Economic Report 2007/2008

2 International Environment and Economic Cooperation

Overview

The world economy remains on track for continued strong growth…

The **world economy** is expected to continue expanding for the fifth consecutive year in 2007, albeit at a more moderate pace, amidst high crude oil prices and uncertainties in the economy of the United States (US). While growth is relatively lower than the 2006 performance, it is nonetheless expected to remain strong with further expansion in economic activities, especially in the fast-growing emerging economies, notably China, India and Russia, as well as recovering Europe and Japan. Global inflation remains at manageable levels although it has edged upwards due to high crude oil prices.

For the **advanced countries**, growth is more balanced across regions with the steady recovery in Europe and Japan partially offsetting the moderation in the US. **Developing countries**, primarily driven by investment and robust trade, are expected to outperform advanced countries and increasingly contribute to global growth. In this context, China, India and Russia are anticipated to account for more than half of this year's growth. Rapid growth has also led several large developing countries to significantly contribute to outward foreign direct investment (FDI), an area where traditionally, developed countries were the main sources.

The more widely-shared growth in 2007 is expected to spill over into 2008, with world trade and investment projected to continue steadily expanding, and against a backdrop of relatively benign inflation. The favourable environment is expected to contribute positively to the Malaysian economy. In addition, Malaysia's continued engagement in regional and multilateral cooperation is set to further deepen its integration with the global economy.

Global Economic Performance

World growth remains robust despite uncertainties in the US, while inflation remains manageable…

The **global economy** is expected to expand at 5.2% in 2007, as shown in *Table 2.1*, mainly driven by robust growth in China, India as well as Russia, which is envisaged to offset the impact of moderation in the US economy arising from the housing market slump and dampened consumer spending. Although global growth remains strong, inflation is still at a manageable level.

The **US economy** grew at 4.0% during the second quarter of 2007 (January-March 2007: 0.6%) as economic activity rebounded, largely due to consumer spending, non-residential fixed investment and exports. Since the beginning of the year, however, persistent weaknesses in the housing sector, exacerbated by delinquencies in subprime mortgages, percipitated a credit crisis over the July-August period and caused greater volatility in the world financial markets. Consequently, the US economy is expected to moderate in the second half, resulting in lower real Gross Domestic Product (GDP) growth of 2.0% in 2007 (2006: 3.3%).

The 13-nation **euro area**, which expanded by 3.1% in the first quarter of 2007 (January-March 2006: 3.0%), registered weaker-than-expected growth of 2.5% in the second quarter (April-June 2006: 2.7%). The largest economy in the euro area, Germany, experienced slower growth in the first half, partly due to lower consumer spending because of the sales tax hike imposed in January 2007, and a contraction in the construction sector, particularly in the second quarter. However, the outlook for the year remains favourable, underpinned by increasing consumer spending due to rising employment and higher wage growth as well as robust exports. The euro area is expected to record 2.6% growth in 2007 (2006: 2.8%).

Japan continued its recovery into the second quarter of 2007, posting a slightly lower growth of 2.3% compared to 2.6% in the first quarter, partly due to consumer spending being constrained by falling wages and higher taxes. Growth nevertheless was driven mainly by exports and business investments, resulting in a nine-year low unemployment rate of 3.7% in June. Against this backdrop, growth for the year is expected to be broadly maintained at a slightly higher rate of 2.6% (2006: 2.2%), thereby extending the present period of recovery into its sixth year.

Growth in **emerging East Asia** is expected to moderate slightly to 8.1% in 2007 (2006: 8.4%). Exports remain the main driver of regional growth, while domestic demand continues to improve in most economies. Apart from the strong global demand for the region's exports, the buoyant Chinese economy also continues to gain importance as an export destination for other economies in the region, including members of the Association of Southeast Asian Nations (ASEAN).

In the first quarter of 2007, **China** posted a higher-than-expected growth of 11.1%, which rose even further to 11.9% in the second quarter (April-June 2006: 11.3%), the fastest pace in 12 years. Growth was driven by continued strong merchandise exports and retail sales. Industrial output rose 18.7%, the highest in almost a decade.

To prevent the economy from overheating, the government continues to tighten land and project controls in addition to enforcing more stringent environmental standards, as well as raising interest rates and reserve requirements to limit new investments. In August, the People's Bank of China raised the benchmark lending rate to 7.02% and the one-year deposit rate to 3.60% (July: 6.84%; 3.33%), the sixth increase since April last year. Both rates are the highest in more than eight years.

TABLE 2.1

Real Gross Domestic Product (GDP) Growth for Selected Countries 2006-2008

(% change)

	2006	2007[1]	2008[2]
World	***5.5***	***5.2***	***5.2***
Advanced Countries	*3.1*	*2.6*	*2.8*
United States	*3.3*	*2.0*	*2.8*
Euro area	*2.8*	*2.6*	*2.5*
United Kingdom	*2.8*	*2.9*	*2.7*
Japan	*2.2*	*2.6*	*2.0*
Asia			
China	*11.1*	*11.2*	*10.5*
Hong Kong SAR	*6.8*	*5.5*	*5.0*
Republic of Korea	*5.0*	*4.4*	*4.4*
Taiwan	*4.6*	*4.2*	*4.3*
India	*9.7*	*9.0*	*8.4*
ASEAN 5	*5.4*	*5.5*	*5.8*
Indonesia	*5.5*	*6.0*	*6.3*
Thailand	*5.0*	*4.5*	*4.8*
Singapore	*7.9*	*7.0*	*5.7*
Philippines	*5.4*	*5.8*	*5.8*
Malaysia	***5.9***	***6.0***	***6.0-6.5***

[1] Estimate.
[2] Forecast.
Source: IMF and national authorities.

