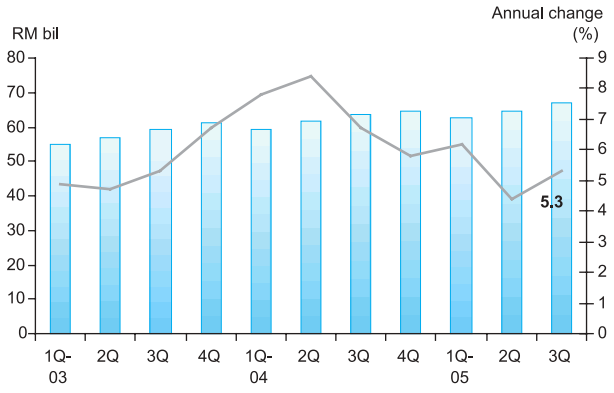
Economic and Financial Developments in the Malaysian Economy in the Third Quarter of 2005

OVERVIEW

Growth strengthened, underpinned by sustained private sector activity…

The Malaysian economy strengthened in the third quarter of 2005, expanding by 5.3%. Private sector activity continued to provide the main impetus to growth.

Stronger real GDP growth in 3Q 2005



Source: Department of Statistics, Malaysia

Domestic demand strengthened, expanding at an annual rate of 9.4%, due mainly to stronger private consumption and investment activities. Private consumption expenditure remained a significant source of growth, expanding by 10.4%. Stable labour market conditions, competitive credit environment and high commodity prices continued to support consumer spending. Major consumption indicators, particularly credit card spending and consumption credit extended, pointed to sustained consumer spending. The number of new passenger cars sold also remained high.

Gross fixed capital formation strengthened to increase by 9.6%. Private sector investments remained strong due to capacity expansion, upgrading, as well as new investments in downstream activities across most sectors of the economy. Growth in private capital spending was evident in the strong growth in imports of capital goods and expansion of lending to the business sector. While Government consumption expenditure increased, Government development expenditure was lower and continued to be focused on the provision of essential services.

Despite the higher petroleum-related expenditure, improved income tax collection by the Federal Government contributed to a lower fiscal deficit of RM805 million or 0.6% of GDP in the third quarter of 2005.

On the supply side, growth continued to be led by the services sector, which expanded by 7.3% during the quarter under review. The sector continued to benefit from strong consumer spending, including spending by tourists, as well as improved business activities. Value added in the manufacturing sector expanded by 3.4% in the third quarter of 2005. Output of the electronics and electrical products (E&E) industry picked up to 3.2%

(2Q 2005: 0.9%), attributable mainly to the strong external demand for computers and computer-related items, as well as the improvement in the global demand for semiconductors. Among domestic-oriented industries, the transport equipment and food products sub-sectors recorded double-digit growth rates, in line with the strong private consumption spending. Meanwhile, industries related to construction continued to contract in tandem with the weak performance of the construction sector.

The primary commodity sector also contributed positively to growth. Value added in the agriculture sector rose by 0.9% during the quarter. The mining sector recorded a growth of 3.4%, supported mainly by sustained increase in natural gas output. Production of crude oil (including condensates) registered a smaller decline of 2.4%. In the third quarter, 745,180 barrels per day were produced compared to 670,520 barrels per day in the previous quarter when several oil fields and plants were closed for maintenance. Meanwhile, the construction sector recorded a smaller decline of 1.4%.

Inflation edged up to 3.4% in the third quarter of 2005, reflecting increases in transport and communication prices, which were affected by the upward revision of retail petrol, diesel and cooking gas prices effective from 1 August 2005. Meanwhile, labour market conditions improved further as indicated by the significantly higher vacancies reported compared with the previous quarter. Sustained growth in labour productivity also supported the strength in the labour market.

On the external front, the trade balance recorded a large surplus of RM23.9 billion (2Q 2005: RM22.9 billion). Gross exports grew by 7.5% in the third quarter of 2005, led mainly by robust growth in exports of minerals (25.8%) and continued expansion in exports of manufactured goods (6.3%). Higher receipts from mineral exports reflected higher prices for crude oil and liquefied natural gas (LNG). LNG export volume also increased during the quarter. Strengthening growth in the E&E industry due to the strong demand for computers and computer-related items and recovery in sales of semiconductors, as well as continued expansion in exports of selected resource-based products, particularly rubber and petroleum products, contributed to the growth in the exports of manufactured goods. Meanwhile, higher agriculture export receipts from rubber, saw logs and sawn timber helped to partially offset the decline in export proceeds from palm oil, which was due entirely to lower prices during the quarter. While lower, export prices of palm oil remained high, averaging at RM1,435 per tonne in the third quarter.

In line with the growth in the exports of manufactured goods, and stronger consumer and investment spending, gross imports grew by 8.1%. Imports of intermediate goods, which were used as raw materials for manufactured goods, expanded at a stronger rate of 6.2%. Imports of capital goods (excluding lumpy items) also increased significantly by 17.4%, with the bulk of the imports being channelled into manufacturing, services, and oil and gas sectors for capacity expansion and upgrading activities.

