bigger markets allow firms to leverage on economies of scale without the trade-offs between scale economies and competition. This would appear to be the main driver for the on-going negotiations to conclude the ASEAN-China, ASEAN-India and ASEAN-Japan FTAs. In the case of the EU, Ireland is a good example of a country that benefitted from its membership of the EU. Ireland has attracted multinational corporations which use Ireland as an export platform to supply to the rest of Europe.

For small countries, FTAs can provide the necessary experience to negotiate in a larger process. Consensus building can be achieved more rapidly in RTAs while bilateral trade partners are also prepared to be bolder in trade liberalisation. FTAs act as a testing ground or pilot project for exploring complex trade issues and establishing some sort of precedence benchmark for trade negotiations involving a larger number of countries, including one at the multilateral level. This is especially reflected in the more recent cases of FTAs which go well beyond trade in goods and services to incorporate an increasing number of WTO-plus areas and issues, as well as last generation of trade issues called ‘disciplines’ that go into the realm of domestic policies such as taxation and measures relating to registration and qualification requirements.

Many countries that are members of RTAs often use the bilateral FTA approach to overcome the ‘convoy’ problem. Bilateral FTAs among ‘like-minded’ partners within a regional agreement is seen as a way to overcome the slow pace of trade integration that is being held back by the ‘least willing member’. An example of this is the so-called ‘two-speed ASEAN’, where some countries in the association want to move forward more quickly while others want to move at a slower pace.

Outlook 2005

Global growth to continue expanding, although at a more moderate pace…

The growth momentum in the global economy in 2005 is expected to decelerate slightly as major economies tighten monetary policy to contain inflationary pressures. Concerns over the possibility of higher oil prices and the slowing down of China’s economy are other factors that can dampen growth.

Notwithstanding these uncertainties, it is anticipated that the Fed would pursue a measured approach in raising interest rates. As for oil price hikes, the effort of the Organisation of the Petroleum Exporting Countries to raise supply to 26 million barrels per day effective 1 August 2004, will help contain the price increases. Against this backdrop, growth in the US is expected to moderate to 3.5%-4% (2004: 4.5%-4.7%), other emerging markets and developing economies at 5.9% (2004: 6%), while Japan is also expected to grow by 2.4% (2004: 4.5%). In contrast, recovery in the euro area is anticipated to strengthen further to post a real GDP growth of 2.3% (2004: 2%) with a gradual pick-up in domestic demand aided by favourable financing conditions. Overall, global growth is projected at 4.4% in 2005 (2004: 4.6%).