The **Republic of Korea** registered growth of 4.0% in the first quarter, and strengthened to 4.9% in the following quarter (April-June 2006: 5.1%), primarily due to a recovery in the semiconductor industry. Exports expanded by 10.7% in the second quarter, and continued to be the main driver of growth for seventeen consecutive quarters, despite the strengthening won.

India grew by 9.1% in the first three months of 2007 (January-March 2006: 10.0%), supported mainly by strong performances in the manufacturing and services sectors that expanded by 12.4% and 9.3%, respectively (January-March 2006: 9.4%; 14.2%). The farm sector, which is the source of livelihood for about 60.0% of the population, remains a concern, growing at only 3.8% (January-March 2006: 6.2%). The weak performance of the sector is expected to push food prices up, leading to inflationary pressures in the economy.

In the **ASEAN** region, GDP growth for the year is expected to range from 4.5% in Thailand to 7.0% in Singapore, mainly driven by exports and domestic investment. Among the emerging markets in ASEAN, Viet Nam notched 7.9% in the first half of 2007, primarily due to surging investments and robust non-oil exports.

As for the other developing countries, expectations for economic growth remain robust in 2007, ranging from 5.5% in the **Middle East** and **emerging Europe**, to 7.6% in the **Commonwealth of Independent States**. Growth is expected to be supported by, among others, strong consumption and investment, as well as firm prices for commodities such as oil, gas, metals and cotton.

Inflation has been generally well contained despite strong global growth, although some emerging market and developing countries face inflationary pressures, especially from rising energy and food prices. Crude oil prices remain high due to production capacity constraints and rising demand, whilst food prices have edged up following weather-related supply shortfalls and increasing use of biofuels. Inflation for the year is projected to be 2.0% for the advanced countries and 5.7% for emerging market and developing countries.

Investment Flows

Investment flows continue to surge...

Global **FDI** inflows grew by 34.3% to USD1,230.4 billion in 2006 (2005: 28.9%; USD916.3 billion). According to the United Nations Conference on Trade and Development (UNCTAD), the US regained its position as the largest recipient of FDI, attracting USD177.3 billion or an increase of 78.2% compared with 2005 (2005: USD99.4 billion; -18.8%). The next two most attractive destinations for FDI inflows were the United Kingdom (UK) registering USD169.8 billion, an increase of 3.2% (2005: USD164.5 billion; 192.7%) and France, USD88.4 billion, an increase of 39.0% (2005: USD63.6 billion; 102.6%).

Asia and Oceania maintained their position as leading targets for FDI in the developing world. FDI inflows to the region reached a new high of USD230 billion, up 15.0% (2005: USD200 billion; 27.2%), with China drawing USD70 billion, down 3.3% (2005: USD72.4 billion; 19.5%) and Hong Kong SAR, USD41.4 billion, up 15.4% (2005: USD35.9 billion; 5.6%). With respect to cross-border mergers and acquisitions (M&As), services remained the dominant sector, notably telecommunications and energy, while the primary sector, especially mining, gained importance.

Gross FDI into Malaysia increased to RM37.2 billion in 2006 (2005: RM26.8 billion) equivalent to 7.1% of Gross National Product (GNP), due to increased acquisition activities by foreign investors and retained earnings reinvested by existing multinational corporations (MNCs). However, after accounting for adjustments in outflows arising mainly from loan repayments to parent companies abroad, net FDI inflows amounted to RM25.9 billion or 4.9% of GNP. The Netherlands, Japan, Singapore and the US remain the top sources of FDI in Malaysia, predominantly in the electrical and electronics (E&E), chemicals and chemical products as well as food manufacturing industries.

With regard to global FDI outflows, developed countries, led by the Netherlands, France and the UK, remained the principal sources of such outflows, which amounted to USD779 billion in 2005. Meanwhile, there were significant increases in outward FDI from developing countries totalling USD133 billion or 17.0% of total outflows. For more than a decade since 1992, there has been a marked increase in growth rates of FDI outflows from developing countries, led by India, Turkey, Colombia and Malaysia, as shown in *Chart 2.1*. Factors driving their expansion abroad include vast business opportunities in new markets, rising costs of domestic production, competition from low-cost producers, push and pull factors prompted by home and host government policies, and the rapid growth of many large developing countries, as well as other market-related factors.

Among the top 15 developing countries, Malaysia ranked eighth in terms of outward FDI in 2005. Most investments were undertaken through acquisitions and joint ventures with some greenfield investments led by large and established Malaysian corporations in the petroleum and services sectors, followed by construction, manufacturing and agriculture. Malaysian investments were directed to various parts of the world, in particular Indonesia (oil palm plantations, banking and telecommunications), Middle East and South Asia (infrastructure, housing and highway projects), Africa and Central Asia (oil and gas), as well as China (utilities).