Reflecting the sustained private consumption spending, imports of consumption goods rose further by 5.3%.

In the financial account, net foreign direct investment (FDI), after adjusting for short-term loan transactions by non-resident controlled companies, recorded an inflow of RM0.9 billion, channelled mainly into the oil and gas, services and manufacturing sectors. The FDI on cash basis does not include retained earnings and investment in the form of imported machinery and equipment. Meanwhile, overseas investment recorded a smaller net outflow of RM1.3 billion, while portfolio investment (equity and debt flows) recorded an outflow of RM0.2 billion.

The net international reserves of Bank Negara Malaysia amounted to RM302.7 billion (USD80.3 billion) as at 30 September 2005. The reserves level has taken into account the quarterly foreign exchange revaluation adjustment, following the strengthening of ringgit against the major currencies. As at 15 November 2005, the reserves amounted to RM285.2 billion (USD75.7 billion), sufficient to finance 8.4 months of retained imports and is 5.7 times the short-term external debt.

Monetary policy continued to support economic growth

The Overnight Policy Rate (OPR) was maintained at 2.70% during the third quarter of 2005. Meanwhile, the daily weighted average of the overnight interbank rate remained relatively stable, moving within a range of 2.66 - 2.73%, and averaging at 2.70% during the quarter.

Gross private sector financing through the banking system and the capital market increased at an annual rate of 7.3% in the third quarter of 2005, resulting from the resilient demand by both businesses and households. On a net basis, banking system loans and PDS outstanding increased at an annual rate of 9.2% at the end of the third quarter of 2005.

Bank lending activity was stronger in the third quarter of 2005, with total loans outstanding expanding at an annual rate of 9.2% at the end of the quarter. Most major loan indicators were higher across the board on an annual and preceding quarter basis. Bank lending to businesses strengthened during the quarter, with loans outstanding growing by 3.9% on an annual basis at the end of the third quarter of 2005. However, bank financing to the small and medium enterprises (SMEs) continued to outpace overall business lending, expanding at a faster annual growth rate of 9.8% at the end of the third quarter. Furthermore, the number of SME accounts which had their loans approved increased to 24,715 during the quarter. Bank lending to households remained resilient, with household loans outstanding growing by 14.9% on an annual basis at the end of the third quarter.

The growth of the monetary aggregates remained broadly in line with the expansion in economic activity. Narrow money, M1, increased at an annual rate of 9.9% at the end of the third quarter of 2005, while, broad money, M3, expanded at an annual rate of 10.9% at the end of the quarter. The main impetus behind the growth of M3 was the higher loans extended to the private sector by the banking system. Government

operations and net external operations were contractionary on M3.

The capital market mobilised RM10.9 billion on a net basis during the third quarter of 2005, due mainly to the higher amount of funds raised from the bond market. The higher amount of gross funds of RM9.7 billion raised in the private debt securities (PDS) market was supported by the prevailing low yields for medium- to long-term bonds. A substantial share of these funds (57.8% of total) were channeled towards financing new activity.

On 21 July 2005, the ringgit peg to the US dollar was replaced with a managed float system. The value of the ringgit is now monitored against a trade-weighted basket of currencies. Since the move to a managed float on 21 July 2005 up to the end of the third quarter of 2005, the ringgit had appreciated against most major and regional currencies. The initial ringgit appreciation against the US dollar following the policy adjustment was however moderated by market expectations of further US interest rate increases.

The banking system remained strong

The financial position of the banking system remained strong in the third quarter of 2005. The risk-weighted capital ratio (RWCR) was 13.3% as at end-September 2005. The banking system also recorded pre-tax profits of RM9.1 billion for the period up to 30 September 2005. This was due mainly to higher income from interest-related and fee-based activities, as well as trading and investment activities. The continued decline in non-performing loans (NPLs) contributed to the improvement in the quality of banking system's assets. Underpinned by higher recoveries and reclassification of NPLs to performing accounts, the net NPLs based on a 6-month classification declined by 2.1% to RM25.5 billion (3-month classification: RM32 billion; -6.9%). With the decline, the net NPL ratio based on 6-month classification improved further to 4.8% (3-month classification: 6.1%).

The near term outlook remains favourable

Prospects for the Malaysian economy in the remainder of the year remain favourable. The global economic expansion is expected to be sustained at a steady pace, despite the high oil prices. The growth momentum in the US has remained strong despite the effects of the hurricanes while the recovery in Japan is becoming more entrenched. Expansion in regional demand is expected to remain strong, supported by the continued improvement in the global electronics cycle and sustained strong growth in P.R. China. The favourable external environment is therefore expected to support the expansion in domestic demand.

Given these developments, the growth momentum in the Malaysian economy is expected to continue into the fourth quarter, supported by both strong external demand and sustained expansion in domestic demand, led by private sector activity. The electronics sector is expected to ride on the current recovery in the global semiconductor industry. Commodity prices are expected to continue to remain at high levels, which would have a positive impact on both exports and private

consumption. Indicators also suggest sustained expansion in private investment activities. The latest DOSM leading index increased, indicating that the economy would continue to expand into the first quarter of 2006.