Global FDI growth is forecast to continue its upward momentum throughout 2007, with the services sector, particularly information and communications technology, public utilities, transportation, tourism, as well as hotels and restaurants, as the main source of investment growth. E&E products, machinery and equipment, as well as metals and metal products are expected to contribute the largest FDI growth in the manufacturing sector. In the primary sector, higher prices and strong demand for natural resources are expected to increase FDI flows, notably into mining and petroleum.

Trade Flows

Robust trade reinforcing global growth, benefitting Malaysia...

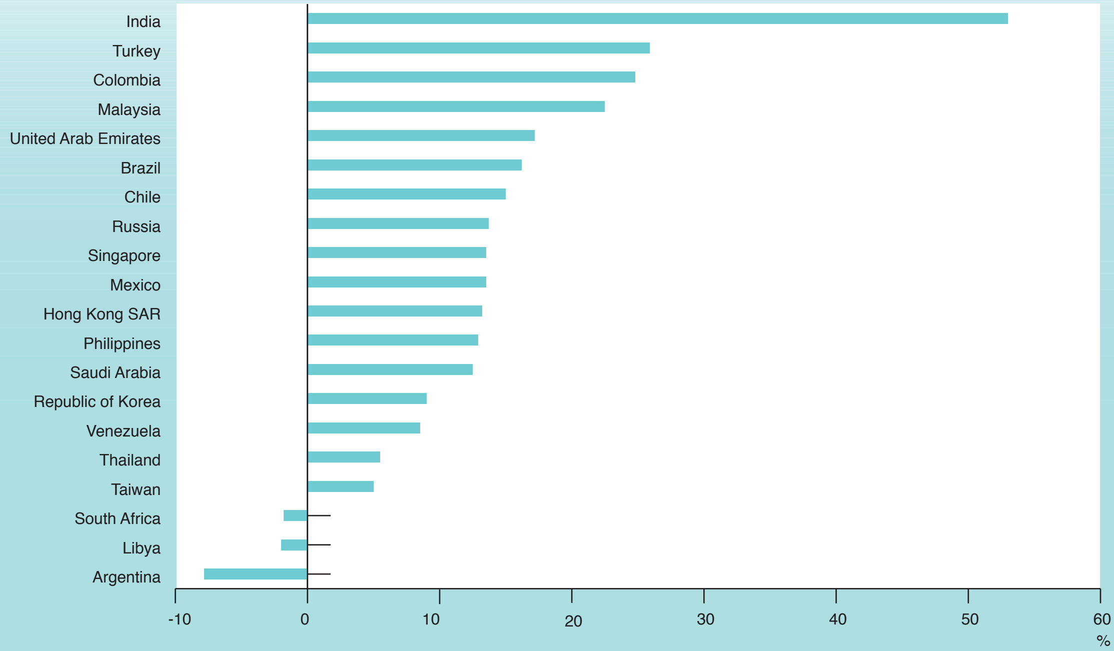
World trade continues to expand in 2007, albeit at a slower pace of 7.1% (2006: 9.4%). Continued strong global growth and sustained import demand of 7.3% (2006: 9.4%), particularly for raw materials and commodities, are the main contributors to trade growth.

Demand for imports in the euro area is expected to expand by 5.4% (2006: 7.9%), supported by rising business confidence. Imports by Japan are

CHART 2.1

Annual Average Growth Rates of Outward FDI Flows from Selected Countries 1992-2004

(3-year moving average, percentage)



Source: UNCTAD.

likely to moderate to 3.0% (2006: 4.5%) as a result of the depreciation in the yen. Following a substantial moderation in corporate and residential investments, import growth in the US will likely be restrained to 3.7% (2006: 6.0%). Despite lower import growth at 12.8% (2006: 15.0%), emerging economies will contribute significantly to world trade, with China leading the way.

In the commodities markets, crude oil prices soared in early August 2007, breaching USD78 per barrel on the back of civil unrest in Nigeria, continuing US refinery constraints and geopolitical tensions in the Middle East. These factors, combined with growing global demand, are expected to keep prices fluctuating at a relatively high level. Crude oil price hikes and rising environmental awareness have caused the demand for alternative fuels, particularly biofuels, to rise. Consequently, prices of biofuel inputs, primarily corn, palm oil, sugar cane and rapeseed, remain high. Non-oil commodities such as palm oil and rubber will also benefit from price gains due to strong demand, especially from China.

The current moderation in the E&E sector is expected to improve in the second half of the year. Global semiconductor sales are estimated to grow by 1.8% or USD270 billion (2006: 10.0%; USD247.7 billion) despite sharp declines in average selling prices for microchips due to stiff competition and excess inventories. The lower average selling price is compensated by higher sales volume of semiconductors, driven by healthy growth in major end-markets such as personal computers, digital consumer appliances and mobile communications, especially in Asia Pacific. Continued growth in E&E is expected to sustain demand for other commodities such as metals and metal products, in particular copper.

Exports of commercial services, which expanded less rapidly than merchandise exports, rose by 11.0% to USD2.7 trillion in 2006 (2005: 11%; USD2.4 trillion). Exports of services from Asia continued to grow faster for the third consecutive year than the global average and the region's services imports, thereby reducing the region's deficit in services trade. The US, the largest services exporter, accounts for 14.3% of the total, mainly in business and financial services. Other major exporters included the UK (8.2%), Germany (6.1%), Japan (4.5%) and France (4.1%).

Malaysia, an open and trade dependent economy, is expected to reap benefits from the continued expansion in world trade. Malaysia's external trade grew 2.2% to reach RM522,383 million during the first six months of the year (January-June 2006: 11.4%; RM511,112 million). Malaysia's trade surplus, however, contracted 10.4% to RM43,597 million (January-June 2006: 1.6%; RM48,638 million) amidst softer global demand for E&E products. The US, Singapore, Japan and China continue to be Malaysia's major trading partners, and accounted for 48.3% of total trade during the first six months of the year (January-June 2006: 50.2%), as shown in *Chart 2.2*.

The **US**, Malaysia's largest trading partner, accounted for 14.1% of total trade (January-June 2006: 16.5%) during the first six months of the year. E&E products comprised 77.5% (January-June 2006: 79.8%) of total exports. A weak US dollar coupled with sluggish demand for automatic data processing (ADP) machines and parts, hybrid integrated circuits, digital monolithic integrated circuits as well as telecommunication equipment and parts saw exports of E&E products to the US contract by 14.1% (January-June 2006: 9.2%). Imports posted a similar trend, declining 14.1% on weak demand for E&E components, machinery, appliances and parts as well as optical and scientific equipment. Consequently, Malaysia recorded a lower trade surplus of RM19,439 million (January-June 2006: RM21,048 million) during the period, as shown in *Table 2.2*. E&E exports to the US are anticipated to pick up towards the second half of the year on account of seasonal sales, more competitive prices as well as introduction of new consumer electronic products.

Singapore remains Malaysia's second largest trading partner with a share of 13.2% (January-June 2006: 13.9%) to total trade. Imports outpaced exports, expanding 6.9% (January-June 2006: 10.0%) in the first six months of the year led by strong demand for refined petroleum products and sustained demand for E&E products, chemical and chemical products as well as machinery, appliances and parts. In contrast, exports to Singapore, comprising mainly E&E components and refined petroleum products, fell by 9.1% (January-June 2006: 13.8%). This was primarily due to weak demand for E&E products and

TABLE 2.2

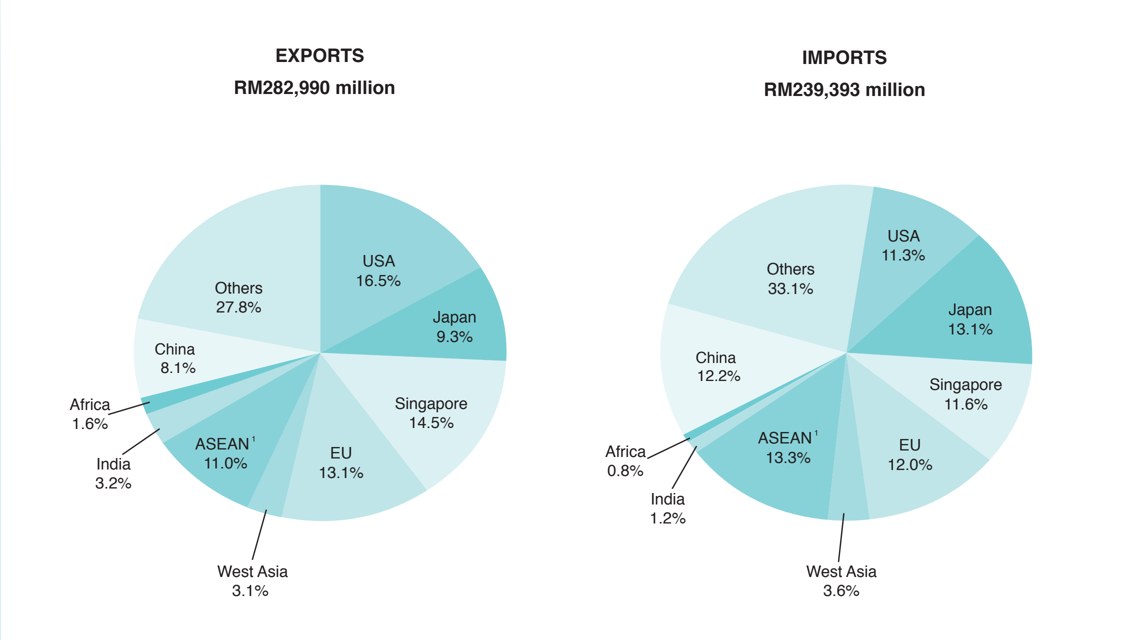
Direction of External Trade - Malaysia
January-June

	RM million						Share of Total (%)				Growth Rate (%)			
	Exports		Imports		Trade Balance		Exports		Imports		Exports		Imports	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
United States	**52,624**	**46,574**	**31,576**	**27,135**	**21,048**	**19,439**	**18.8**	**16.5**	**13.7**	**11.3**	**8.3**	**-11.5**	**18.1**	**-14.1**
Singapore	**45,206**	**41,100**	**25,922**	**27,721**	**19,283**	**13,379**	**16.2**	**14.5**	**11.2**	**11.6**	**13.8**	**-9.1**	**10.0**	**6.9**
Japan	**24,558**	**26,232**	**31,453**	**31,260**	**-6,895**	**-5,028**	**8.8**	**9.3**	**13.6**	**13.1**	**-0.5**	**6.8**	**5.0**	**-0.6**
North East Asia														
(not including Japan)	**51,452**	**55,974**	**57,465**	**63,187**	**-6,013**	**-7,213**	**18.4**	**19.8**	**24.9**	**26.4**	**8.0**	**8.8**	**17.1**	**10.0**
China	18,253	22,912	27,189	29,170	-8,936	-6,258	6.5	8.1	11.8	12.2	12.5	25.5	21.7	7.3
Hong Kong SAR	14,813	12,893	5,778	6,929	9,035	5,965	5.3	4.6	2.5	2.9	-1.1	-13.0	20.0	19.9
Republic of Korea	11,010	12,066	12,546	12,364	-1,536	-297	3.9	4.3	5.4	5.2	15.5	9.6	22.4	-1.5
Taiwan	7,341	8,035	11,914	14,645	-4,573	-6,610	2.6	2.8	5.2	6.1	7.2	9.5	2.2	22.9
ASEAN														
(not including Singapore)	**30,488**	**31,008**	**32,431**	**31,925**	**-1,943**	**-917**	**10.9**	**11.0**	**14.0**	**13.3**	**12.4**	**1.7**	**13.0**	**-1.6**
Thailand	15,238	14,507	12,715	13,128	2,523	1,379	5.4	5.1	5.5	5.5	7.3	-4.8	14.7	3.2
Indonesia	6,454	8,470	9,294	9,041	-2,841	-571	2.3	3.0	4.0	3.8	4.6	31.2	18.5	-2.7
Philippines	3,920	3,969	5,378	3,960	-1,458	9	1.4	1.4	2.3	1.7	7.2	1.2	-12.7	-26.4
Viet Nam	3,747	2,921	2,198	3,000	1,549	-80	1.3	1.0	1.0	1.3	82.8	-22.0	46.6	36.5
Brunei	627	626	94	162	533	464	0.2	0.2	0.0	0.1	12.1	-0.1	271.2	73.3
European Union	**33,836**	**37,090**	**25,947**	**28,819**	**7,888**	**8,271**	**12.1**	**13.1**	**11.2**	**12.0**	**14.1**	**9.6**	**5.0**	**11.1**
Germany	5,940	7,181	9,644	11,957	-3,704	-4,777	2.1	2.5	4.2	5.0	11.8	20.9	7.0	24.0
Netherlands	9,401	10,644	1,786	1,585	7,616	9,058	3.4	3.8	0.8	0.7	15.6	13.2	22.9	-11.2
United Kingdom	4,972	4,896	3,298	3,271	1,674	1,625	1.8	1.7	1.4	1.4	6.5	-1.5	-1.8	-0.8
France	3,590	3,503	3,389	3,443	201	60	1.3	1.2	1.5	1.4	13.8	-2.4	14.1	1.6
Italy	1,862	2,002	2,402	2,207	-540	-205	0.7	0.7	1.0	0.9	34.4	7.5	0.7	-8.1
Ireland	745	771	1,432	1,081	-687	-310	0.3	0.3	0.6	0.5	-18.5	3.5	0.3	-24.5
South Asia	**11,294**	**12,128**	**2,359**	**3,200**	**8,935**	**8,928**	**4.0**	**4.3**	**1.0**	**1.3**	**14.6**	**7.4**	**10.6**	**35.7**
India	8,072	8,922	2,159	2,919	5,913	6,002	2.9	3.2	0.9	1.2	16.7	10.5	9.5	35.2
West Asia	**7,329**	**8,860**	**9,399**	**8,676**	**-2,070**	**184**	**2.6**	**3.1**	**4.1**	**3.6**	**15.9**	**20.9**	**50.2**	**-7.7**
United Arab Emirates	3,511	4,792	1,512	2,114	1,998	2,677	1.3	1.7	0.7	0.9	6.3	36.5	26.0	39.8
Saudi Arabia	878	1,230	3,952	3,351	-3,073	-2,121	0.3	0.4	1.7	1.4	-4.9	40.1	57.3	-15.2
Iran	729	954	978	687	-249	266	0.3	0.3	0.4	0.3	22.7	30.9	59.5	-29.7
Oman	175	221	1,751	1,128	-1,576	-907	0.1	0.1	0.8	0.5	6.1	26.3	106.0	-35.6
Australia	**8,854**	**9,476**	**3,899**	**5,054**	**4,955**	**4,422**	**3.2**	**3.3**	**1.7**	**2.1**	**8.0**	**7.0**	**-6.3**	**29.6**
New Zealand	**1,534**	**987**	**608**	**790**	**926**	**197**	**0.5**	**0.3**	**0.3**	**0.3**	**115.9**	**-35.6**	**-6.8**	**29.8**
Africa	**3,737**	**4,410**	**2,143**	**1,816**	**1,594**	**2,595**	**1.3**	**1.6**	**0.9**	**0.8**	**5.1**	**18.0**	**68.2**	**-15.3**
Rest of the World	**8,963**	**9,151**	**8,034**	**9,811**	**929**	**-660**	**3.2**	**3.2**	**3.5**	**4.1**	**23.1**	**2.1**	**-2.1**	**22.1**
Total	**279,875**	**282,990**	**231,237**	**239,393**	**48,638**	**43,597**	**100.0**	**100.0**	**100.0**	**100.0**	**10.5**	**1.1**	**12.6**	**3.5**

Source : Department of Statistics, Malaysia.

CHART 2.2

Direction of External Trade - Malaysia January-June 2007



[1] Not including Singapore
Source: Department of Statistics,Malaysia.

lower shipments of refined petroleum products. Accordingly, total trade declined by 3.2% to RM68,820 million in the first six months of the year with Malaysia recording a lower trade surplus of RM13,379 million (January-June 2006: RM71,128 million; RM19,283 million). An upswing in global demand for E&E products towards the second half of the year is expected to boost bilateral trade between the two countries.

Malaysia continues to record a trade deficit with **Japan**, its third largest trading partner and largest source of imports. However, a lower trade deficit of RM5,028 million (January-June 2006: RM6,895 million) was recorded in the first six months of the year following higher exports of liquefied natural gas (LNG). Imports were sustained at RM31,260 million while exports, led by robust demand for LNG, rebounded 6.8% to RM26,232 million (January-June 2006: RM31,453 million; -0.5%; RM24,558 million). Principal exports to Japan include semiconductor devices, telecommunications and sound equipment, ADP machines and parts, LNG as well as wood products while imports include E&E components, machinery, appliances and parts as well as iron, steel and other metal products.

Exports to **China**, Malaysia's fourth largest trading partner, have been on the uptrend, driven by robust demand for E&E products, palm oil, chemical and chemical products as well as natural rubber. Rapid developments in China's information and communications technology sector, coupled with strong presence of MNCs, have fuelled demand for E&E products, in particular, digital monolithic integrated circuits as well as ADP machines and parts which surged 35.9% during the first six months of the year (January-June 2006: 16.6%). Imports from China comprised mainly ADP machines and parts, semiconductor devices, machinery, appliances and parts, chemical products as well as iron, steel and other metal products. Trade with China remains in deficit, although it narrowed to

RM6,258 million (January-June 2006: RM8,936 million) during the first six months of the year on account of higher exports of manufactured goods and shipments of palm oil.

ASEAN (excluding Singapore) remains an important regional trading partner. Its share to Malaysia's total trade was sustained at 12.0% (January-June 2006: 12.3%) during the first six months of the year. Trade deficit with ASEAN, however, improved significantly by 52.8% to RM917 million (January-June 2006: -24.2%, RM1,943 million). This is mainly on account of lower imports of semiconductor devices. Main exports to ASEAN included parts and accessories for ADP machines, semiconductor devices, organic chemicals, crude petroleum as well as machinery, appliances and parts. E&E products, chemicals and chemical products, transport equipment as well as crude petroleum formed the bulk of imports.

Efforts toward market diversification through bilateral, regional and multilateral trade initiatives, trade facilitation as well as aggressive trade and investment promotions have seen the emergence of new export markets for Malaysia. Of increasing significance are the Netherlands, India, Pakistan and several countries in West Asia, including United Arab Emirates, Turkey, Saudi Arabia and Iran. Principal exports to these countries in the first six months were E&E products, crude petroleum, palm oil, jewellery, chemical products, optical and scientific equipment as well as machinery, appliances and parts.

International Economic Cooperation

Active engagement at regional and multilateral levels…

As countries become more integrated into the global trading and financial system, it is imperative for Malaysia to actively engage in **international cooperation** efforts to share ideas and seek solutions at the regional and multilateral levels towards addressing common issues with a view to ensuring global financial stability. The key fora where Malaysia actively participates include ASEAN, ASEAN+3 (China, Japan and the Republic of Korea), Asia Pacific Economic Cooperation (APEC), Asia-Europe Meeting (ASEM), International Monetary Fund (IMF), World Bank, Asian Development Bank (ADB), Islamic Development Bank (IDB) and World Trade Organisation (WTO).

The year 2007, which marks the 40th anniversary of **ASEAN** cooperation, will also be a watershed for ASEAN integration and community building. In this regard, the *Kuala Lumpur Declaration on the Establishment of the ASEAN Charter*, signed on 12 December 2005, provided the impetus for the drawing up of the landmark constitutional document embodying fundamental principles, goals, objectives and structures for ASEAN. The ASEAN Charter, which the Leaders are expected to endorse by end-2007, will also confer a legal personality on ASEAN, thus formalising its establishment as a full-fledged inter-governmental organisation.

A parallel development is the effort to accelerate the establishment of the ASEAN Economic Community (AEC) by 2015, ahead of the full realisation of the ASEAN Community in 2020. The AEC will transform ASEAN into a single market and production base, a highly competitive economic region and a region of equitable economic development, fully integrated into the global economy. Under the ASEAN Finance Ministers' process, Malaysia currently chairs the initiative on the ASEAN Infrastructure Financing Mechanism, which aims to recycle ASEAN savings into infrastructure development and to spur further economic growth in the region.

In the context of strengthening regional financial stability, **ASEAN+3** continues to deepen financial cooperation through two principal initiatives, namely, the Asian Bond Markets Initiative (ABMI) and the Chiang Mai Initiative (CMI). The ABMI aims to foster the development of bond markets in the East Asian region, while the CMI was established post-Asian financial crisis to assist member countries facing liquidity or balance of payments problems (refer feature article, *Regional Cooperation in East Asia: Chiang Mai Initiative*).

In the effort to promote free and open trade and investment in the Asia Pacific region, **APEC** continues to focus on trade and investment facilitation as well as finance cooperation. In line

REGIONAL COOPERATION IN EAST ASIA: CHIANG MAI INITIATIVE

Overview

The Chiang Mai Initiative (CMI) is a regional liquidity support facility through which the central banks of the 13 ASEAN+3 member countries agreed to make available lines of credit to each other in the event of a temporary balance of payments or liquidity crisis.[1] An offshoot of the 1997/98 Asian financial crisis, the CMI was launched in recognition of the need to collaborate more cohesively, both as a buffer against the recurrence of a similar crisis as well as to meet the challenges posed by globalisation and liberalisation. The prevailing circumstances at that time underscored the need for a quick-response, cooperative financing arrangement that could supplement the International Monetary Fund (IMF) facility.

Framework of the CMI

The CMI comprises the ASEAN Swap Arrangement and a network of Bilateral Swap Arrangements, as follows:

i. **ASEAN Swap Arrangement (ASA)** – launched in 1977 with a total facility of USD100 million, the ASA initially involved Indonesia, Malaysia, the Philippines, Thailand and Singapore. The ASA has since been expanded to include all ASEAN member countries, with a total sum of USD2 billion currently at members' disposal. A member country could request to swap its domestic currency for US dollar, yen or euro up to twice its committed amount and for up to six months. As a quick disbursement facility, drawdown from the ASA would be made within seven business days upon request to the designated Agent Bank managing the facility; and

ii. **Bilateral Swap Arrangements (BSAs)** – the size of the swap arrangement under each agreement signed between ASEAN+3 member countries is determined through bilateral negotiations. A quick disbursement of up to 20.0% of the maximum drawdown would be allowed when the swap-providing country determines that the swap-requesting country is facing a short-term liquidity problem. The balance will only be released once the swap-requesting country is on an IMF programme. To date, 16 BSAs totalling USD80 billion have been signed involving eight member countries.

Recognising the importance of macroeconomic and financial surveillance in the early detection of systemic risks within the region, the CMI also provides for timely data exchanges and regular reviews. The biannual Informal ASEAN+3 Finance and Central Bank Deputies Meeting continues to reinforce the exchange of information and encourage frank and candid discussions on regional issues. To further enhance the policy dialogue process, the following two groups were established:

i. **Group of Experts** – this Group comprises several regional professional experts. It serves as an independent assessment vehicle of economic and financial vulnerabilities, particularly in the areas of macroeconomic policy, fiscal policy, monetary policy as well as trade and international finance; and

ii. **Technical Working Group on Economic and Financial Monitoring** – this Group assists in developing an early warning system to detect emerging risks as well as strengthening member countries' surveillance capacities and capabilities.

Next Steps

To further strengthen the CMI, the ASEAN+3 member countries have agreed to work toward an advanced framework to multilateralise the CMI. A Task Force has been set up to study the possible options and, as an initial step, will focus on establishing a self-managed reserve pooling arrangement governed by a single contractual agreement.

In conclusion, the advancement of the CMI framework reflects the strengthening of ASEAN+3 cooperation. Supported by enhanced macroeconomic surveillance and data exchanges among member countries, the multilateralisation of the CMI is expected to fulfill its objective of further augmenting financial stability and resilience in the East Asian region.

[1] Encompasses the ten member countries of the Association of Southeast Asian Nations (ASEAN), as well as China, Japan and the Republic of Korea.

with this, the APEC Finance Ministers' process continues to emphasise fiscal sustainability as well as the development of finance and capital markets. Member economies also derive benefits from various capacity building programmes in these areas, organised by APEC-affiliated financial institutions, including international financial institutions.

The cooperation between Asia and Europe under **ASEM** aims at fostering a closer relationship and promoting greater understanding between the peoples of both continents in the spirit of mutual respect and equal partnership. The membership of ASEM, which originally comprised 25 European Union (EU) countries, the European Commission and ASEAN+3 countries, was further augmented with the admission of Bulgaria, Romania, India, Mongolia and Pakistan. Following the success of the ASEM Trust Funds I and II, the ASEM process, which includes biennial meetings of the Finance Ministers, will focus on the establishment of ASEM Trust Fund III to promote dialogues in economics and finance, employment and social policy, environment as well as cultural diversity.

Malaysia continues to engage with the Bretton Woods Institutions, namely, the IMF and World Bank. The **IMF** Executive Board concluded the 2006 Article IV consultation in February 2007 and welcomed the continued robust performance of the Malaysian economy. The Board was encouraged by the progress achieved in the reform of government-linked companies and welcomed further efforts in strengthening the financial sector. They also supported Malaysia's focus on upgrading human capital to meet the needs of higher value-added industries and reducing red tape to improve the investment climate.

Malaysia continues to work closely with the **World Bank** in non-lending programmes, in particular training and advisory services. Under these programmes, Malaysian officials and institutions have benefitted from various capacity building initiatives in areas such as taxation, investment, education, knowledge-based economy and productivity. Malaysia was the spokesperson for the Southeast Asia constituency in the International Monetary and Financial Committee in 2006 and represents the Group in the Development Committee for 2007. In this regard, Malaysia has an important role to play in the current debate on quota reform and other governance issues of both institutions to ensure greater voice and representation to better reflect today's world economy, including the many fast-growing emerging markets, especially in Asia.

Having graduated from the **ADB** borrowing programme in 2006, Malaysia's engagement is now largely focussed on technical assistance and regional cooperation programmes. Malaysia has also contributed a total of USD15 million since 1997 to the Asian Development Fund, which provides concessional loans for less developed member countries to undertake programmes to reduce poverty and improve the quality of life. Malaysia's future engagement will continue to focus on, among others, promoting regional integration in financial markets, enhancing public goods provision in the health sector and supporting sustainable environmental management.

Malaysia's involvement in the **IDB** includes actively promoting Islamic finance, trade and investment among member countries. In May 2007, Malaysia pledged USD20 million to the IDB's Poverty Alleviation Fund (PAF), which aims to reduce poverty through infrastructure, health and education projects. In recognition of its role in the IDB, Malaysia secured a directorship for the period of 2007-2010 in the International Islamic Trade Finance Corporation (ITFC). As an autonomous body of the IDB, the ITFC focuses on promoting trade among member countries through various trade financing products and capacity building programmes. Malaysia will enhance its involvement with the IDB, especially through the ITFC and PAF, as well as further cooperation in the coming years in areas such as trade, *zakat* management and Islamic financial market development. In the move to strengthen its presence in the region, the IDB is in the process of setting up a permanent regional office in Cyberjaya.

As an open economy, Malaysia remains committed and participates actively in the **WTO** rules-making process and trade liberalisation negotiations. In February 2007, Malaysia assumed the chairmanship of the General Council, the WTO's highest decision-making body. This is in recognition of Malaysia's active role and positive contributions to WTO negotiations, having chaired the Dispute Settlement Body in 2006 and the Negotiating Group on Trade Facilitation from 2004-2006.

Malaysia's chairmanship of the General Council is challenging now that the Doha Round, with a specific focus on development, has reached a critical stage. Having missed several deadlines and suspended since July 2006 due to the impasse over the necessary concessions, the resumption of negotiations in February 2007 raised hopes on the possibility of concluding the Round by end-2007. However, chances are now slim after the breakdown of trade talks among the four key players (G4), namely the US, EU, India and Brazil, in June 2007. While the immediate focus is to attain agreement on the three key issues – agricultural tariffs, agricultural subsidies and industrial tariffs – negotiations on other areas of the Doha Development Agenda such as services, safeguard mechanisms and intellectual property rights remain equally challenging.

Outlook 2008

Global economic prospects remain optimistic amidst a challenging environment...

Global growth in 2008, expected to be generally more broad-based both across regions and within countries, will continue to spur world trade and investment flows. Growth in world trade volume is projected at 7.4% in 2008 (2007: 7.1%), supported by steady demand-driven expansion in global high-technology industries, commodities and services. With regard to investment, global FDI is expected to remain strong, driven by rising M&A activities, sustained economic growth and an increase in fixed capital spending. Leading FDI recipients among the developed countries would be the US, Belgium, Luxembourg, France and the UK, while China, Hong Kong SAR, Singapore and India are expected to be the top four among newly-industrialised and emerging economies.

The positive outlook, however, could be affected by a fallout of the US subprime mortgage crisis, impacting on the real economy in the US and the global economy. The ensuing credit crunch prompted central bank intervention in early August to ease pressures on the global financial system, but the effectiveness of the measures has yet to be determined. Other near-term risks include the possibility of a disorderly unwinding of global imbalances, and global inflationary pressures arising from higher crude oil prices.

In the longer term, risks that could undermine growth encompass trends such as aging population and rising protectionist sentiments, as well as environmental consequences of rapid development. These issues will continue to be discussed at various regional and multilateral fora with a view to ensuring economic stability and sustainable development.

Notwithstanding these risks, the global economy is anticipated to continue expanding at 5.2% in 2008 (2007: 5.2%) with Japan, Europe and emerging Asia, in particular China and India, counterbalancing a possible moderation of the US economy. Malaysia is well positioned to take advantage of the growing external market as well as the increasing trade and investment opportunities, supported by continuous efforts to enhance national competitiveness and resilience.